ENFORCEMENT OF CORPORATE RIGHTS-THE RULE IN FOSS v HARBOTTLE: DEAD OR ALIVE

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Abstract

The principle on the enforcement of a corporation's right of action which is encapsulated as the rule in Foss v Harbottle has continued to attract discombobulating academic and judicial comments in defining the scope and exceptions to that rule. The recent statutory interventions which are witnessed in the UK and South Africa by redefining the right of the minority shareholders and other persons to intervene in the corporation's right of action are seen by some writers as having extinguished the flame ignited by the decision in Foss v Harbottle. A detailed examination of the real purport of Wigram VC's pronouncement in that case is undertaken, streamlining the rule and the subsequent decisions of courts carving out rooms for departure from the rule. The paper argues that the statutory interventions in jurisdictions under discussion only borders on derivative action which is an exception to the rule. The effect of those statutory provisions on the rule itself is not too significant as would justify the suggestion that the rule is now extinct. Thus, the paper concludes that the rule in Foss v Harbottle remains the principal approach to the enforcement of a corporation's right of action.

Keywords: Corporate Rights, Derivative Action, Enforcement Common Law, Statute

1. INTRODUCTION

Since that famous pronouncement made by Sir James Wigram VC about the middle of the nineteenth century in *Foss v Harbottle*[1] which accorded judicial recognition to the corporation's right of action in its own name, divergent views have continued to emerge from writers and the judiciary in their restatement of the scope and applications of that rule. This conundrum of views was succinctly captured by French, Mayson and Ryan as follows:

> The rule in *Foss v Harbottle* is the deepest mystery of company law but it is of great practical importance. A lawyer must be able to determine whether his or her client's claim will or will not be heard by the court. So if the client's claim concerns the affairs of a company of which the client is a member, the lawyer must determine whether the claim is an exception to the rule. Unfortunately there is disagreement over defining the rule itself, let alone its exceptions, and the topic has been, and will continue to be, the subject of a vast amount of academic and judicial comment.[2]

The parliament in the UK and South Africa seem to have joined the fray, more as arbiters than as combatants. The parliamentary intentions are felt mostly in that aspect of the rule which seeks to draw exceptions rather than modifications of the substantive rule as stated by Wigram VC. The aim seems to be to open a wider window for individuals interventions in corporate matters for the enhanced protection of corporate interests. The significance of those interventions on the common law concept of derivative action has witnessed the description by writers of the rule in *Foss v Harbottle* as having been consigned to the dustbin of history.[3] The undergoing analysis of judicial decisions and statutory provisions in the UK and South Africa, however, does not seem to lend credence to any suggestion that the rule has been abolished.

2. THE RULE IN FOSS V HARBOTTLE

The principles laid down in that case which have metamorphosed into an arm of the common law rules of corporate governance relating to the enforcement of corporate rights have been subjected to various interpretations and expatiations by academics and the judiciary. The proper appreciation of what those principles are can be gleaned from the facts and the pronouncement of Sir James Wigram VC upon those facts. The relevant part of the facts that informed the decision of the court are that some of the directors of the company had in their capacity as such, purchased their own land at an over-value for the use of the company. They were also alleged to have mortgaged the land and applied the money raised from the mortgage for payment to themselves of the price of the land. The plaintiffs alleged that the two remaining directors had refused to institute the suit, and

[1] [1843] 2 Hare 460.

[2] Derek French, Stephen Mayson & Christopher Ryan, *Mayson, French & Ryan on Company Law 31st ed* (Oxford: Oxford University Press, 2014) p. 547.

[3] Paul L Davies, Sarah Worthington, Eva Micheler, *Gower and Davies' Principles of Modern Company Law 9th ed* (London: Sweet & Maxwell 2012) p. 654 stated that the rule in *Foss v Harbottle* is consigned to the dustbin. In the South African statutory context, Cassim observed that the abolition of the common law derivative action happily relegates to the history books the 'notorious' rule in *Foss v Harbottle*. See FHI Cassim 'Shareholder Remedies and Minority Protection' in FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev and J Yeats (eds), *Contemporary Company Law2nd ed* (Cape Town: Juta & Co Ltd, 2012) p. 778.

showed, in fact, that it would be against their personal interest to do so, inasmuch as they were answerable in respect of the transactions in question; if the plaintiffs could not, therefore, institute the suit themselves they would have no redress. These set of facts were legally reconstructed by Wigram VC reflecting the nature of the alleged injury and the real victim of the wrongdoing as follows: "[t]he Victoria Park Company is an incorporated body, and the conduct with which the Defendants are charged in this suit is an injury not to the Plaintiffs exclusively; it is an injury to the whole corporation by individuals whom the corporation entrusted with powers to be exercised only for the good of the corporation."[4]

Upon this foundation was laid the first principle of the enforcement of corporate rights which is described by writers as the 'proper plaintiff principle/rule'.[5] This inference was drawn from that arm of the decision of Wigram VC where he held that "it was not, nor could it successfully be, argued that it was a matter of course for any individual members of a corporation thus to assume to themselves the right of suing in the name of the corporation. In law the corporation and the aggregate members of the corporation are not the same thing for purposes like this."[6]

The strength of this finding lies on the distinct legal personality of the company. The fact that a company is separate or distinct from the members has never been in doubt. This legal contraption which received unparalleled judicial impetus from the House of Lords in *Salomon v Salomon & Co Ltd*[7] has never waned in its acceptance even in modern company statutes. Section 19 of the South African Companies Act[8] (in like manner as its English counterpart[9]) declares *ex abundante cautela* that a company enjoys juristic personality from the date and time of its incorporation having all the legal powers and capacity of an individual as prescribed by the Act.

The underlying question in this arm of the judgment which recognizes the company as the proper plaintiff and at the same time as a juristic person borders on the rightful persons that could in law institute legal action for and in the name of the company. The artificial nature of the corporate entity invariably deprives the company of that unique character of self will which is inherent in natural persons. Wigram VC had obviously ruled out the individual members as competent persons to seek redress for the company as that would amount to a departure from the rule which, *prima facie,* would require that the corporation should sue in its own name and in its corporate character.[10] This is a rule of law and practice which is admittedly technical, but founded on the general principles of justice and convenience which could only be departed from upon compelling reasons of very urgent character.[11] Reading through the company's Act of Incorporation, the judge held that the directors as the governing body are the only ones vested with power to sue in the name of the company. The residuary power lies in the general meeting which could be exercised where the governing body is incapacitated, but no individual incorporators is empowered to sue in the manner proposed by the plaintiffs on the present record.[12]

The vesting of the company's management powers in the directors has consistently continued to receive judicial approval. This feature of corporate governance has been elevated to the status where any interference by the general meeting is deemed unacceptable by the courts.[13] In *Shaw & Sons (Salford) Ltd v Shaw*[14] Greer LJ was very specific on this issue where he stated that "if powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if the opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove."

The importance of shielding the board's management powers from shareholders control founds justification for the paradigm shift of that practice in South Africa from a mere matter of company's internal arrangement to a statutory affair.[15] Section 66(1) of the South African Companies Act, for instance, provides that "[t]he business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise." This provision is complemented by the standard set in section 76(4) (a) (iii) of the Act which provides that:

> (4) In respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of a company—
> *(a)* will have satisfied the obligations… if—
> (iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a *rational basis* for believing, and did believe, that the decision was in the best interests of the company.[16]

Both provisions do not only preclude unwarranted shareholders interference in management powers, but also enjoins respect for decisions honestly taken by the directors which they

[4] *Foss v Harbottle* above note 1 p. 202 para. 490.

[5] See French, Mayson & Ryan above note 2 p 546 where the authors stated that if a wrong is done to a company, as a person separate from its members, only the company may sue for redress. This is the significant principle stated by Wigram VC in *Foss v Harbottle* itself and is known as 'proper claimant' principle.

[6] Above note 4.

[7] (1897) AC 22 (HL). Lord Macnaghten's speech at page 51 reflects the court's position. He said: "The company is at law a different person altogether from the subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustees for them.' In *Dimbleby & Sons Ltd v National Union of Journalists* [1984] 1 WLR 427 at 435, Lord Diplock explained the essence of this judicial attitude as being "to enable business to be undertaken with limited financial liability [on the part of the members] in the event of the business proving to be a failure."

[8] Act 71 of 2008.

[9] S 16 of the UK Companies Act 2006.

[10] Above note 6 para 491.

[11] Ibid 203 para 492.

[12] Ibid 203 para 493.

[13] See *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* [1989] BCLC 100. *Automatic Self-Cleansing Filter Syndicate Ltd v Cunninghane* [1906] 2 Ch 34. *Scott v Scott* [1943] 1 All ER 582.

[14] [1935] 2 KB 113 CA at 134.

[15] It remains a matter of internal arrangement in the UK. See The Companies (Model Articles) Regulations 2008, SI 2008/3229, art 3.

[16] Emphasis added.

consider to be in the interests of the company. This statutory position is drawn from the judicial disinclination to interfering in management decisions. Lord Wilberforce buttressed this judicial stance in *Howard Smith v Ampol Petroleum Ltd*[17] where he held that there is no appeal on merits from management decisions to courts of law nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at. In *Burland v Earl*[18] Lord Davey was very explicit in his objection to any form of judicial interference in matters of internal management of the company and in fact emphasized that the court has no jurisdiction to do so.

The exclusion of shareholders from interfering in management decisions is a strong reason for the courts to exhibit some reluctance in doing so, as the simple question is; if the shareholders as a general meeting cannot interfere in management decisions, why should the courts? The courts cannot be more interested in the running of the affairs of the company than the shareholders themselves except perhaps when the interests of the creditors are involved.[19] Respecting management decisions ensures corporate functionality though the necessary checks and balances should not be rule out. This perhaps is what the parliament had in mind by demanding in that provision that the decision taken by the director should have a 'rational basis'. The requirement of 'rational basis' for decision making demands some level of objectivity in the assessment of the relevant decision to ascertain its sustainability in the context of the director's acclaimed state of mind. An illustration is found in the decision of Jonathan Parker J in *Regentcrest plc v Cohen*[20]

> The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company. The issue is as to the director's state of mind. No doubt, where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest.

The judicial reluctance if not refusal to interfere in matters of corporate management is identified as one of the reasons for the rule in *Foss v Harbottle*.[21] Although Wigram VC did not explicitly state as such, there are sufficient grounds in the judgment to justify such inference.

The second arm of the rule is described as the ratifiability principle or the majority rule.[22] Wigram VC had articulated this principle in his judgment where he said:

> The complaint is that those trustees have sold lands to themselves, ostensibly for the benefit of the *cestui que trusts.* The proposition I have advanced is that, although the Act should prove to be voidable, the *cestui que trusts* may elect to confirm it. Now, who are the *cestui que trusts* in this case? The corporation, in a sense, is undoubtedly the *cestui que trust;* but the majority of the proprietors at a special general meeting assembled, independently of any general rules of law upon the subject, by the very terms of the incorporation in the present case, has power to bind the whole body, and every individual corporator must be taken to have come into the corporation upon the terms of being liable to be so bound. How then can this Court act in a suit constituted as this is, if it is to be assumed, for the purposes of the argument, that the powers of the body of the proprietors are still in existence, and may lawfully be exercised for a purpose like that I have suggested? Whilst the Court may be declaring the acts complained of to be void at the suit of the present Plaintiffs, who in fact may be the only proprietors who disapprove of them, the governing body of proprietors may defeat the decree by lawfully resolving upon the confirmation of the very acts which are the subject of the suit.[23]

The principle was reaffirmed even more explicitly by the same Judge in *Bagshaw v Eastern Union Railway Co*[24] where he stated that if the act, though it be the act of the directors only, be one which a general meeting of the company could sanction, a bill by some of the shareholders, on behalf of themselves and others, to impeach that act cannot be sustained, because a general meeting of the company might immediately confirm and give validity to the act of which the bill complains. Successive court decisions have continued to expatiate and explain the practicalities of this principle.[25] But those decisions are mired in controversy in defining what is or is not ratifiable by the majority of the members.[26] Lord Davey had

[17] [1974] AC 821 at 832 (HL). See also *Richard Brandy Franks Ltd v Price* (1937) 58 CLB 136.

[18] [1902] AC 83 at 93 (PC). See also *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 per Scrutton LJ at 22–24. *Regentcrest v plc v Cohen* [2001] 2 BCLC 80 per Jonathan Parker J at 105.

[19] See *Hellard & Anor (Liquidators of HLC Environmental Projects Ltd) v Carvalho* [2013] EWHC 2876 (Ch) para 92. *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd, Eaton Bray Ltd v Palmer* [2002] EWHC 2748 (Ch), [2003] 2 BCLC 153 para 74. *Kalls Enterprises Pty Ltd v Baloglow* [2007] NSWCA 191, 25 ACLC 1094 para 162. *Roberts v Frohlich* [2011] EWHC 257 (Ch) para 85, *Bell Group Ltd v Westpac Banking Corporation* [2008] WASC 239 paras 4438–4439, *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722 at 730, *Brady v Brady* [1988] BCLC 20 (CA) at 40h–I, *GHLM Trading Ltd v Maroo & Ors* [2012] EWHC 61 (Ch) para 164.

[20] [2001] 2 BCLC 80 at 105. See also *Vivendi SA Centenary Holdings Iii Ltd v Richards & Ors* [2013] EWHC 3006 (Ch) para 147.

[21] See French, Mayson & Ryan above note 5 p. 548.

[22] Hannigan observed that at common law shareholder's remedies are dominated by the rule in *Foss v Harbottle* which has two elements: first, the proper plaintiff in respect of a wrong allegedly done to a company is *prima facie* the company; secondly, where the alleged wrong is a transaction which might be made binding on the company by a simple majority of the members, no individual member of the company is allowed to bring a claim in respect of it. Brenda Hannigan, *Company Law 3rd ed* (Oxford: Oxford University Press, 2012) p. 417. See also French, Mayson & Ryan above note 21 p 550.

[23] *Foss v Harbottle* above note 12 pp. 203–204 para. 494.

[24] (1849) 7 Hare 114 at 130.

[25] *Davidson v Tulloch* (1860) 3 Macq 783 at 792, *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066 per Jenkins LJ, *MacDougall v Gardiner* (1875) 1 ChD 13 at 25 per Mellish LJ, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1980] 2 All ER 841, per Vinelott J, *Smith Croft (No 2)* [1987] 3 All ER 909 per Knox J.

[26] See KW Wedderburn, 'Unreformed Company Law' (1969) 32 MLR 563. KW Wedderburn, 'Shareholders Rights and the rule in *Foss v Harbottle*' (1957) CLJ 194.

sought, early in the 20th century, in *Burland v Earle*[27] to clear the air on the ensuing controversy by suggesting that acts which are of fraudulent character or *ultra vires* are not ratifiable. Examples of such acts were given as where the majority are endeavoring directly or indirectly to appropriate to themselves money, property, or advantages which belong to the company, or which other shareholders are entitled to participate.

But the conducts which Wigram VC found to be ratifiable in *Foss* are not significantly different from some of the illustrations offered by Lord Davey. Indeed, cases of expropriation of company's opportunity have been found to be ratifiable as witnessed in *Regal (Hastings) Ltd v Gulliver*[28] where Lord Russell of Killowen had suggested, in the judgment of the House of Lords, that the directors could, had they wished, have protected themselves by a resolution (either antecedent or subsequent) of the shareholders in the general meeting. Not even the approach adopted by Vinelott J in *Prudential Assurance Co Ltd v Newman Industries Ltd and Others (No 2)*[29] where the judge held that fraud lies, not in the character of the act or transaction giving rise to the cause of action, but in the use of the voting power by the controlling shareholders/directors to ratify the transaction, could resolve the controversy. That decision draws a line between the majority and the minority shareholders and locates fraud in a ratification process which places the minority shareholders at a disadvantage. This is not, however, suggesting that fraud cannot also be found on the character of a transaction. The expropriation of corporate opportunities and self-dealing by the directors are good instances of fraud founded on the character of the transaction.[30] Although it is accepted that the shareholders could ratify frauds arising from the directors breach of duty in certain circumstances, there is still an underlying controversy relating to the nature of the transaction and in what circumstances a ratification would be allowed.[31]

These discombobulated judicial decisions on the issue of ratification demanded parliamentary intervention. When that intervention came, it was not geared at defining the conduct that is ratifiable or not, but rather the effect of such ratification or ratifiability of a particular conduct on the minority shareholders right of action. The provisions toeing this innovative path are found in sections 263 and 165 of the UK and South African Companies Acts respectively. The intrinsic impact of those provisions on the second arm of Wigram VC's decision seems to form the basis upon which the suggestion is made by some writers that the rule in *Foss v Harbottle* is now extinct.[32] Incidentally, those statutory provisions in both jurisdictions deal with the concept of derivative action. The veracity of those writers' opinions will as such be tested in that context.

3. DERIVATIVE ACTION

Derivative action is a common law device by which the shareholder is allowed to seek redress for and on behalf of the company for an injury done to the company. This meaning is now statutorily recognized in the UK and affirmed in recent judicial decisions.[33] The first description of a minority shareholder right of action for an injury to the company as derivative action was made by the United States Supreme Court.[34] The aim was to address the real owner of the right of action which is the company. The shareholder's right to sue is thus derived from the company.

Prior to the US court pronouncement on this concept, the English courts have dealt with this type of action more as a representative action by the shareholder on behalf of the company.[35] The circuitous nature of the proceedings then was described by Lord Denning MR in *Wallersteiner v Moir (No 2)*[36] as a cumbersome process demanding two stages of proceedings: first, in the name of the shareholders and, subsequently in the company's name after leave is obtained from the court. An innovative path adopted by Lord Hatherly LC in *Menier v Hooper's Telegraph*[37]which required only one action in the name of the minority shareholder against the wrongdoer and the company as a nominal defendant was approved by the Court of Appeal.[38]

An aspect of Lord Denning MR's decision that is relevant to this discourse lies in the justification for a derivative action which was set down as follows:

> If it is defrauded by a wrongdoer, the company itself is the one person to sue for the damage. Such is the rule in *Foss v Harbottle*. The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs - by directors who hold a majority of shares - who can then sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorise proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue them themselves. Yet the company is the one person who is damnified. In one way or another some

[27] [1902] AC 83 at 93.
[28] [1967] 2 AC 134n (HL).
[29] [1980] 2 All ER 841.
[30] See *Burland v Earle* [1902] AC 83 where Lord Davey referred to the transaction as being of fraudulent character.
[31] For more discussion on the various facets of this controversy, see Anthony O Nwafor & Gloria C Nwafor, 'Breach of Duty: Power of Shareholders to Ratify Directors Fraudulent Dealings' (2014) 10 (2) *Corporate Board: Role, Duties & Composition* 32.
[32] See Davies *et al* above note 3 p 654, Cassim above note 3 p 778.
[33] See s 260(1) of the UK Companies Act 2006. See *Abouraya v Sigmund* [2014] EWHC 277 (Ch) para 12, *Hughes v Weiss* [2012] EWHC 2363(Ch) para 27, *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) paras 68, 73.
[34] See *Hawes v City of Oakland* 104 U.S. 450 (1882) where the United States Supreme Court gave judicial expression to the concept known as derivative action. See also *Whitten v Dabney* 171 Cal 621 (1915), quoted in *Heckman v Ahmanson* 168 Cal App 3d 119, 214 Cal.Rptr. 177 (Ct. App. 1985), at 183–184.
[35] Which was why it was originally referred to as minority shareholder's action. See *East Pant Du United Lead Mining Co. Ltd. v Merryweather* (1864) 2 Hem. & M. 254.
[36] [1975] 2 WLR 389 at 395–396 (CA)
[37] (1874) 9 Ch App. 350.
[38] The two stage proceedings is retained in both UK and South Africa but in the manner recommended by Lord Hatherley LC in *Menier's case*. See *Bamford v Harvey* [2012] EWHC 2858 (Ch) para 2, *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) para 2. See also See also *Francis George Hill Family Trust v South African Reserve Bank and Others* [1992] ZASCA 50; 1992 (3) SA 91 (AD), *TWK Agriculture Ltd v NCT Forestry Co-operative Lt and Others* 2006 (6) SA 20 (N), *Kalinko v Nisbet and Others* 2002 (5) SA 766 (W).

> means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.[39]

The passage explicitly demonstrates what the rule in *Foss v Harbottle* entails, i.e., that the company itself is the only person to sue for the damage done to it. The right of the minority shareholder to sue which could only be triggered when the company's right of action is incapacitated due to the involvement in wrongdoing by the relevant organ that would have instituted action for the company is not an intrinsic part of that rule. Indeed, in *Foss*, Wigram VC had described the shareholders action as a '*departure*' from the rule[40] and an '*anomalous form of suit*' which he could not see any reason why it should be resorted to when the powers of the corporation could be called into exercise.[41] A further confirmation that the minority shareholders' right of action was not the concern of the court is buttressed by the finding by Wigram VC that "during the years 1840, 1841 and 1842 there was a governing body, that by such body the business of the company was carried on, that there was no insurmountable impediment to the exercise of the powers of the proprietors assembled in general meetings to control the affairs of the company, and that such general meetings were actually held."[42] Thus, as the relevant organs of the company that could seek redress in the name of the company were all active, there was no basis for the consideration of the minority shareholders right of action on behalf of the company. This position of the law was recently given credence by Lewison J in *Iesini & Ors v Westrip Holdings Ltd & Ors*[43] where the Judge held that whether a company should bring proceedings to redress a wrong was a matter that was to be decided by the company internally; that is to say by its board of directors, or by a majority of its shareholders if dissatisfied by the board's decision and that the court would not second guess a decision made by the company in accordance with its own constitution.

Subsequent court decisions have, as such, consistently referred to the minority shareholders right of action as encapsulated by the concept of derivative action as an exception to the rule in *Foss v Harbottle.* In *Burland v Earle*[44] Lord Davey had recognised that the cardinal principle is that company should sue for an injury done to it as laid down in *Foss v Harbottle,* but that an exception is made where the persons against whom the relief is sought are themselves in control of the majority of the shares in the company, and will not permit action to be brought in the name of the company. In *Prudential Assurance Co Ltd v Newman Industries Ltd and others (No. 2)*[45] the UK Court of Appeal stated that "[a] derivative action is an exception to the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested. This is sometimes referred to as the 'Rule in *Foss v Harbottle*'" Similarly, in *Cinematic Finance Ltd v Ryder*[46] Roth J observed that the general rule is that a cause of action vesting in a company should be pursued by the company and not by its shareholders. A similar approach was adopted by the South African court in *Hillcrest Village (Pty) Ltd and Another v Nedbank Limited and Others*[47] where Mavundla J held that save for certain exceptions, in general, when a wrong is alleged to have been done to a company the proper plaintiff to sue the wrongdoer is the company itself.

A derivative action is conceived as an exception to the rule in *Foss* to deal with the particular circumstances when the company cannot or will not bring an action against the alleged wrongdoer. In *Edwards v Halliwell*[48] Jenkins LJ observed that the rule in *Foss* is not an inflexible rule and will be relaxed where necessary in the interest of justice. Wigram VC did not, however, relax the rule in *Foss.* Although there are statements in the judgment suggesting positive disposition of the judge in that regard,[49] the facts as pleaded did not give room for a consideration of that possibility.

The rule itself is a substantive rule bordering on the powers of the company to conduct its own affairs as a juristic entity. The exception referred to as derivative action is described by the court as a 'mere matter of procedure designed to afford remedy to the company for wrong which would otherwise escape redress'.[50] It simply lays down when and how the minority shareholder may seek redress for wrong done to the company. Such power is secondary in nature and cannot extinguish the primary and substantive rule on which its existence is predicated.

This submission, however, does not put an end to the ensuing controversy over that rule. The second arm of the rule that denies the minority shareholder a right of action where the wrong is ratifiable by a majority of the shareholders seems to have fallen severely under the weight of the statutory innovation. Section 263(2)(c) which is contained in Part 11 of the UK Companies Act that deals generally with the concept of derivative action directs the courts to decline permission to commence a derivative action if the court is satisfied that:

> (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission—
> (i) was authorised by the company before it occurred, or
> (ii) has been ratified by the company since it occurred.

[39] *Wallersteiner v Moir (No 2)* (1975) 1 All ER 849 (CA) at 857 D – F. See also *Francis George Hill Family Trust v South African Reserve Bank and Others* [1992] ZASCA 50; 1992 (3) SA 91 (AD) where Denning MR's decision was considered and applied by the South African Court of Appeal.

[40] *Foss'case* above note 23 para 491.

[41] Ibid para 504.

[42] Ibid paras 502–503.

[43] [2009] EWHC 2526 (Ch) para 73.

[44] [1902] AC 83 at 93.

[45] [1982] Ch. 204 at 210. See *also Abouraya v Sigmund & Ors* [2014] EWHC 277 (Ch) para 26.

[46] [2010] EWHC 3387 (Ch) para 9.

[47] [2008] ZAGPHC 134 para 5.2.

[48] [1950] 2 All ER 1064 at 1067.

[49] For instance, at page 204 para 494, the judge stated that "[i]n order then that this suit may be sustained it must be shown either that there is no such power as I have supposed remaining in the proprietors, or, at least, that all means have been resorted to and found ineffectual to set that body in motion: this latter point is nowhere suggested in the bill."

[50] *Burland v Earle* [1902] AC 83 at 93 per Lord Davey.

Factors which the court should consider in deciding whether or not to grant permission to commence an action are also set down in section 263(3) and include:

> (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—
> (i) authorised by the company before it occurs, or
> (ii) ratified by the company after it occurs.

A distinctive feature of subsection 2(c) is that actual ratification forecloses the right of action. But that provision does not foreclose the power of the court to examine the validity of the ratification process. That position was adopted by Hodge QC sitting as a Judge of the High Court in *Singh v Singh*[51] where the judge declined to grant permission on the ground that the conduct on the part of the first defendant of which the complaint is made has been 'effectively' ratified by the company. The emphasis is on 'effective' ratification and not just mere ratification. A ratification to be effective must satisfy the threshold laid down in section 239 of the Act relating to disqualification from voting by interested wrongdoer and connected persons. The judicial power to scrutinise the ratification process is strengthened by section 239(7) which provides that section 239 does not affect any other enactment or rule of law imposing additional requirements for valid ratification or any rule of law as to acts that are incapable of being ratified by the company. Although the position at common law, remains uncertain as to what is or is not ratifiable, and it has in fact been held by the court that there is no limit to the power of the majority to ratify an act or transaction,[52] what is certain is that the circumstances or process of ratification can be inquired into by the court. This legal position is buttressed by the decision of Knox J in *Smith v Croft (No 2)*[53] to the effect that the ultimate,

> question has to be…: is the plaintiff being prevented improperly from bringing these proceedings on behalf of the company? If it is an expression of… an appropriate independent organ that is preventing the plaintiff from prosecuting the action he is not improperly but properly prevented and so the answer to the question is No. The appropriate independent organ will vary according to the constitution of the company concerned and the identity of the defendants, who will in most cases he disqualified from participating by voting in expressing the corporate will.

The provision set down in section 263(2)(c) differs from Wigram VC's position in *Foss* in that the provision emphasises actual ratification as against mere prospect of the conduct being ratified which was the concern of the court in *Foss*. The prospect of ratification does not bar derivative proceedings under the Act but an actual and effective ratification certainly does.[54]

The South African Companies Act of 2008 embodies extensive provisions on derivative action in section 165. Apart from subsections 1 and 2 of that section (which clumsily runs up to subsection 16) all other provisions in that section are matters of procedure. While subsection 1 provides statutory route to a derivative action, subsection 2 redefines the scope of persons that may institute derivative proceedings to protect the interests of the company.[55] The provision of subsection 1 of section 165 deserves some attention as it forms the basis upon which the suggestion is made that the rule in *Foss v Harbottle* is now abolished in South African. That provision is as follows:

> Any right at common law of a person *other than a company* to bring or prosecute any legal proceedings on behalf of that company is abolished, and the rights in this section are in substitution for any such abolished right.[56]

The provision does not harbour any ambiguity on what is abolished. It is the right at common law of any person to bring or prosecute legal proceedings on behalf of the company. That is actually what the common law concept of derivative action stands for. It is only by that concept that an individual is allowed to vindicate a company's right of action. The right of the company at common law to seek redress for wrong done to the company is not affected and is indeed explicitly preserved in that provision by the exemption phrase 'other than the company' as contained in the provision. The recognition and preservation of the corporation's right of action is exactly what the rule in *Foss v Harbottle*, a common rule, entails. The explicit nature of this provision makes inescapable the questioning of the basis for the suggestion that the rule in *Foss* is now abolished in South Africa.

On issue of procedure, although the Act now provides an alternative route for a derivative action, this does not suggest that those standards set at common law for granting of leave to the applicant to prosecute this type of action are also abolished. In fact some of those conditions set down by the Act as prerequisites for bringing of a derivative action remain either explicitly or implicitly the same as under the common law. This is buttressed by the provision of section 165(5) which requires that the court may grant leave only if satisfied, among other conditions, that the applicant is acting in good faith, and that the action is in the interests of the company.[57] In *Mouritzen v Greystone Enterprises (Pty) Ltd & Another*[58] where this provision was considered, Ndlovu J observed that in most, but not all, instances both requirements would overlap. An instance where a person does not act in good faith but is driven by an ulterior motive, such as personal vendetta, will generally not be in the best interests of the company. If a broad view of these concepts is taken by the court,

[51] [2013] EWHC 2138 (Ch) para 39.

[52] See *Prudential Assurance Co Ltd v Newman Ind Ltd (No 2)* [1981] Ch 257 at 307 per Vinellot J who held that there is no obvious limit to the power of the majority to authorise or ratify an act or transaction whatever its character provided that the majority does not have an interest which conflicts with the interests of the company.

[53] [1987] 3 All ER 909 at 955–956. See also *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) paras 127.

[54] See *Hughes v Weiss* [2012] EWHC 2363(Ch) para 42, *Bamford v Harvey* [2012] EWHC 2858 (Ch) para 5.

[55] See s 165(2)(a–d) which confers right of action on the shareholder or beneficial owner of shares, director or prescribed officer of the company, registered trade union and another person granted leave by the court.

[56] Emphasis added.

[57] See s 165(5)(b)(i)(iii). Note that both requirements are also prescribed at common law.

[58] 2012 (5) SA 74 (KZD) para 62.

it cannot realistically arrive at a fair decision by shutting its eyes to the position of the wrongdoer either within or outside the company when brought to the attention of the court. That of course is a common law position on this type of action.[59] An illustration is found in the Australian case of *Swansson v Pratt*[60] where Palmer J observed that an action sought to be instituted by a former shareholder with a history of grievances against the current majority of shareholders or the current board may be easier to characterize as brought for the purpose of satisfying nothing more than the applicant's private vendetta. An applicant with such a purpose would not be acting in good faith even when the alleged wrongdoers are seemingly in control of the company. In *Mouritzen's case*[61] Ndlovu J expressed the view that factual proof of any pre-existing personal animosity between the parties, as in that case, does not *per se* serve as conclusive proof that any person referred to in section 165(2) of the Act is not acting in good faith in serving a demand under that subsection, or instituting an application under section 165(5). However, personal animosity between the opposed parties is an important factor which the Court will always take into account *together with other relevant evidentiary material* presented before the Court in a given situation, in determining whether or not an applicant has, on a balance of probabilities, satisfied the 'good faith' requirement. The reference to 'other evidential material' is an indication that the factors which could be considered by the court as provided in section 165(5) of the Act are not exclusive and would as such include the relationship or position of the wrongdoer in the company.

There are no mandatory grounds for declining leave as is the case under the English law, but one of the factors which should inform the decision of the court and is of primary importance to this discourse is found in section 165(14) of the Act which provides as follows:

> (14) If the shareholders of a company have ratified or approved any particular conduct of the company-
> (a) the ratification or approval-
> (i) does not prevent a person from making a demand, applying for leave, or bringing or intervening in proceedings with leave under this section; and
> (ii) does not prejudice the outcome of any application for leave, or proceedings brought or intervened in with leave under this section; or
> (b) the court may take that ratification or approval into account in making any judgment or order.[62]

This provision is particularly of significance in redefining the second arm of the rule in *Foss v Harbottle*. It embodies a paradigm shift from that arm of the rule which recognises a mere possibility of ratification as sufficient to prevent a derivative action. It also differs from the UK Companies Act provision in that it does not recognise actual and effective ratification as a bar to a derivative action. But the provision should not be taking as implying that ratification of wrong done to the company by shareholders does not have any real impact on derivative action under South African law. Section 75 of the Act provides for the ratification of directors wrongful acts. Subsection 7 of that section provides that:

> A decision by the board, or a transaction or agreement approved by the board, or by a company…, is valid despite any personal financial interest of a director or person related to the director, only if -
> (a) it was approved following disclosure of that interest in the manner contemplated in this section; or
> (b) despite having been approved without disclosure of that interest, it -
> (i) has subsequently been ratified by an ordinary resolution of the shareholders following disclosure of that interest.

This provision implies that ratification is valid if effectively obtained as prescribed by law. Thus, the requirement of section 165(14)(b) that the court may take the ratification into account in arriving at its decision should be read as an obligation on the court to examine the effectiveness or validity of the ratification as provided in section 75 of the Act. It is important that such consideration should be undertaken by the court at the early stages of the proceedings when leave is sought as it is done under the English law[63] to prevent a long drawn litigation on a wrong which has become extinct following an effective ratification process. Thus, the major difference between the statutory position in South Africa as under the English law and the rule in *Foss* remains that the former emphasises effective ratification and not just a mere prospect of ratification as in the latter as a vitiating factor for an individual's right of action to vindicate a wrong done to the company.

4. CONCLUSION

The fact that in both jurisdictions there are presently elaborate statutory provisions on derivative action are simply not sustainable as ground for any suggestion that the rule in *Foss v Harbottle* is now extinct. Dignam and Lowry had observed in relation to the UK Companies Act provisions that:

> If we compare the language of ss 261-264 with the common law rule it replaces, it is apparent that there is little or no change of emphasis in terms of formulation. The focus of the rule laid down in *Foss v Harbottle* and its jurisprudence was on prohibiting claims unless one of the exceptions to the rule was satisfied. The statutory language similarly proceeds from the rather negative standpoint that the court *must*

[59] See *Bamford v Harvey* [2012] EWHC 2858 (Ch) para 29 where Roth J accepted that even as 'wrongdoer control' was not an explicit condition in section 263(2) of the UK Companies Act, it remains a factor to be taken into consideration as section 263(3) of the Act is not exclusive. See also *Stimpson v Southern Private Landlords Association* [2009] EWHC 2072 (Ch) para 46 per Judge Pelling QC sitting as a Judge of the High Court.

[60] [2002] NSWSC 583 para 41 per Palmer J, referred to by Ndlovu J in *Mouritzen's case* above note 58 para 59.

[61] Ibid.

[62] As amended by s 104 of Companies Amendment Act 3 of 2011.

[63] See *Singh v Singh* [2013] EWHC 2138 (Ch) para 39 where Hodge QC (sitting as a Judge of the High Court) in dismissing application for leave to commence a derivative action held that "this is a clear case where permission to bring a derivative claim should be refused…, the principal reason for that is that the conduct on the part of the first defendant of which complaint is made is conduct that was either authorised by the company before it occurred, or has effectively been ratified by the company since then."

> *dismiss* the application or claim in the circumstances specified in [the Act].[64]

In *Cinematic Finance Ltd v Ryder & Ords*[65] Roth J affirmed the subsistence of the rule in *Foss* inspite of the statutory provisions where he said:

> I accept that proceedings for a derivative claim are now comprehensively governed by the Act. But in my judgment the Act is not seeking to change the basic rule that a claim that lies in a company can be pursued only by the company or to disturb the fundamental distinction between a company and its shareholders. There is nothing to suggest that the Act intended such a radical reversal of long-standing and fundamental principles.

The position adopted by the Judge finds credence, as stated by Roth J, in the Report of the Law Commission on Shareholder Remedies which states *inter alia*: "(i) *Proper plaintiff* Normally the company should be the only party entitled to enforce a cause of action belonging to it. Accordingly, a member should be able to maintain proceedings about wrongs done to the company only in exceptional circumstances."[66] Thus, in *Bamford v Harvey*[67] Roth J declined to grant permission to commence a derivative action where the company is in a position to initiate proceedings in its own name. Similarly, in *Stimpson v Southern Private Landlords Association*[68] Judge Pelling QC (sitting as a Judge of the High Court) adopted a stance which is reminiscent of Wigram VC's position in *Foss* by declining to grant permission where the claimant is found to be in a position to "requisition an EGM, obtain if he can a replacement Board and that Board can if it judges it appropriate to do so, applying the duties imposed upon them by Sections 172, authorise the litigation."

The major achievement of the statutory provisions in both jurisdictions is that the law now prescribes more flexible criteria than the 'wrongdoer control' and 'fraud on minority' exceptions to the rule in *Foss v Harbottle*,[69] thus making the concept of derivative action more easily accessible by the shareholders and other persons who are given the right of action under the statute. Thus, a decision such as that handed down by Mavundla J in *Hillcrest Village (Pty) Ltd and Another v Nedbank Limited and Others*[70] where the Judge declined to allow a derivative action on the ground that none of the defendants were either directors or shareholders nor that any majority of such directors or shareholders as constituted were among the defendants, but on the contrary the defendants were all outsiders, i.e. persons not being directors and or shareholders of the company, may no long stand as good law in South Africa. But the fact that the company is the proper plaintiff to vindicate any wrong done to it as a juristic person, a position which was indisputably articulated by Wigram VC in *Foss*, remains as potent under the existing statutory arrangements in both the UK and South Africa, as it was at common law.

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[65] [2010] EWHC 3387 (Ch) para 11.

[66] Ibid, paras 11–12. See Law Commission Report No 246 (1997) para 1.9. See also *Bamford v Harvey* [2012] EWHC 2858 (Ch) para 25 where this position was reaffirmed by Roth J.

[67] [2012] EWHC 2858 (Ch).

[68] [2009] EWHC 2072 (Ch) para 26.

[69] See *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65, [2009] BCC 161 para 38 per Reed LJ.

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