INTRODUCTION

A derivative action is a court action initiated by a person (e.g. a shareholder or director) on behalf of a company in order to protect such company’s legal interests. It is referred to as a derivative action because a person who initiates it derives the right of action in law from the company whose legal interests is sought to be protected. It is generally utilised where a person who commits wrongdoings against a company controls decision making within that company and uses his or her control (alone or with others) to prevent the said company from instituting legal proceedings against that miscreant person.

Globally, the concept of derivative action is inextricably linked with the case of Foss v Harbottle¹ (“Foss v Harbottle Case”). That case invented what became the ‘rule in Foss v Harbottle’ or the ‘proper plaintiff rule’. In terms of the rule in Foss v Harbottle, only the company may institute legal proceedings in relation to wrongdoings committed against it. The rule however acknowledged that if a company failed to institute legal action against a wrongdoer, a shareholder could in certain circumstances² institute action on behalf of that company. However, a shareholder was precluded from instituting the said action if an alleged wrong could be ratified by the majority of the shareholders.

The wisdom of the rule in Foss v Harbottle was later questioned. It was argued that it stifled the effectiveness of derivative actions. In order to circumvent the deficiencies of the common law derivative actions, the legislature promulgated s 266 of the Old Companies Act, 61 of 1973 (“Old Act”). International trends later changed and favoured the abolition of the common law derivative action in order to avoid confusions in the concurrent application of both the common law and statutory derivative actions. These international trends heavily influenced South Africa’s adoption of s 165 in the Companies Act, No. 71 of 2008 (“New Act”). Section 165 specifically abolishes the common law derivative action as set out in Foss v Harbottle and sets out a new statutory derivative action.

In Mouritzen v Greystone Enterprises and Another³ (“Mouritzen Case”), Ndlouv J handed down the first judgment in South Africa in relation to the new statutory derivative action. This note analyses the Mouritzen Case and highlights key aspects which are useful in understanding the process of initiating derivative actions under the New Act.

The facts of the Mouritzen Case were as follows: K Mouritzen and D Mouritzen are brothers and the only directors of Greystone Enterprises (Pty) Ltd (“Company”). The Mouritzen Family Trust (the beneficiaries of which are the families of both K and D Mouritzen) holds 98 shares in the capital of the Company and D Mouritzen and his wife hold 49 shares each. K and D Mouritzen were paid equal monthly salaries by the Company and were issued with credit

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Section 165 of the New Act

In summary, s 165 provides that –
• any right at common law of a person other than a company to bring a derivative action is abolished and substituted by s 165 (165(1));
• a person may serve a demand upon a company to commence a derivative action if that person is a shareholder or director of that company or is a trade union representing employees of that company (s 165(2));
• a company that has been served with a demand in terms of s 165(2) may apply within 15 business days to a court to set aside the demand only on the grounds that it is frivolous, vexatious or without merit (s 165(3));
• if a company does not make an application contemplated in s 165(3), that company must within 60 business days after being served with the demand, either initiate or continue legal proceedings, or take related legal steps to protect the legal interests of the company, as contemplated in the demand or serve a notice on the person who made the demand, refusing to comply with the demand (s 165(4)); and
• a person who has made a demand in terms of s 165(2) may apply to a court for leave to bring or continue proceedings in the name and on behalf of the company, and the court may grant leave only if the court is satisfied that the applicant is acting in good faith, the proposed or continuing proceedings involve the trial of a serious question of material consequence to the company; and it is in the best interests of the company that the applicant be granted leave to commence the proposed proceedings or continue the proceedings, as the case may be (s 165(5)(b)).

Section 165(2) Demand – Directory or Peremptory?

Ndlovu J observed that the use of the word “may” in relation to the service of a s 165(2) demand may obscure the legislative intent that the service of a s 165(2) demand is a prerequisite for the institution of a s 165(5) derivative action. He said:

“...I observe that the service of the demand on the company is an essential prerequisite for the institution of an application under section 165(5) and without which such person is obviously barred from launching the application. Given this observation, it is imperative and compulsory that a prospective applicant must comply with the service requirement before proceeding in terms of section 165(5). On this basis, the section ought, in my view, to be understood in the context that an applicant ‘must’ serve the demand on the company. It is a peremptory provision.”

It is submitted that s 165(2) of the New Act must always be read with s 165(6). Section 165(6) provides that a person contemplated in s 165(2) of the New Act (i.e. a shareholder, director, prescribed officer etc.) may, in exceptional circumstances, apply to court for leave to bring a derivative action without serving a s 165(2) demand.

The issue of whether or not a s 165(2) demand is directory or peremptory was also raised in academic cycles prior to the New Act becoming operational. Ndlovu J was not specifically called upon to decide on the directory or peremptory nature of the serving of the s 165(2) demand; however, his clarification of this important procedural aspect of s 165 should be welcomed.
**SERVICE OF THE S 165(2) DEMAND**

As indicated above, D Mouritzen argued that the s 165(2) demand sent by his brother was not properly served because it was not delivered at the Company’s registered address or principal place of business. Ndlovu J noted that there was nothing in s 165(2) of the New Act which suggests that a s 165(2) demand must be served by delivering it to the registered office of a company and said:

“…I find that the purposive interpretation of section 165(2) does not require that a demand referred to in that section must necessarily be served on a company by delivering it at its registered office or its principal place of business. In my view, any legally recognizable manner of service of any court process or document initiating application proceedings shall be adequate, provided that the court considering the matter, in the exercise of its discretion, is satisfied that the demand was duly served on the company for which it was intended.”

Although the Mouritzen Case clarifies the issue of service, it is submitted that it will be prudent for persons initiating derivative actions to ensure that there is adequate proof of delivery of a s 165(2) demand to the company in issue to ensure that service is beyond reproach.

**REFUSAL TO COMPLY WITH THE S 165(2) DEMAND**

Ndlovu J noted the email response by D Mouritzen to the s 165(2) demand (where he disputed the allegations made by K Mouritzen in relation to the abuse of his credit card), said that such response was in D Mouritzen’s capacity as a director of the Company and decided that such response constituted a refusal to comply with the s 165(2) demand as contemplated in s 165(4)(b)(ii) of the New Act.

**WAS K MOURITZEN ACTING IN GOOD FAITH IN BRINGING THE DERIVATIVE ACTION?**

In this aspect of his judgment, Ndlovu J compared s 165 of the New Act with similar legislation in New Zealand, Canada and Australia and referred to decided cases on statutory derivative actions in Australia. In this regard, Ndlovu J borrowed from Australia the following factors which South African courts must consider when determining whether or not the ‘good faith’ requirement set out in s 165 has been fulfilled:

- whether or not the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success; and
- whether or not the applicant is seeking to bring the derivative suite for such collateral purpose as would amount to the abuse of court process.

Ndlovu J decided that although a court should take into account personal animosity between the parties when considering whether or not the applicant has satisfied the ‘good faith’ test, personal animosity on its own does not constitute proof that a person who initiates a derivative action is acting in bad faith.

One of the reasons for the overhaul of company law in South Africa was to harmonize the South African company legislation with best practices internationally. Therefore, our courts will, where appropriate, use foreign law in order to develop the South African company law jurisprudence under the New Act as Ndlovu J did in the Mouritzen Case.

**IS THE DERIVATIVE ACTION IN THE BEST INTERESTS OF THE COMPANY?**

Ndlovu J referred to the Australian case of Swansson v Pratt where, in the context of a provision similar to s 165(5)(b)(ii) of the New Act, it was decided that s 237(2)(c) of the Australian Corporations Act require the court “…to be satisfied, not that the proposed derivative action may be, appears to be, or is likely to be, in the best interest of the company, but, that it is in the best interests.” In concluding that the derivative action was in the best interests of the Company, Ndlovu J said:

“The applicant is a trustee of the Mouritzen Family Trust which has the majority shareholding in the company. Any financial maladministration and mismanagement of a company will naturally adversely affect the financial condition of that company. Therefore, as a representative of the majority shareholder, the applicant is entitled to call for a proper investigation of any suspected irregularities and abuse of the company’s assets. The Mouritzen Family Trust has a direct and substantial interest in the success and prosperity of the company in that if the allegations against the second respondent are proven, that would have a direct negative impact on the value of the Mouritzen Family Trust’s shareholding in the company.”
The judgment in the Muritzen Case is an important first judicial step towards removing the dark shadow of the common law derivative action from the South African jurisprudence. The ability of shareholders, directors, prescribed officers, and trade unions to successfully bring derivative action in terms of s 165 with ease is likely to encourage good corporate governance practices and serve as a deterrent against malfeasance by people who control companies.

One of the criticisms of derivative actions is that persons considering instituting derivative actions may be discouraged by prohibitive legal costs. In the Muritzen Case, Ndlovu J left the issue of costs for determination by the court hearing the actual derivative action. It is hoped that that court will use its discretion in terms of s 165(10) cautiously to ensure that it does not give credence to views that have been expressed in Australia13 that courts are reluctant to allow derivative action applicants access to company funds to cover litigation costs even when the company is in a financial position to cover those costs.

1 [1843] EngR 478.
2 These circumstances included instances where a wrongful act done against the company was unratifiable (e.g. fraud on the minority) and the wrongdoers controlled the company.
3 [Case No. 10442/2011], (as yet unreported), handed down 8 June 2012 in the KwaZulu Natal High Court, Durban.
4 Muritzen Case, at Para [24].
6 Ndlovu J said that if the legislature intended delivery to the registered address to be a requirement of service, it would have expressly done so as it did in s 345(1)(a)(i) of the Old Act.
7 Muritzen Case, at Para [33], Emphasis added.
8 Swansson v Pratt [2002] NSWSC 583.
9 Muritzen Case, at Para [58].
10 Muritzen Case, at Para [59]. This conclusion is supported in Swansson v Pratt (note 8 above), at Para [41].
11 Hopefully judges will always keep in mind the following warning by Schutz J: “…ransacking the libraries of the world may, where not appropriate, lead to not more than more paper, more cost, more delay and even more confusion, without any commensurate benefit.” Standard Bank Corporation v The Competition Commission & Others 200(2) SA 798 (SCA), Para [30].
12 Muritzen Case, at Para [64].