THE LAUNCHING OF DELINQUENCY PROCEEDINGS UNDER THE COMPANIES ACT 71 OF 2008 BY MEANS OF THE DERIVATIVE ACTION

Lewis Group Limited v Woollam
2017 (2) SA 547 (WCC)

1 Introduction

Section 162 of the Companies Act 71 of 2008 (hereinafter "the Companies Act") introduces a novel provision into our law in that it empowers a broad range of persons to apply to the court to declare a director delinquent in certain circumstances. The effect of a declaration of a person as delinquent is that he is disqualified, for the duration of the order, from being a director of a company (s 69(8)(a) of the Companies Act).

In *Lewis Group Limited v Woollam* (2017 (2) SA 547 (WCC)) (hereinafter "*Lewis Group v Woollam*") the Western Cape High Court was faced with an application brought by Lewis Group Limited in terms of section 165(3) of the Companies Act for an order setting aside a demand served on it by a shareholder, Mr David Woollam (hereinafter "Woollam") on the ground that it was frivolous, vexatious or without merit. Woollam wished to rely on the derivative action to require Lewis Group Limited to commence proceedings to declare four of its directors delinquent under section 162 of the Companies Act. The main question before the court was whether, under the Companies Act, a shareholder might institute proceedings to declare a director delinquent under section 162 of the Companies Act using the derivative action. The court, per Binns-Ward J, held that this may not be done and that the application must be instituted in terms of section 162 of the Companies Act. This note critically analyses the judgment and evaluates whether the court came to the correct decision.

2 The facts

Woollam, a minority and beneficial shareholder of Lewis Group Limited, a public company listed on the Johannesburg Stock Exchange, served a notice in terms of section 165(2)(a) of the Companies Act requesting Lewis Group Limited to commence proceedings to declare delinquent its chief executive officer, chief financial officer, chairperson of the board and chairperson of the audit and risk committee. In terms of section 165(2)(a) of the Companies Act a shareholder or a person entitled to be registered as a shareholder of the company or a related company, is empowered to serve a demand upon a company to commence legal proceedings or to take related

steps to protect the legal interests of the company. The demand is a precursor to the possible institution of derivative proceedings under section 165(5) of the Companies Act (*Mouritzen v Greystones Enterprises (Pty) Ltd* 2012 (5) SA 74 (KZD) par 22; *Mbethe v United Manganese of Kalahari (Pty) Ltd* 2016 JDR 0271 (GJ) par 47).

The basis of Woollam's contention that the four directors of the company should be declared delinquent by a court were that (i) Lewis Stores (Pty) Ltd (a subsidiary of Lewis Group Limited) had sold employment insurance to its customers who were pensioners and self-employed people who had no insurable interest in terms of the relevant insurance policies; (ii) the customers of Lewis Stores (Pty) Ltd were required, whether they wished to or not, to purchase extended warranties on goods purchased; (iii) compulsory delivery fees were charged, irrespective of whether the customers required delivery of the goods to be effected; (iv) the accounts of Lewis Group Limited appeared to overstate revenue from the sale of insurance policies; (v) Lewis Group Limited had inappropriate revenue obligation policies with regard to the sale of extended warranties that resulted in the on-going overstatement of reported revenue; and (vi) there were various accounting policy errors in the interim financial statements of Lewis Group Limited for the period ended 30 September 2015.

Lewis Group Limited applied to the court to set aside Woollam's demand in terms of section 165(3) of the Companies Act on the basis that it was frivolous, vexatious or without merit. The court was required to decide whether Woollam was entitled to proceed derivatively for the given relief when he was already given standing under the Companies Act to proceed with such relief personally.

3 Judgment

The court observed that the object of the delinquency remedy in section 162 of the Companies Act goes to the provision of a protective remedy in the public interest (par 40). The right of a shareholder that is afforded protection in terms of section 162 is not a right of the company, the court stated, but it is instead a personal right that each shareholder enjoys individually as an investor to take action to ensure that the management of companies, in general, is kept in fit hands (par 43).

In finding that Woollam was not entitled to use the derivative action remedy in section 165 of the Companies Act to achieve a declaration of delinquency in terms of section 162 of the Companies Act, the court stated that a shareholder's right to seek a declaration of delinquency against a director under section 162 co-exists with the same right separately invested in the company by the same provision (par 27). After investigating the preliminary procedures in terms of section 165 of the Companies Act in regard to derivative proceedings, the court opined that these procedures are not well suited to proceedings by shareholders to declare directors delinquent (par 45–49). Accordingly, the court ruled that it is not within the scheme of the Companies Act that shareholders should ordinarily seek to proceed derivatively to obtain a delinquency order in terms of section 162 of the Companies Act (par 49).

The court conceded that the language of sections 162 and 165 of the Companies Act read together do not explicitly exclude the use of the derivative action procedure in section 162 proceedings (par 50). It held that it is not inconceivable that, exceptionally, it might be "appropriate in certain circumstances" (par 50) for a shareholder to institute delinquency proceedings derivatively. One example the court gave where a shareholder may do so is where a company has already instituted proceedings for a declaration of delinquency but has failed to prosecute them to conclusion. In these circumstances the best interests of the company might be served, the court said, by the continuation by the shareholder of the proceedings derivatively because the costs that were already incurred by the company would be squandered if the shareholder were to initiate proceedings afresh for the same relief on the same facts in his own name (par 51). This, however, is an exception, and in general, the court held, a shareholder must institute delinquency proceedings personally rather than by a derivative action.

The court held that in any case there was no merit in Woollam's demand to have the four directors of Lewis Group Limited declared delinquent because, due to insufficient evidence, he had failed to prove that the conduct of the directors in question fell within the scope of section 162(5)(c) of the Companies Act. (See par 53–82 where the court examined the various grounds of complaint. Since the court found that there was insufficient evidence to substantiate Woollam's allegations against the directors, this note has not analysed the court's reasoning in detail on this point.) The court found that Woollam's allegations against the directors did not merit an investigation by the company whether it should apply for a declaration of delinquency against the four directors (par 65). The court consequently set aside Woollam's demand in terms of section 165(3) of the Companies Act on the ground that it was vexatious (par 52).

4 Analysis and discussion

4 1 Purpose of delinquency declarations

In finding that the object of section 162 of the Companies Act "goes essentially to the provision of a protective remedy in the public interest" (par 40) the court relied on the Australian cases of *Re v HIH Insurance Ltd (in prov liq); ASIC v Adler* ([2002] NSWSC 483) (hereinafter "*Asic v Adler*") and *Rich v Australian Securities and Investments Commission* ([2004] 220 CLR 129). In *Asic v Adler* Santow J declared that disqualification orders are designed to protect the public from the harmful use of the corporate structure and that such orders are not punitive (par 56). Binns-Ward J in *Lewis Group v Woolam* concurred with Wallis JA in *Gihwala v Grancy Property Ltd* ([2016] ZASCA 35) that section 162 of the Companies Act is not a penal provision (par 40).

To the extent that section 162 does not impose a criminal sanction on a delinquent director, the provision is not a penal one. It is however submitted that section 162 of the Companies Act does have a punitive element. One punitive effect of declaring a director delinquent is that there is a substantial

and significant interference with the individual's entrepreneurial freedom (see *Re Lo-Line Electric Motors Ltd* 1988 2 All ER 692 696 and *Re Crestjoy Products Ltd* 1990 BCC 23 26). A further punitive effect of a declaration of delinquency is that it carries a stigma for a person who is disqualified from acting as a director. The reputational damage caused by a delinquency order is extensive and is likely to endure for an extended period of time (see *Re Westminister Property Management Ltd Official Receiver v Stern* 2001 BCC 121 par 36).

In *Rich v Australian Securities and Investments Commission* (*supra*) the Australian High Court, per McHugh J, found that the conclusion reached by Santow J in *Asic v Adler* that disqualification proceedings have no punitive element was incorrect. McHugh J proclaimed that protective proceedings and punitive proceedings are not mutually exclusive categories and that the supposed distinction between "punitive" and "protective" was "elusive" (par 32). Several subsequent decisions of the Australian courts have concurred with McHugh J that disqualification orders are not purely protective and that they do have a penal element, contrary to the finding of Santow J in *Asic v Adler* (see for instance *Australian Securities and Investments Commission v Vizard* [2005] FCA 1037 par 35; *Australian Securities and Investments Commission v Beekink* [2007] FCAFC 7 (2007) par 80–91; *Gilfillan and Ors v Australian Securities and Investments Commission* [2012] NSWCA 370 par 180–185; *Australian Securities and Investments Commission v Axis International Management Pty Ltd (No 6)* [2011] FCA 811 (2011) par 9). It is submitted that in *Lewis Group v Woollam* the court, with respect, overlooked the fact that the notion that disqualification orders are purely protective, as asserted in *Asic v Adler*, on which it relied as authority for this proposition, has in fact been rejected by the Australian High Court in *Rich v Australian Securities and Investments Commission supra* and by several subsequent decisions, which have proclaimed that disqualification proceedings do in fact have a punitive element as well. The court failed to consider these subsequent authorities in maintaining that the purpose of delinquency orders is purely protective and not penal.

4 2 Institution of a delinquency declaration by means of a derivative action

The court gave various reasons why Woollam was not permitted to institute delinquency proceedings by means of a derivative action. These reasons are discussed below.

4 2 1 Absence of a quorum on the board of directors

When a company has been served with a demand in terms of section 165(2) of the Companies Act to commence legal proceedings to protect the legal interests of the company, it may within 15 business days apply to a court to set aside the demand on the grounds that it is frivolous, vexatious or without merit. These terms are not to be read *eiusdem generis* and must be given their ordinary meaning (*Amdocs SA Joint Enterprise (Pty) Ltd v Kwezi Technologies (Pty) Ltd* 2014 (5) SA 532 (GJ) par 14). If a company does not make such an application or the court does not set aside the demand, the

company must appoint an independent and impartial person or committee to investigate the demand (s 165(4)(a)). The impartial person or committee must report to the board on any facts or circumstances that may give rise to a cause of action contemplated in the demand or that may relate to any proceedings contemplated in the demand (s 165(4)(a)(i)). The report must further indicate the probable costs that would be incurred if the company were to pursue (or continue) any such cause of action, as well as whether it appears to be in the best interests of the company to pursue any such cause of action (s 165(4)(a)(ii) and (iii)). Within 60 business days after being served with the demand (or within a longer period as allowed by a court) the company may 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 it may serve a notice on the person who made the demand, refusing to comply with it (s 165(4)(b)).

In *Lewis Group Limited v Woollam* the court opined that the investigation procedure contemplated in section 165(4) would be likely to give rise to an "intractable" conflict of interest situation when it is not the interests of the company but the personal status of the directors themselves that is in issue (par 45). The directors concerned, the court said, would probably be required to recuse themselves from making the decision whether to comply with the demand. This, the court said, would result in there not being a sufficient number of directors to form a quorum. Consequently, the court proclaimed, the company would be in a position in which it would not be able to decide whether to proceed with the derivative action or not (par 45). On this basis, the court held that the preliminary procedures in terms of section 165 are not well suited to the proceedings by shareholders for the declaration of directors as delinquent.

It is submitted that the court is correct that if the delinquency of a board member is in issue the director concerned would have to recuse himself from a decision by the board of directors whether to initiate or continue the legal proceedings or refuse to comply with the demand. However, the recusal of a director from the board meeting would not in every instance necessarily result in there being an insufficient number of directors to form a quorum. If however, this situation does arise, section 165 of the Companies Act is silent on how the matter must be resolved. It is submitted that the absence of a quorum on the board of directors due to a conflict of interest need not necessarily be a bar to the board of directors making a decision whether to proceed with the action or not. By way of analogy, under section 75(5)(f)(i) of the Companies Act if a director of a company has a personal financial interest in respect of a matter to be considered at a board meeting, he must leave the meeting after disclosing his interest, but while absent from the meeting, he is to be regarded as being present at the meeting for the purpose of determining whether sufficient directors are present to form a quorum. Such director is not to be regarded as being present at the meeting for the purpose of determining whether a resolution has sufficient support to be adopted (s 75(5)(f)(ii)). While the conflict of interest in regard to a company deciding whether to proceed with the action itself or not would not relate to a personal financial interest but to the status of the directors, in accordance with the precepts of section 75(5)(f) and in the absence of any express guidance in section 165 of the Companies Act, one could argue by

parity of reasoning that if those directors who have a conflict of interest were to recuse themselves from making the decision whether to proceed with the action or not, they could nevertheless still be regarded as being present at the meeting for the purposes of determining whether there is a quorum. The remaining directors would then, without difficulty be able to vote on this decision.

It is of interest that the United States of America (USA) Revised Model Business Corporation Act 1984 (hereinafter the "MBCA") specifically makes provision for the situation where there are insufficient directors to form a quorum on the board of directors to decide whether or not the maintenance of the derivative proceedings is in the best interests of the corporation. Section 7.44(b)(1) of the MBCA provides that the decision whether or not the maintenance of the derivative action is in the best interests of the company must be made by a majority vote of qualified directors present at a meeting of the board if the qualified directors constitute a quorum. A qualified director is a director who does not have a material interest in the outcome of the derivative proceedings or a material relationship with a person who has such an interest (s 1.43(a)(2) of the MBCA). If the qualified directors do not form a quorum, then the decision must be made by a majority vote of a committee consisting of two or more qualified directors appointed by a majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum (s 7.44(b)(2)). The MBCA goes even further and makes provision for a company to apply to the court to appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceedings is in the best interest of the corporation (s 7.44(e)).

It is submitted that the approach adopted under the MBCA to resolve the problem of a lack of a quorum is a pragmatic and commendable approach. Since section 165 of the Companies Act is silent on dealing with the way forward if there are insufficient directors to form a quorum on the board of directors to decide whether to proceed with the action or not, it is submitted that our legislature should consider adopting a similar provision.

4 2 2 Fiduciary duties of directors owed to individual shareholders

The court in *Lewis Group v Woollam* asserted that the duty of company directors to act honestly and in accordance with their fiduciary duties to the company "is owed not only to the company but also to the shareholders personally" (par 49). The court found justification for this statement in the provisions of section 218(2) of the Companies Act (par 49). It proclaimed that the debate whether at common law directors owe a fiduciary duty to an individual shareholder is rendered largely academic by section 218(2), which makes it clear that such a duty is owed to individual shareholders (par 49). The court consequently held that the fact that directors owe a duty to shareholders personally, as indicated by section 218(2), is an indication that it is not within the scheme of the Companies Act that a shareholder should ordinarily seek to proceed derivatively to obtain the remedy available in

terms of section 162 of the Companies Act because a shareholder has personal standing to seek the relief (par 49).

It is widely accepted that under the common law, directors stand in a fiduciary relationship to the company and do not therefore owe a fiduciary duty to the shareholders individually (see *Percival v Wright* [1902] 2 Ch 421 (ChD); *Pergamon Press Ltd v Maxwell* [1970] 2 All ER 809 (Ch) 814; *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 198 (PC) 217–219; *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd* 2006 (5) SA 333 (W) par 16.6; Havenga "Directors' Fiduciary Duties under our Future Company Law Regime" 1997 9 *SA Merc LJ* 310 321; Blackman, Jooste, Everingham, Yeats, Cassim, De la Harpe, Larkin and Rademeyer *Commentary on the Companies Act* (2012) 2(9) 5–381–5–383; Cassim *et al Contemporary Company Law* 2ed (2012) 515–516). There may, however, be certain specific or special circumstances based on the facts of the particular case where directors may be found to owe a fiduciary duty to a specific individual shareholder. Such circumstances may arise for instance if directors act as agents for shareholders, or due to the family character of a company, or the position of the directors in the company and their families, or their high degree of inside knowledge (see *Coleman v Myers* [1977] 2 NZLR 225 CA (NZ); *Sage Holdings Ltd v The Unisec Group Ltd* 1982 (1) SA 337 (W) 365–366; *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192; *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACSR 543 CA (NSW); *Peskin v Anderson* [2001] 1 BCLC 372; Blackman, Jooste, Everingham *et al Commentary on the Companies Act* 5–384–5–393). It is nevertheless generally accepted under the common law that although a director may owe fiduciary duties to an individual shareholder he does not do so by the mere fact of being a director, but only where some personal relationship arises between the director and shareholder or because of some particular dealing or transaction between them (see *Sharp v Blank* [2015] EWHC 3220 (Ch) par 12).

Section 218(2) states that a person who contravenes "any provision" of the Companies Act is liable to "any other person" for any loss or damage suffered by that person as a result of that contravention. While the words "any other person" in section 218(2) would include shareholders and the reference to "any provision" of the Companies Act would include the directors' fiduciary duties set out in section 76 of the Companies Act (see *Grancy Property Limited v Gihwala* 2014 JDR 1292 (WCC) par 104; *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd* [2014] 3 All SA 454 (GJ) par 42), in order for a shareholder to rely on section 218(2) to institute an action against a director for a breach of his fiduciary duties, the shareholder must have personally suffered some "loss or damage" as a result of the breach of fiduciary duty. A plaintiff under a section 218(2) claim must specify the exact loss or damage sustained by him as a result of the contravention of the Companies Act (*Rabinowitz v Van Graan* 2013 (5) SA 315 (GSJ) par 11). To succeed on the basis of section 218(2), it must not only be shown that a person had contravened a provision of the Companies Act and that another person had suffered loss or damage, but it must also be shown that such loss or damage suffered was as a result of that contravention (*Burco Civils CC v Stolz* (26201/2015) [2016] ZAGPPHC 350) par 47). In other words, there must be proof of a causal link or connection between the

contravention of the Companies Act and the damage or loss for which the person may be held liable (see *Burco Civils CC v Stolz supra* par 47).

A director's breach of a fiduciary duty would in most instances not necessarily result in personal loss or damage being suffered by a shareholder. In most instances, the loss or damage would be suffered by the company itself. The so-called loss suffered by a shareholder by way of a reduction in the value of his shares is merely reflective of the loss suffered by the company and is not a loss in its own right (see *Prudential Assurance Company Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354 366–367 where the court held that a shareholder cannot recover a sum equal to the diminution in the market value of his shares because such a "loss" is merely a reflection of the loss suffered by the company; *Stein v Blake* [1998] 1 All ER 724 (CA) 729; *Johnson v Gore, Wood and Co* [2002] 2 AC 1 (HL) 62; *Itzikowitz v Absa Bank Ltd* 2016 (4) SA 432 (SCA) par 10–11 and Cassim *et al Contemporary Company Law* 517). In *Lewis Group v Woollam* the court accepted that the reflective loss suffered by a shareholder by way of a diminution in the value of his shares may not be claimed under section 218(2) of the Companies Act (par 49). Accordingly, it is submitted that section 218(2) of the Companies Act is not, in fact, any indication that directors owe their fiduciary duties to shareholders personally since a shareholder may not generally institute an action against a director for breach of his fiduciary duty under section 218(2). He may do so only if he has personally suffered any loss or damage, which he is able to accurately quantify, as a result of the breach of the director's fiduciary duty. It is with respect, submitted that section 218(2) has not altered the common law position that directors generally stand in a fiduciary relationship to the company and not to the individual shareholders, as proclaimed by the court in *Lewis Group v Woollam*.

4 2 3 No need in the "interests of justice" for shareholder to litigate in company's name

The court in *Lewis Group v Woollam* asserted that when both the company and the shareholder have the same standing to sue for the same relief on the basis of the same facts, the company must be entitled to say that the shareholder has no need in the interests of justice to litigate in the corporation's own name when he can do so on his own (par 48).

It is respectfully submitted, however, that there is merit, in the interests of justice, in a shareholder wishing to proceed derivatively for the relief provided for in section 162 of the Companies Act, instead of instituting the proceedings himself. One reason why a shareholder may wish to choose to serve a demand on a company in terms of section 165(2) of the Companies Act to commence legal proceedings to declare its directors delinquent is that the shareholder would not have to personally bear the high costs and expenses of protracted legal proceedings. If the company complies with the shareholder's demand under section 165(2) of the Companies Act to initiate delinquency proceedings, the shareholder's legal costs would be minimal and he would not even have to enter a courtroom.

Section 165(10) of the Companies Act states that a court may make any order it considers appropriate about the costs of the person who applied for or was granted leave, the company or any other party to the proceedings. If a shareholder is successful under section 165 of the Companies Act in instituting derivative proceedings, the company may be ordered by the court to bear his legal costs and expenses. Even if a shareholder is not successful in instituting derivative action proceedings, a court may, in its discretion, require the company to bear the legal costs and expenses of the proceedings. A court may, for instance, make such a determination if the shareholder had acted *bona fide* and his application was meritorious despite the fact that he was unsuccessful in his application. To use another example, section 7.46(1) of the MBCA provides that on the termination of derivative proceedings the court may order the corporation to pay the plaintiff's expenses incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation.

In contrast, section 162 of the Companies Act does not contain any provision relating to the costs orders, which a court may grant. Presumably, the common law rule that costs follow the event would apply, that is, that costs are generally awarded against the unsuccessful party and that the successful party should be awarded his costs (see for instance *Union Government v Gass* 1959 (4) SA 401 (A) 413; *Kunene v South African Mutual Fire And General Insurance Co Ltd* 1977 (4) SA 508 (D) 511; *Nxumalo v Mavundla* 2000 (4) SA 349 (D) 354; *Mancisco and Sons CC (in liquidation) v Stone* 2001 (1) SA 168 (W) 181; *Gauteng Provincial Legislature v Kilian* 2001 (2) SA 68 (SCA) par 24; *Nzimande v Nzimande* 2005 (1) SA 83 (W) par 75). This means that a shareholder who is unsuccessful under section 162 would most likely bear the legal costs and expenses of all the parties involved in the application. It seems onerous and burdensome to require a shareholder who institutes an action under section 162 of the Companies Act to declare a director delinquent to bear all the legal costs, particularly if the purpose of section 162 is said to be "essentially to the provision of a protective remedy in the public interest" (*Lewis Group v Woollam* par 40). The unfairness of the costs burden on a single shareholder is further underscored if one considers that all the shareholders of the company would benefit from the shareholder's efforts to declare a director of the company delinquent. A *bona fide* shareholder who does not have deep pockets but wishes to protect the public from the future misconduct of a director of a company would be discouraged and disincentivised from instituting a section 162 application if he bears the risk of personally paying for the high legal costs. This may result in shareholder apathy, and in delinquent directors escaping accountability for their misconduct. On the other hand, if the *bona fide* shareholder were empowered to serve a demand on a company in terms of section 165(2) to commence legal proceedings or to institute delinquency proceedings by means of a derivative action, this may encourage and incentivise him, for the protection of the public, to take such a step. On this basis, it is submitted that there is certainly merit, in the interests of justice, in permitting shareholders to institute delinquency proceedings in terms of section 165 of the Companies Act.

4 2 4 Redundancy of the filtering processes of section 165 of the Companies Act

The court stated that section 165 of the Companies Act has certain inbuilt filters, which are lacking in section 162 (par 47). One filter is that the demand and the ensuing investigation in terms of section 165(4) of the Companies Act give the company the opportunity to make a properly informed decision whether to institute the litigation proceedings itself (par 47). Another filter is that the investigator's report falls to be submitted to the company's board of directors (par 47). A further filter, the court said, is that if a complainant is unable to set forth his demand with cogency, the demand may be set aside by a court on the basis that it is vexatious (par 47). These filters, the court asserted, are redundant if the intending litigant is able to proceed for the relief sought regardless of its outcome (par 47).

It is submitted with respect that the inbuilt filters of section 165 are not necessarily redundant if the litigant is able to proceed for the relief sought if his demand is set aside. The independent and impartial investigation in terms of section 165(4) serves to protect the company and its board of directors. It confirms whether the allegations against the directors of the company are true or not. As the court pointed out, the investigator's report falls to be submitted to the board of directors and it is not intended to provide a mechanism for disgruntled parties to launch a fishing expedition for facts to found an action (par 47). Therefore, even if a shareholder is able to proceed in terms of section 162 of the Companies Act if he is unsuccessful under section 165, the company and the board of directors will have the advantage of already having conducted an investigation into the director's conduct and of being better prepared to respond to the allegations made against a director under section 162. This may augment the defence by the directors and enable the directors to fervently defend any allegations made under section 162. As the court correctly pointed out, there are no inbuilt filtering processes for proceedings in terms of section 162. A shareholder is empowered to institute an application to declare directors delinquent under section 162 even if the application is vexatious or frivolous, without the company or the board of directors having had an opportunity and the time to first investigate the allegations made against the directors.

If a company is able to successfully apply to court to set aside a demand in terms of section 165(3) on the basis that it is frivolous, vexatious or without merit, this may well serve to discourage a shareholder from thereafter proceeding in terms of section 162 to declare the directors of the company delinquent.

For the above reasons it is accordingly respectfully submitted that the inbuilt filtering process of section 165 would not necessarily be a redundant exercise if the intending litigant is able to proceed for the relief in terms of section 162, as maintained by the court.

5 The exception laid down by the court

The legislature explicitly empowered a shareholder, director, prescribed officer, registered trade union that represents employees of the company or

another representative of employees of the company to apply to court both for an order declaring a director delinquent and to institute proceedings by means of the derivative action procedure (see ss 162(2) and 165(2)). As the court itself conceded, the language of sections 162 and 165 read together do not expressly exclude the use of the derivative action procedure in section 162 proceedings (par 50). Had the legislature wished to exclude delinquency proceedings being instituted by means of a derivative action, it would have expressly done so.

While the court stated that using the derivative action procedure to institute delinquency proceedings might be "appropriate in certain circumstances" (par 50) it failed to define when these exceptional circumstances may arise. The court simply gave one example of when it would be appropriate, which is when a company has already instituted delinquency proceedings but fails to prosecute them to conclusion (par 50). In light of the exception carved out by the court, it appears that a shareholder may institute delinquency proceedings using the derivative action procedure provided that it does so in "appropriate" circumstances. This has the implication that should a shareholder wish to use the derivative action procedure in section 162 proceedings; he may first have to overcome the hurdle of convincing the court that he is doing so in "appropriate" circumstances.

This additional hurdle is not required by either section 165 or by section 162 of the Companies Act. It may well serve to unnecessarily complicate the already complex and multifaceted procedures laid down in section 165 of the Companies Act. It is submitted that the exception laid down by the court is vague since the circumstances when it would be appropriate to use the derivative action procedure in section 162 proceedings have not been defined by the court.

6 Good faith and the danger of abuse of section 162 of the Companies Act

It is important to guard against abuse by those persons with *locus standi* bringing applications to declare directors delinquent, because such persons may well use the mechanism of applying to the court to declare a director delinquent to lodge vexatious claims, which may result in damage being caused to the company and to the reputation of directors. This is particularly important in regard to a public company listed on the Johannesburg Stock Exchange, where the price of the company's shares may easily be affected by the mere institution of an application in terms of section 162.

In *Lewis Group v Woollam*, Lewis Group Limited argued that Woollam had not acted in good faith by instituting proceedings to have the four directors of the company declared delinquent. Lewis Group Limited contended that Woollam was involved in short-selling activities and that his conduct in instituting delinquency action proceedings against the directors of the company was directed at driving down the share price of the company to benefit his short-selling activities. The negative publicity given to the company as a result of the delinquency action proceedings instituted by

Woollam did, in fact, have an adverse effect on the share price of the company (par 86).

The question whether the applicant had acted in good faith does not arise under section 165(3) of the Companies Act but it is a relevant consideration under section 165(5) of the Companies Act. In *Mouritzen v Greystones Enterprises (Pty) Ltd* (*supra* par 58) the court said that the good faith requirement in section 165(5) of the Companies Act means that the applicant had to show good conscience and sincere belief in the existence of reasonable prospects of success in the proposed litigation, and an absence of an ulterior motive (see further on the good faith requirement Delport *Henochsberg on the Companies Act 71 of 2008* (2016) 1(10) 586(5); Cassim *The New Derivative Action under the Companies Act: Guidelines for Judicial Discretion* (2016) 37–55). If a company refuses to comply with the applicant's demand, the applicant may apply to the court in terms of section 165(5) for leave to bring the proceedings in the name and on behalf of the company. In order to succeed with this application, the court must be satisfied that the applicant is acting in good faith. In *Lewis Group v Woollam* the court held that while the focus in an enquiry into whether the demand is without merit under section 165(3) is on whether a *prima facie* case has been made out for the company to pursue, matters that are relevant to demonstrating that the demand is frivolous or vexatious within the meaning of section 165(3) could overlap with those that are relevant to an enquiry into good faith in terms of section 165(5) (par 89). In other words, the good faith of the applicant may be taken into account by a court in considering whether to set aside the demand under section 165(3) of the Companies Act.

The court noted that Woollam had indeed failed to disclose his short-selling activities when involved in publicising his adverse opinions of the business activities of Lewis Group Limited (par 87). It proclaimed that this raised an ethical question, but it did not decide on whether Woollam had acted in bad faith because the question had already been referred by Lewis Group Limited to the Financial Services Board for investigation. The Financial Services Board subsequently cleared Woollam of insider trading due to insufficient evidence (see FSB Press Release 28 September 2016 https://www.fsb.co.za/Departments/communications/Documents/2016-09-28%20(2).pdf (accessed 2017-05-02)).

This illustrates the extent of the power conferred on a single shareholder to institute proceedings to declare a director delinquent, which, if instituted in bad faith, may potentially affect not only the reputation of the directors concerned but also the share price of a company. Section 162 of the Companies Act does not contain any filters to protect against abuse of the provision. If the application under section 162 of the Companies Act is frivolous or vexatious, a court will not grant an order of delinquency against the director concerned, but the application, while it is pending, may nevertheless affect the reputation of the director concerned as well as the share price of the company. If a shareholder were to institute proceedings to declare a director delinquent by means of a derivative action, the good faith requirement would serve to filter out at an early stage any proceedings that are frivolous or vexatious. This would have the advantage of quickly curbing the abuse of section 162 since a court would be able to screen out at a

preliminary stage any proceedings instituted with an ulterior motive. The damage done to the share price of Lewis Group Limited and to the reputation of directors could well have been more extensive had the application been instituted by Woollam in terms of section 162 of the Companies Act and had the directors of the company been involved in a protracted legal battle under section 162 of the Companies Act.

7 Consideration of foreign legislation

In coming to the conclusion that shareholders should not seek to proceed derivatively to obtain a delinquency order in terms of section 162 of the Companies Act the court drew on and relied on the equivalent legislation in the United Kingdom (UK), Australia and New Zealand.

In the UK, under the Company Directors Disqualification Act 1986, applications to court for a disqualification order against a director must be made in most instances by the Secretary of State for Business Enterprise and Regulatory Reform. In certain instances the application may be made by the official receiver of a company in a winding-up of the company, the liquidator, or any past or present shareholders or creditors of any company "in relation to which that person has committed or is alleged to have committed an offence or other default" (see s 16(2)). As the court in *Lewis Group v Woollam* pointed out, in the UK an application by a shareholder or creditor for a disqualification order against a director is personal in character and is not to be brought derivatively (par 7). Under the Australian Corporations Act of 2001, the Australian Securities and Investments Commission is the only body conferred with *locus standi* to apply to the court to obtain a disqualification order against a director (see Part 2D.6 (Disqualification from Managing Corporations) of the Australian Corporations Act of 2001). Likewise, under the Companies Act, 1933 of New Zealand there is no provision for a company itself to apply to the court for a disqualification order against a director. The equivalent legislation in these jurisdictions, as pointed out by the court, do not confer standing on companies to bring an action to court to disqualify directors and remove them from office (par 10). This influenced the court's decision that a delinquency application in terms of section 162 of the Companies Act may not be brought by means of a derivative action.

However, the court failed to consider the provisions of the MBCA and the various USA States, where the equivalent legislation to section 162 of the Companies Act expressly requires court proceedings to remove a director from office to be instituted by means of a derivative action. Section 8.09(a) of the MBCA sets out various grounds upon which a director may be removed from office by a court. These grounds are very similar to the grounds that are set out in section 162(5) of the Companies Act. In fact, some of the grounds in section 162(5)(c) of the Companies Act (such as gross abuse of the position of director and intentionally inflicting harm upon the company) mirror those set out in section 8.09(a) of the MBCA. In terms of section 8.09(a) of the MBCA proceedings to remove a director from office must be commenced "by or in the right of the corporation". This means that the proceedings must be brought by the board of directors, or, by a shareholder suing derivatively. In terms of section 8.09(b) of the MBCA, a shareholder proceeding on behalf

of the corporation under section 8.09(a) must comply with all of the requirements of sections 7.41 to 7.47 of the MBCA, save for section 7.41(i).

Sections 7.41 to 7.47 of the MBCA deal with the derivative action proceedings. Briefly, these procedures are that a shareholder must serve a written demand on the corporation to take suitable action (s 7.42). Derivative proceedings may thereafter not be commenced until 90 days have expired from the date of delivery of the demand unless the shareholder has been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the 90-day period to expire (s 7.42). If the corporation commences an inquiry into the allegations made in the demand, the court may stay the derivative proceeding for such period as the court determines appropriate (s 7.43). In terms of section 7.44, the derivative proceeding must be dismissed by the court on motion by the corporation if it is established that, after a reasonable inquiry has been conducted, the maintenance of the derivative proceeding is not in the best interests of the corporation. Derivative proceedings may not be discontinued or settled without the court's approval (s 7.45). Section 7.46 deals with the costs orders which a court may make, while section 7.47 deals with the applicability of derivative proceedings to foreign corporations. Overall, these provisions are analogous to the derivative action proceedings under section 165 of the Companies Act.

The only provision that a shareholder is not required to comply with in terms of section 8.09(b), is section 7.41(i). Section 7.41(i) provides that a shareholder may not commence or maintain a derivative proceeding unless the shareholder was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time. In other words, the plaintiff must have been an owner of shares in the company at the time of the act or omission complained of. This rule has been expressly relaxed for purposes of instituting a derivative action in terms of section 8.09 of the MBCA to judicially remove a director from office, which means that a person who purchases shares subsequent to the act or omission complained of may institute a derivative action under section 8.09 of the MBCA. The shareholder must nevertheless fairly and adequately represent the interests of the corporation in enforcing the right of the corporation (see s 7.41(ii) of the MBCA).

Likewise, section 225(c) of the Delaware General Corporation Law states that judicial removal proceedings must be instituted "upon application by the corporation, or derivatively in the right of the corporation by any stockholder". Other USA States which also require judicial removal proceedings of a director to be commenced derivatively in the right of the company by the shareholders are Connecticut (see s 33–743(a) and (b) of the Connecticut General Statutes), the District of Columbia (see s 29–306.09(a) of the District of Columbia Code), Idaho (see s 30–29–809(2) of the Idaho Code), Iowa (see s 490.809(1) of the Iowa Code), South Dakota (see s 47–1A–809 of the South Dakota Business Corporation Act) and Wyoming (see s 17–16–809(a) of the Wyoming Business Corporation Act). Only one USA State, Pennsylvania, permits a single shareholder to bring an action to remove a director from office. Section 1726(d) of the Pennsylvania Business

Corporation Law is akin to section 162 of the Companies Act in that it empowers a single shareholder to apply to the court to remove a director from office. Section 1726(c) nevertheless states that the company must be a party to the application, and the shareholder must, in addition, comply with the requirements relating to derivative actions (see s 1726(c) of the Pennsylvania Business Corporation Law).

Section 5(2) of the Companies Act states that, to the extent appropriate, a court interpreting or applying the Companies Act may consider foreign company law. In *Nedbank Ltd v Bestvest (Pty) Ltd; Essa v Bestvest 153 (Pty) Ltd* (2012 (5) SA 497 (WCC) par 26) the High Court remarked that company law in South Africa has for many decades tracked the English system and taken its lead from the relevant English Companies Act and jurisprudence, but section 5(2) of our Companies Act now encourages our courts to look further afield and to have regard in appropriate circumstances to other corporate law jurisdictions, be they American, European, Asian or African, in interpreting the Companies Act. Consequently, in terms of section 5(2) of the Companies Act, the court in *Lewis Group v Woollam* ought to have taken USA law into account. The court, with respect, may have overlooked the fact that in the USA proceedings to disqualify a director, on grounds which are akin to those provided in section 162(5)(c) of the Companies Act, must be brought by derivative proceedings. The court's judgment may have been influenced in a different direction had it considered USA law on this point.

8 Conclusion

This note critically analysed the court's decision in *Lewis Group v Woollam* not to permit a shareholder to institute delinquency proceedings by using the derivative action. As a general comment, it was argued that section 162 of the Companies Act does not have a purely protective function and that one must bear in mind that the provision does have a punitive element to it. It was submitted, with respect, that the Australian authorities on which the court had relied for the notion that proceedings under section 162 are purely protective have been rejected by subsequent Australian jurisprudence.

Regarding the court's decision not to permit delinquency proceedings to be instituted by means of the derivative action, this note argued that it is not an insurmountable problem that some members of the board of directors may have to recuse themselves from making the decision whether to comply with the demand in terms of section 165(2). It was argued further that contrary to the assertion made by the court, section 218(2) of the Companies Act does not establish a fiduciary duty owed by directors to the shareholders individually. This note contended that, contrary to the court's submissions, there is merit, in the interests of justice, in permitting shareholders to institute delinquency proceedings by means of the derivative action. It was further argued that the filtering processes of section 165 are not redundant if a litigant is able to proceed for the relief in terms of section 162 if he is not successful under section 165.

The exception laid down by the court when delinquency proceedings may be instituted by derivative action proceedings was questioned on the basis

that the exception is vague and may serve to add an additional hurdle, which a shareholder may have to overcome when instituting delinquency proceedings by means of the derivative action. This may serve to further complicate the already multifarious procedures laid down in section 165.

This note suggested that one must guard against the potential abuse of section 162, which unlike section 165 does not contain any filters to curb abuse. It was pointed out that if delinquency proceedings were instituted by derivative action proceedings, this would, in fact, have the advantage of curbing the abuse of section 162 because it would enable a court to screen out, at an early stage, any allegations made against directors that are frivolous or vexatious.

Finally, it was pointed out that the MBCA and the USA States require proceedings to disqualify a director to be instituted by means of the derivative action. The court did not, with respect, consider USA legislation in its judgment, as it is now required to do by virtue of the provisions of section 5(2) of the Companies Act. Had the court done so, the relevant provisions of the MBCA may have influenced its judgment.

Woollam has been granted leave to appeal the judgment of *Lewis Group v Woollam* to the Supreme Court of Appeal. It remains to be seen whether the Supreme Court of Appeal agrees with the Western High Court that delinquency action proceedings may not be instituted by means of the derivative action, or whether it overturns this decision.

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