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Derivative action under the Companies Act 2015: New jurisprudence or mere codification of common law principles?

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Abstract

One of the salient features of Kenya's Companies Act 2015 is the codification of derivative action (the rule in Foss v Harbottle *and its exceptions). While the statutory provision for derivative action is aimed at addressing the challenges that arose from common law derivative action, the statutory derivative action fails to achieve this outcome. At best, it is a restatement of the common law principles flowing from the rule in* Foss v Harbottle *and its exceptions.*

Introduction

Derivative action is one of the exceptions to the principles established in the landmark case of *Foss v Harbottle*.[1] It can simply be defined as a means by which a member of a company who is dissatisfied with the acts or omissions of the directors of the company owing to the fact that such acts or omissions have occasioned harm to the company, can institute court proceedings to seek relief on behalf of the company for the wrongs it has suffered. While it was initially an exception to the rule in *Foss v Harbottle*, the derivative action has now been codified in the Companies Act 2015 (the Act).[2] Despite the codification, the question that still begs to be answered is the extent to which derivative action is a

1 (1843) 2 Hare 461.
2 See generally Part XI, *Companies Act* (Act No. 17 of 2015).

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potent and effective tool to prevent loss to a company due to the misadventures of directors. Consequently, this article problematises the issue by examining the efficacy, practicability and effectiveness of statutory derivative action as a tool for safeguarding the interests of a company from the actions of wayward directors. The discussion is especially relevant in the wake of increased cases of corporate fraud, allegedly involving complicit directors, which have occasioned harm to the companies concerned as well as third parties.[3]

The article is divided into four main thematic areas. The first part traces the origins of derivative action, its development and eventual codification in the Act. The second part of the article discusses various court decisions illustrating how Kenyan courts have interpreted and applied the common law principles on the rule in *Foss v Harbottle* and its exceptions. The discussion of the cases seeks to establish the gaps (if any) that were identified by the courts with regard to derivative actions before the codification of the rule. Part three analyses Part XI of the Act which contains provisions on the derivative claim. This analysis seeks to establish the extent to which statutory derivative action is similar to or departs from common law derivative action. The discussion also sets the stage for the last part of the article which critiques the statutory derivative action. The last part entails a discussion on the gaps that exist in the statutory derivative action as currently framed.

In enacting the Act, Kenya borrowed heavily from the United Kingdom's (UK) Companies Act of 2006 (UK Act). An examination of the UK Act, as well as decisions emanating from UK courts on derivative actions, would provide a useful comparison of the extent to which the provisions of Kenya's Act on derivative actions will aid the cause of the members who seek to right the wrongs inflicted on a company by rogue directors. Given that there are few (if any) cases that have been decided by Kenyan courts on statutory derivative action, the article utilises decisions on derivative actions from courts of the UK that were based on the statutory derivative action of the UK Act. The article also discusses deriv-

3 For instance, over the past ten months, three banks in Kenya, namely Dubai Bank, Imperial Bank and Chase Bank, have been placed under receivership leading to loss of deposits by their clients. Part of the reason for the closure of the three banks was due to either illegal or unethical conduct by the directors combined with a cocktail of factors which led to the fall of the companies. See 'Vincent Agoya: Warrants of arrest issued against Dubai Bank directors' *Daily Nation,* 20 November 2015 http://www.nation.co.ke/news/Warrants-of-arrest-issued-against-Dubai-Bank-directors/-/1056/2964484/-/2jjo8fz/-/index.html on 11 August 2016; 'Geoffrey Irungu: Bank gave Sh16.6bn unsecured loans to directors, CBK says' *Daily Nation*, 7 April 2016 http://www.nation.co.ke/news/Rogue-bank-goes-down-with-Sh96b/1056-3150706-q2kfehz/index.html on 11 August 2016; 'Imperial Bank directors freed on Sh18m cash bail' *Daily Nation,* 29 March 2016 http://www.nation.co.ke/news/Imperial-Bank-directors/1056-3138214-c8pwdnz/index.html on 11 August 2016.

ative action in the United States of America (USA). The USA has been selected for the comparative analysis due to the fact that its procedures on derivative action differ significantly from those of other countries whose law on derivative action mirrors the common law position. The effect of the different procedures has been that obtaining redress through the derivative action is much easier in the USA than Kenya and other countries which adopted the common law derivative action with minimal if any modification. Based on the discussion undertaken in the sections highlighted above, the article ultimately makes its conclusion on the extent to which derivative action is a potent tool for shareholders to prevent loss to a company due to failure by its directors to discharge their duties.

Derivative action at common law: A historical appraisal

A derivative action/claim has been defined as a representative claim on behalf of all shareholders other than the defaulting shareholders against the wrongdoers and the defaulting shareholders, and the company as a nominal defendant.[4] It is derivative since the right to sue is not vested directly in the shareholder who brings the derivative claim but flows from the right of the company to institute proceedings in its own name. Put simply, the shareholder derives the right from the rights that are vested in the company.

The derivative claim traces its origins to the landmark case of *Foss v Harbottle*.[5] The case involved two shareholders who brought an action against the company's directors and promoters alleging that the directors had defrauded the company by selling it land at an exorbitant price. The two shareholders contended that as a result of the exorbitant prices, the company had incurred losses as it had paid a higher price than it would have had the land been sold to it at the prevailing market rates. Of importance was the fact that the land was sold to the company by its directors. The two shareholders, therefore, instituted proceedings on their own behalf and on behalf of all the other shareholders of the company except the defaulting shareholders. The Court held that the action of the two claimants could not proceed as the individual shareholders were not the proper claimants. The proper claimant was the company as it was the one which had suffered the alleged wrongs. In the words of Wigram VC:

4 Hicks A and Goo S, *Cases & materials on company law*, 5ed, Oxford University Press, Oxford, 2004, 380. See also, Ogego J, 'Old wine in new wine skin: An analysis of the derivative actions under the Companies Act 2015 (Kenya)' http://www.academia.edu/19367883/Old_Wine_in_New_WIneskin_A_review_of_derivative_actions_under_Companies_Act_2015_Kenya_ on 13 June 2016.

5 (1843) 2 Hare 461.

> It was not, nor could it successfully be, argued that it was a matter of course for any individual member 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; and the only question can be whether the facts alleged in this case justify a departure from the rule which, *prima facie*, would require that the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative…whilst the supreme governing body, the proprietors at a special general meeting assembled; retain the power of exercising the functions conferred upon them by the Act of Incorporation, it cannot be competent to individual corporators to sue in the manner proposed by the plaintiffs on the present record.[6]

In arriving at this determination, the UK Vice Chancellor's Court observed that at law, a company enjoys a separate legal personality from its shareholders. Therefore where a company suffers a wrong, the company itself should institute legal proceedings to remedy the wrong. This is what is referred to as the proper plaintiff principle. The case also established the primacy of the 'internal management rule' whose underlying rationale is that for a company to function effectively, the will of the majority of the members must prevail. The internal management rule as applied to derivative actions specifically provides that if the shareholders in a general meeting can ratify the wrongful act committed against the company, then individual shareholders cannot bring a derivative action on behalf of the company. In other words, it is the members of the company, and not the courts, who are best placed in making decisions about the company. Therefore, courts will adopt a restrictive approach so as not to interfere with the effective functioning of the company.

There are two main justifications for the rule in *Foss v Harbottle*. First, it has been argued that the proper plaintiff principle prevents a deluge of suits which may arise if the floodgates were open to all shareholders to bring derivative claims whenever they feel that the company has been wronged.[7] To guard against this, only the company ought to be allowed to institute proceedings for the wrongs it suffers. The second justification for the rule is that it may be pointless for a member to bring a derivative claim for a wrong suffered by the company yet the company, through its organs, can ratify the wrongs complained of.[8] In effect, this will render any litigation founded on such wrongs an action in futility as the actions complained of will no longer be wrongs but rather proper corporate acts.

6 *Foss v Harbottle* (1843) 2 Hare 462.

7 Bourne N, *Bourne on company law,* 6ed, Routledge, London, 2013, 227; Ogolla J, *Company law,* 2ed, Focus Books, Nairobi, 2006, 245.

8 Bourne, *Bourne on company law,* 227.

While the rule in *Foss v Harbottle* is well intentioned and justifiable on some grounds, it also has certain inherent risks and challenges as far as the institution of derivative claims is concerned. The first challenge flows from the proper plaintiff rule which mandates the organs of the company to act on its behalf on all matters and only where such organs fail to discharge their mandate can the courts allow a derivative action.[9] In the event that the organs which are mandated to act on behalf of the company are controlled by the wrongdoers, it would be almost impossible for such organs to act in the best interest of the company in situations where the best interests of the company require that the organs concerned should institute legal proceedings on behalf of the company. The second challenge flows from the 'ratification rule' which provides that members of a company may, during the general meeting, ratify the acts or omissions which are the subject of the derivative suit. It is arguable that the 'ratification rule' could serve to limit the scope of derivative actions severely as most wrongs suffered by a company are ratifiable by members during the general meeting.[10] It is these concerns that led to the subsequent enunciation by the courts of specific circumstances where individual shareholders can be allowed to bring a derivative action on behalf of the company.

While the exceptions to the rule were developed in various cases, Jenkins LJ, in *Edwards v Halliwell,*[11] summarised the exceptions under three limbs thus:

> The cases falling within the general ambit of the rule are subject to certain exceptions...in cases where the act complained of is wholly *ultra vires* the company, the rule has no application because there is no question of the transaction being confirmed by any majority… where what has been done amounts to what is generally called in these cases a fraud on the minority and the wrongdoers are themselves in control of the company, the rule is relaxed in favour of the aggrieved minority who are allowed to bring what is known as minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue…the rule did not prevent an individual member from suing if the matter in respect of which he was suing was one which could validly be done or sanctioned, not by a simple majority of the members of the company or association, but only by some special majority…[12]

Each of these exceptions and an additional one not discussed in the above-mentioned case excerpt deserve particular mention.

9 Kershaw D, *Company law in context: Text and materials,* 2ed, Oxford University Press, Oxford, 2012, 602.
10 Kershaw, *Company law in context,* 602.
11 [1950] 2 All ER.
12 *Edwards v Halliwell* [1950] 2 All ER.

Ultra vires *acts*

This exception provides that while a company, through the general meeting of shareholders, can ratify the acts of directors, the ratification cannot be extended to acts that are outside the scope of the company's powers as per its constitutive documents. Consequently, members of a company are allowed to bring derivative actions provided they can establish that the act complained of is outside the scope of what is permissible under the company's constitutive documents.[13]

Requirement of a special majority

This exception arises where a company's constitutive documents provide for a special majority approval before the company can undertake certain actions. Where such actions are undertaken without a special majority, an individual shareholder may institute a suit in his/her own name for the violation of the company's constitution. It is important to note that a simple majority will not suffice to sanitise an act which requires approval by a special majority.

Fraud by those in control

Just as was the case with *ultra vires* acts, fraud cannot be ratified by the company. Where those in control of the company commit fraudulent acts against a company, it is arguable that by virtue of their control over the company, the company will not institute proceedings for the fraudulent acts committed against it. Consequently, the exception allows a member of such company to institute a derivative claim on behalf of the company. In *Prudential Assurance Company v Newman Industries,*[14] the UK Court of Appeal stated that the issue of fraud against the company could be considered where it was established that the board of the company was under the control of fraudsters.

The personal rights exception

The personal rights exception arises where a company infringes the rights of a member or members of the company where such rights are provided for by

13 See *Parke v The Daily News Ltd* [1962] Ch 927 and *Simpson v Westminster Palace Hotel Co* (1860) HL Cas 712. Both cases are illustrative of the fact that *ultra vires* acts could not be ratified by a company.

14 [1980] 2 All ER 341.

the company's constitution. In such instances, as the company is unlikely to bring a suit on behalf of the aggrieved members, an individual shareholder may institute proceedings against the company either on his own behalf or on his own behalf and on behalf of all other shareholders whose rights have been infringed by the company.[15]

The four common law exceptions to the rule in *Foss v Harbottle* also found enunciation in the jurisprudence of Kenyan courts. This was especially due to the fact that it was not until 2015 that Kenya codified derivative claims through the enactment of the Act. While the historical appraisal largely focuses on the formulation and development of the rule and its exceptions in the UK, a brief discussion on how Kenyan courts have applied the rule and its exceptions in the years preceding the enactment of the Act is important. This is because it provides the background against which the codified derivative action is evaluated.

Interpretation and application of the rule in *Foss v Harbottle* and its exceptions in Kenyan courts

Kenyan courts have over the years affirmed the rule in *Foss v Harbottle*, as well as its exceptions. While there are few if any cases that have been decided on the statutory derivative claim as provided for in the Act, there exist numerous court decisions based on common law principles. This section uses a number of such cases illustratively.

In *Dr Jane Wambui Weru v Overseas Private Investment Corporation*,[16] the Court, in affirming both the proper plaintiff principle and the internal management rule held as follows:

> By derivative suits, the minority shareholder(s) feeling that wrongs have been done to the company which have not been rectified by the internal mechanisms…because the majority shareholders are in control of the company, come to court as agents of the wronged company to seek relief(s) for the company itself, all the shareholders including the wrongdoers, and not for the personal benefit of suing the minority shareholders…it is a cardinal principle in company law that it is for the company and not for the individual shareholder to enforce rights and actions vested in the company…mere irregularity in internal running of a company cannot be a basis for one to bring a derivative suit for such can be rectified by a vote/

15 See for instance, *Pender v Lushington* (1877) 6 Ch D and *Wood v Odessa Waterworks Co* (1889) 42 ChD 636. In both cases, individual shareholders were able to institute proceedings against the companies which had infringed their rights.

16 [2012] eKLR.

> resolution at the company's meetings and if a shareholder contemplates using a personal claim of infringement of his rights, then a derivative suit will be of no avail as the relief must be for the benefit of the company.

In *Atlaf Abdulrasul Dadani v Amini Akberazi Manji & 3 Others,* (the Dadani Case),[17]the Court held as follows:

> If due to an illegality the shareholder perceives that the company is put to loss and damage but cannot bring an action for relief in its own name, such a shareholder can bring an action by way of derivative suit.

Charles Meto v Amos Kosgey & 3 Others[18] is illustrative of the principle that leave to bring a derivative claim before the courts will only be granted where the alleged wrong was suffered by the company and not the individual shareholder. In this case, the Court dismissed the plaintiff's application for leave to institute a derivative action on account of the fact that the plaintiff was not complaining that the company had been wronged. As per the judge's examination of the evidence adduced, the plaintiff only appeared to be at best alluding to the fact that the company was used by his fellow shareholders as a vehicle to defraud him. Consequently, the Court dismissed the plaintiff's claim as it could not meet the threshold required to grant leave to commence a derivative action.

In the absence of a specific law governing the procedure on instituting a derivative claim, Kenyan courts have sought to explain the procedure to be followed when an aggrieved shareholder seeks to bring a derivative claim. The position of the courts was that in seeking the leave of the court to institute the derivative action, the plaintiff must first demonstrate that he has *locus standi* to institute the proceedings. Additionally, the plaintiff must also establish a *prima facie* case. These requirements are illustrated in *CMC Holdings Limited* case where the learned judge held that:

> …the long-standing practice, and which I find reasonable, has always been that before a derivative action is filed, the applicant brings to court an *ex parte* application for leave, supported by a detailed affidavit so as to demonstrate that he has *locus standi* to institute such an action and that he has a *prima facie* case.[19]

The holding above also highlights the fact that the application for leave to commence a derivative claim should be brought *ex parte* rather than *inter partes*. Arguably, the rationale for the *ex parte* application is that by their very nature, derivative claims entail allegations that directors have committed wrongs against

17 [2004] eKLR.

18 [2014] eKLR.

19 *In the Matter of CMC Holdings Limited* [2012] eKLR.

the company. Thus, where the application for leave is heard *inter partes* rather than *ex parte*, there is a likelihood that the directors of the company concerned may try to scuttle the application. Once leave is granted, the application and the plaint are served on the company as well as the directors who allegedly occasioned the loss complained of.

However, in the *Jane Wambui* case discussed above, the Court, in addressing the procedure on how to bring a derivative claim, stated as follows:

> The permission or leave to continue with a derivative action is sought after the suit has been instituted…the plaint plus the application to continue with the derivative action must be served before the application is heard and the application had to be heard *inter partes* because the plaintiff has to demonstrate a *prima facie* case by the company against the wrong doing directors and that the plaintiff should bring the case before the permission, the proceedings are virtually stalled.[20]

Similarly, in the *Dadani* case discussed above, the Court affirmed the position that one must institute the suit before seeking the leave of the court to continue with a derivative action.

The *CMC* and *Jane Wambui* cases point to different approaches with regard to when one should seek leave of the court to institute the derivative claim. Additionally, while in the former the court stated that the application is made *ex parte*, in the latter, it was held that the application should be heard *inter partes*. It is noteworthy that the Court in the *CMC* case decried the lack of a statutory provision addressing the issue of the time of making the application for leave to institute a derivative claim. In addition to evaluating other areas of concern with regard to the statutory derivative claim, the discussion on the statutory derivative claim in the subsequent parts of this article also examines the extent to which the Act has addressed the concerns emerging from the different holdings in the *CMC* and *Jane Wambui* cases.

The courts have also defined the evidentiary threshold required to establish the *prima facie* case in order to found a derivative suit where the plaintiff seeks to rely on the grounds of fraud. In *Tash Goel Vedprakash v Moses Wambua Mutua and Rabbit Republic Limited*,[21] the Court held that, 'At the stage of leave, there is no requirement that full proof of fraud be established by the applicant. What is needed is *prima facie* evidence of fraud on the company.'[22]

20 [2012] eKLR.

21 [2014] eKLR.

22 *Tash Goel Vedprakash v Moses Wambua Mutua and Rabbit Republic Limited* [2014] eKLR.

Gikonyo J, in explaining what amounts to fraud in seeking to be granted leave for an application for a derivative action, expressed himself thus:

> Fraud covers even those wrongs which the directors commit for the benefit of other people. Any fraudulent transaction by the board which is calculated to benefit others or one or more of the board members, and on which the company has failed or the directors have deliberately refused to take action entitles a minority shareholder to file a derivative suit on behalf of the company.[23]

A further demonstration of the evidentiary threshold to establish a *prima facie* case in order to found a derivative claim is illustrated in the *Dadani case* where the High Court held that in a situation where the plaintiff shareholder owns 50% of the shares in a company and thus such shareholder cannot establish that the 'majority' shareholders are in control of the company, all that such a plaintiff has to do in order to be allowed leave to institute a derivative action is to demonstrate that a board resolution was not possible.[24] Once this is established, the plaintiff will have demonstrated his *locus standi* to institute the derivative action. In *David Langat v St Luke's Orthopaedic & Trauma Hospital Limited & 2 Others,*[25] the issue for determination before the court was whether a shareholder who held 50% of the shares in a company can be granted leave to institute a derivative action as one of the exceptions to the rule in *Foss v Harbottle*. The Court held that the need to establish a majority or minority before being granted leave to institute a derivative action may lead to injustice. According to the Court, the paramount function of the court is to ensure that justice is done. Consequently, the Court stated that it would allow leave for the applicant to institute the derivative claim since despite owning 50% of the shares of the company, the applicant had demonstrated that the company had been injured by the acts of one of its shareholders,

> The position which a shareholder in a 50:50 situation finds himself in is no less different from the position that a minority shareholder finds himself in. A minority shareholder is handicapped and frustrated because he can pass no resolution to benefit the company. His views are prone to being trampled upon by the majority and he finds himself hamstrung, unable to do anything on behalf of the company. That position is similar to that in which a person holding 50:50 shareholding finds himself. He is unable to pass any resolution because the other half must accede to it. If the other half does not permit the resolution to pass then the one shareholder is stuck, just as he would be stuck if he was a minority…in our present case, there is strictly no majority and no minority. The person against whom the action is intended is, however, in *de facto* control of all resolutions, including resolutions to sue. There

[23] *Silouanos Samuel Mwangi Gichanga v Makarios Tillyrides & 5 Others* [2015] eKLR.

[24] [2004] eKLR.

[25] [2013] eKLR.

is no other way that Sunrise Ltd (the company) can put forth any claims separate from having a derivative action filed on its behalf.[26]

The discussion on the interpretation and application of the rule in *Foss v Harbottle* and its exceptions by Kenyan courts illustrates that the courts have by and large stuck to the parameters that were established in the leading cases on the topic in the UK where the principles were first developed. The next section discusses the statutory derivative claim and the extent to which it is similar to or departs from the common law principles on derivative action.

An analysis of Part XI of the Companies Act 2015

As indicated earlier, this section discusses statutory derivative claims as provided for in the Act. Unlike the repealed Companies Act,[27] the Act provides for derivative action thus codifying what were previously common law principles.[28] It is arguable that codification of derivative actions is aimed at addressing some of the concerns that had been raised about the rule in *Foss v Harbottle* and its various exceptions.[29] As such, this section primarily seeks to evaluate the extent to which codification of derivative action may provide clarity on the concerns that have been raised about the common law principles on derivative action. Since Part XI of Kenya's Act was borrowed from and is therefore similar to Part 11 of the UK Act, the discussion in the section weaves in relevant criticisms that have been advanced against the statutory derivative action in the UK.

The Act defines a derivative claim as proceedings brought by a member of a company in respect of a cause of action vested in the company and seeking relief on behalf of the company.[30] According to this definition, there are certain conditions that must be present in order to institute proceedings based on a derivative claim. First, the claim must be by a member of the company. In other words, persons who are not members of the company cannot bring a derivative claim before the courts. It is important to note that it is immaterial whether the person seeking to bring the derivative claim became a member of the company

26 [2013] eKLR.

27 Chapter 486, Laws of Kenya.

28 See generally Part XI, *Companies Act* (Act No. 17 of 2015)

29 For instance, Julia Tang describes the common law derivative action, which was also applicable in Kenya, as obscure, complex, rigid, old-fashioned and unwieldy. See Tang J, 'Shareholder remedies: Demise of the derivative claim' 1 *University College London Journal of Law and Jurisprudence,* 2 (2012), 178.

30 Section 238(1), *Companies Act* (Act No. 17 of 2015).

before or after the cause of action arose.[31] Second, the cause of action must be vested in the company. Put differently, while it is a member who brings the derivative claim, such member will be seeking a remedy on behalf of the company for a wrong that was suffered by the company. Consequently, any awards made by the court will go to the company itself and not to the member who brought the derivative claim. At best, the member may only be indemnified by the company for the costs of the suit. The third condition that must be present in order to found a derivative claim is that the relief sought must be on behalf of the company. The member bringing the derivative action must not have any ulterior motive in bringing the claim. His/her claim must be solely to seek relief on behalf of the company.

The Act states that a derivative claim may only be brought in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.[32] However, the right to institute a derivative claim by a member of the company is not absolute as the Act requires one to seek leave of the court in order to continue with a derivative claim.[33] From the above provisions, it is deducible that while the Act enumerates the grounds upon which derivative actions can be instituted, it also addresses the inherent risk of instituting multiple suits by aggrieved shareholders. This is achieved through providing for the establishment of a *prima facie* case as a control mechanism to ensure that only deserving cases proceed to the substantive claim of the derivative action.

By requiring the claimant to apply to the court in order to be allowed permission to continue with a derivative claim, the Act seeks to respond to the challenge posed by the different approaches adopted by the courts with regard to the time of seeking leave of the court and whether the application should be heard *inter partes* or *ex parte*. The answer to the latter concern is more straightforward as the Act seems to favour an *ex parte* application. This flows from the fact that the relevant sections of Part XI of the Act only state that the applicant should seek leave of the court to continue with the derivative claim and that upon evaluating the application, the court may make any orders it deems fit including dismissing or allowing the claim.[34] There is no requirement on the company or its directors to enter any appearance at this point. The company is only to enter appearance

31 See section 238(5), *Companies Act* (Act No. 17 of 2015).
32 Section 238(3), *Companies Act* (Act No. 17 of 2015).
33 Section 239(1), *Companies Act* (Act No. 17 of 2015).
34 See generally section 239, *Companies Act* (Act No. 17 of 2015).

where the application for leave is successful and the court has given direction on the evidence to be produced by the company.[35]

However, the Act fails to address the time at which the application should be made.[36] Consequently, the Act does not provide a chiasmus to the various approaches adopted by the courts in such cases as the *CMC, Jane Wambui* and *Dadani*. Perhaps guidance can be sought from the UK legislation. After enacting the Companies Act 2006, the UK also amended its Civil Procedure Rules by inserting a new section, 19C, which addresses derivative claims. The section not only explicitly provides for an *ex parte* hearing for a derivative claim but also addresses the issue of the time when the leave is to be sought.[37] Accordingly, the court first dispenses with the application and only where leave is granted will the claimant proceed to serve the company with the plaint and the permission for leave. It remains to be seen whether Kenyan courts will stick to this approach as happened in the *CMC case*. Perhaps appropriate amendments to the Civil Procedure Rules 2010 may address the question of the time of making the application with a degree of finality.

A member of a company can also apply for permission to continue a claim brought by the company on the grounds that the manner in which the company commenced or continued the claim amounts to an abuse of court process; the company has failed to prosecute the claim diligently and it is appropriate for the member to continue the claim as a derivative claim.[38]

The Act also sets out a number of factors that courts should consider in deciding whether to grant an applicant leave to continue with the derivative claim. The factors include: whether the member seeking to continue the action is acting in good faith; the importance that a person acting in accordance with his duty to promote the interests of the company would attach to continuing with the derivative claim; whether the breach of duty is likely to be ratified by the company; whether the company has decided not to pursue the claim and whether the breach complained of could be pursued in the member's own right rather than on behalf of the company.[39]

35 See section 239(3)(a), *Companies Act* (Act No. 17 of 2015).
36 See generally section 239, *Companies Act* (Act No. 17 of 2015).
37 See generally Part 19, Practice Direction 19C on Derivative Claims, Civil Procedure Rules (Rules and Directions) (UK).
38 Section 240, *Companies Act* (Act No. 17 of 2015).
39 Section 241 (2), *Companies Act* (Act No. 17 of 2015).

The Act remedies the situation where an uninterested member, acting under the orders of the management, would institute a derivative claim so as to bar other genuinely interested members from instituting the derivative claim. The Act does this by providing that a member can apply for permission to continue a derivative claim brought by another member.[40] Such an application should be based on any of the following grounds: that the manner in which the proceedings were commenced or continued amounts to an abuse of the process of the court; that the claimant has failed to prosecute the claim diligently, and that it is appropriate for the applicant to continue the claim.[41]

The Act also provides for instances where the courts should deny a member's application to continue a derivative claim. These include: where the actual or proposed breach of duty has been authorised or ratified by the company, or where a person exercising independent judgment would not seek to continue the claim.[42]

An analysis of the various provisions of Part XI of the Act reveals that the provisions are essentially a codification of the common law principles on derivative action and its exceptions. While it is hoped that the codification would address the criticisms that have been levelled against the rule in *Foss v Harbottle* and its exceptions, there are still a number of gaps which may serve to have a negative impact on the effectiveness of the statutory derivative action. A comparative analysis with a country that has a more flexible approach to the derivative claim lays a good basis for discussing the gaps in derivative action as provided in the Act. The next section discusses derivative action in the USA.

Derivative action in the USA

While the various states comprising the USA have different laws on various matters, with regard to derivative action, civil procedure and laws governing corporations mirror the Federal Rules of Civil Procedure and the Model Business Corporations Act which is the basis for corporate law in most US states. Accordingly, this article limits itself to a comparative analysis with the Federal Rules of Civil Procedure and the Model Business Corporations Act.

40 Section 242 (1), *Companies Act* (Act No. 17 of 2015).
41 Section 242 (2), *Companies Act* (Act No. 17 of 2015).
42 Section 241 (1), *Companies Act* (Act No. 17 of 2015).

The statutory derivative action in the USA, while directly traceable to common law derivative action, differs significantly from the latter. Unlike common law derivative action as well as the statutory derivative action in Kenya and the UK, one does not have to seek leave of the court in order to institute derivative action proceedings. Accordingly, claimants seeking to bring derivative claims in the USA do not face the evidential burden that their counterparts in countries such as Kenya and the UK face in meeting the evidential threshold required to establish a *prima facie* case in order for the court to grant leave to proceed with the substantive claim.

As discussed earlier in this contribution, a member who seeks to institute a derivative action in Kenya and the UK is disadvantaged as far as the acquisition of relevant information is concerned. Often, such information is in the possession of the directors of the company who may not be willing to release it as it could be used against them in the derivative action suit. Consequently, a member of a company who wishes to use this information to institute derivative action proceedings may not be able to access it with the result that his/her chances of meeting the evidential threshold required to establish a *prima facie* case will be severely limited. This diminishes in turn the prospects of the court granting such a party leave to institute the substantive claim. In this regard, the 'no leave' requirement espoused in the USA Federal Rules of Civil Procedure is a plausible option as regards enhancing the potency of derivative action as a tool for preventing loss to companies from acts or omissions of the company's directors.

The general requirements that a party who seeks to institute derivative action proceedings in the USA must meet include: fair and adequate representation of the interests of members who are similarly situated in enforcing the rights of the company;[43] membership of the company at the time the transaction complained of arose, and demonstration of any steps that the party took in efforts to have the wrong complained of addressed by the directors of the company.[44] The steps entail making a written demand to the directors requiring them to take the necessary corrective action. Where such steps are unsuccessful, the complaint must state the reasons for not obtaining the action. Where the party completely fails to make any effort, the complaint must state the reasons for not making the effort.[45] Additionally, a party will only be allowed to commence derivative action proceedings after 90 days from the date s/he made the written demand to the

43 Rule 23.1, *Federal Rules of Civil Procedure* (USA); Section 7.41, *Model Business Corporations Act* (USA).

44 Rule 23.1, *Federal Rules of Civil Procedure* (USA); Section 7.41, *Model Business Corporations Act* (USA).

45 Rule 23.1, *Federal Rules of Civil Procedure* (USA).

company.[46] The requirement for the 90 days period need not be met in instances where the company has informed the party making the demand that the demand has been rejected or where the company may suffer irreparable loss if the action is not instituted before the 90 days are over.

The requirements highlighted above reflect a more flexible approach to derivative actions than the requirements to institute derivative actions under both common law and the statutory derivative action in Kenya and the UK. A key feature of statutory derivative action in the USA that is not present in both Kenya and the UK is the requirement of making a written demand before one can begin to institute the derivative proceedings. The written demand enables companies to take remedial action to address the concerns of the aggrieved shareholders. Effectively it serves as a filter to ensure only the deserving cases proceed to the courts. This is unlike the situation in Kenya and the UK where an aggrieved shareholder has no duty to seek internal remedies from the company's directors but can proceed directly to the court to commence the process of seeking redress for the wrong suffered by the company.

Consequently, the statutory derivative action in the USA is more effective in enabling shareholders of a company to prevent loss to a company due to the misadventures of directors. This is because it affords an aggrieved shareholder the opportunity to seek an internal remedy and where this is rejected or frustrated, then the shareholder can proceed to court, armed with the company's rejection of the written demand. It is arguable that a derivative claim instituted against such a background stands a higher chance of success than a claim where a member proceeds directly to the court without seeking internal remedial action from the company. Additionally, the requirement for written notice serves as a filter mechanism to reduce the number of derivative action suits in courts as many potential suits are resolved at the company level. This is different from Kenya and the UK where all potential derivative action suits end up before the courts which then use the requirement to establish a *prima facie* case as a filter mechanism to determine which suits merit a substantive trial.

The Model Corporations Act further provides that upon the termination of any derivative action proceedings, the court may order the company to pay the plaintiff reasonable expenses (including advocates' fees) incurred in the proceedings if it finds that the proceedings have resulted in a substantial benefit to the

46 Section 7.42, *Model Business Corporations Act* (USA).

company.[47] Similarly, where the court finds that the plaintiff instituted the proceedings without reasonable cause or for an improper purpose, it may order such plaintiff to pay any defendant to the proceedings reasonable fees that were incurred in the litigation. While the latter provision is also available, albeit through the court's discretion, under the statutory derivative action in Kenya and the UK, the provision to reimburse the plaintiff for the costs incurred in instituting the derivative claim is not available under the Act. This may dissuade aggrieved shareholders of a company from instituting derivative action proceedings as they have to meet all the costs of the suit without any possibility of recovering the expenses from the company even when the proceedings result in a substantial gain to the company. This may lead in turn to instances where a company continues to suffer loss as a result of the actions of directors, yet such actions could have been curtailed through the institution of derivative proceedings.

The comparative analysis in this section identifies the relative strengths of statutory derivative action in the USA that have arguably made it more effective than common law derivative action and the statutory derivative action in Kenya. The discussion highlights the inadequacies in statutory derivative action as provided for under the Act. The next section builds upon this discussion as it examines the gaps in derivative action as provided for under the Act.

Gaps in derivative action as provided for in the Companies Act, 2015

This section discusses gaps in derivative action as provided for in the Act. The discussion is undertaken under four limbs, namely: the requirement to establish a *prima facie* case, the duty to promote the success of a company, the good faith requirement and the costs of the derivative action litigation.

Establishing a prima facie *case*

The court is to dismiss an application for a derivative claim if the supporting evidence filed by the applicant does not disclose a *prima facie* case for giving permission.[48] It is arguable that although well intentioned, the *prima facie* case obligation may impose an unnecessary hurdle for applicants.[49] If the intention

47 Section 7.46, *Model Corporation Act* (USA).
48 Section 239(2), *Companies Act* (Act No. 17 of 2015).
49 Tang, 'Shareholder remedies', 181.

of providing derivative actions in statute was to create 'modern, flexible and accessible criteria',[50] the inclusion of a *prima facie* case has not assisted in delivering such criteria. Moreover, the *prima facie* obligation may act as a deterrent for potential applicants.[51]

A further challenge that flows from the *prima facie* requirement is that a member of a company who seeks to bring a derivative claim may not be in a position to obtain all the relevant information that might form the basis of his evidence to establish a *prima facie* case. This is due to the fact that such information may be in the possession of directors who may not be enthusiastic to share it with a member who in essence intends to use the information to sue them. Additionally, while the Act provides for the need to establish a *prima facie* case, it does not provide any guidance on the evidentiary threshold that a person seeking to bring a derivative claim must meet in order to establish the *prima facie* case. While the requirement for establishing a *prima facie* case was intended to guard against frivolous suits, the uncertainty with regard to the evidentiary threshold to be met in establishing a *prima facie* case as well as the fact it may be difficult for a member to obtain the required information to meet the evidentiary threshold may serve to deter potential applicants from instituting derivative actions.

Duty to promote success of the company

The Act provides that a director in a company shall exercise independent judgement.[52] The repealed Companies Act did not have this provision. If the decisions of directors, in light of the business judgement rule, are to remain centre stage in the interpretation of Section 144, this can 'operate to abrogate the court's discretion in favour of that of the company's management, who could effectively scupper any derivative claim.'[53] The business judgement rule is a legal principle that makes officers of a company immune from liability for loss incurred in corporate transactions that are within their authority and power to make when sufficient evidence demonstrates that the transactions were made in good faith.[54] This section therefore touches on the concerns that deferring to the judgment of the company's management will hinder the pursuance of derivative

50 See UK Law Reform Commission, *Shareholder remedies report*, 1997, 6.
51 Tang, 'Shareholder remedies', 181.
52 Section 144, *Companies Act* (Act No. 17 of 2015).
53 Lowry J and Reisberg A, *Pettet's company law: Company and capital markets law,* 3ed, Pearson Longman, Harlow, 2009, 239.
54 Lowry and Reisberg, *Pettet's company law,* 239.

claims.[55] This is because few directors will pursue a derivative claim for reasons such as reputational damage to the company, high financial costs and disruption to management but will now be able to justify their reasons by reference to their good faith judgment under Section 144. The interpretation of Section 144 ultimately lies with the courts whose role is to exercise tight judicial control.[56]

The case of *Lesini and Others v Westrip Holdings Ltd and Others*[57] is significant for clarifying Section 241(1)(a), which is to the effect that the court will not grant a member leave to institute a derivate claim if a director exercising independent judgement does not institute such a claim, applies 'only where the court is satisfied that no director acting in accordance with his or her duty to promote the success of a company, would seek to continue the claim'.

Further, in *Lesini,*[58] Lewison J, while examining whether there was a mandatory bar to instituting a derivative claim, provided a list of factors which a director acting in accordance with Section 172 of the UK Act, which is similar to Section 144 of Kenya's Act, would consider. This includes factors such as the size of the claim, cost of proceedings, disruption to the company's activities and company's ability to fund the proceedings. Though not a Kenyan case, the *Lesini* case may prove useful for lawyers and applicants seeking an indication of what Kenyan courts may deem important as factors for directors to consider before declining to institute a suit.

It may take many more years before a substantive body of case law on the interpretation of Section 144 within Section 241(1)(a) is built. The courts will initially have to grapple with the Act's lack of clarity until a proper footpath is built.

Good faith

The applicant's good faith in bringing a derivative claim is one of the discretionary factors the courts must take into account in considering whether to give permission.[59] Unfortunately, 'good faith' is not defined under the Act. This is regrettable because it may lead to uncertainty in the application of the test during the permission stage and therefore 'to complexity of case law.'[60]

55 Lowry and Reisberg, *Pettet's company law,* 187.
56 HL Deb 27 February 2006, vol 679, col GC5 (Lord Goldsmith).
57 [2009] EWHC 2526 (Ch).
58 [2009] EWHC 2526 (Ch).
59 Section 241(2)(a), *Companies Act* (Act No. 17 of 2015).
60 Poole J and Roberts P, 'Shareholder remedies: Corporate wrongs and the derivative action' *Journal of Business Law* (1999), 107.

However, the UK Law Reform Commission on Derivative Action stated that it favoured the test of 'honestly and with no ulterior motive' although it recognised that an applicant who may benefit commercially and thus has an ulterior motive, may still be considered by the courts as an appropriate person to bring the action.[61] This follows the general proposition that courts wield considerable discretion in determining whether a derivative claim should proceed or not. An explicit definition may have been restrictive.[62] Nevertheless, given the courts penchant for dismissing derivative claims, it is questionable whether the court's exercise of discretion would be any better. It may be the lesser of two evils. The Law Commission considered that good faith should not be a prerequisite for leave.

Barrett v Duckett,[63] though decided before the enactment of the UK Act, is instructive in construing the application of good faith under Kenya's Act. The Court of Appeal denied the applicant *locus standi* as she had an ulterior motive in bringing the claim, namely, her personal grievances against the defendants. She was not pursuing the derivative claim *bona fide* on behalf of the company. In particular, evidence of the applicant acting partially towards her daughter by not initiating litigation against her stood against the applicant. It is submitted that the Court of Appeal came to the right conclusion as there was strong evidence that the applicant was not considering the position of the company but her own personal circumstances.

However, if the good faith test were to be satisfied only in cases where there was no ulterior motive, then derivative claims would be few and far between.[64] This was acknowledged by Sir Mervyn Davies (sitting as a High Court Judge) when he stated,'[n]o doubt there is ill-feeling between [the parties] but that in itself cannot debar [the applicant], were it to do so most derivative [claims] would be frustrated.'[65]

Perhaps good faith is about the honest belief of the applicant and whether the applicant has a collateral purpose that amounts to an abuse of process. The Australian case of *Swansson v R A Pratt Properties Pty Ltd*,[66] where the court favoured this test could be used persuasively. Ulterior motive or collateral purpose clearly has a role to play in the good faith test under Section 241(2)(a).

61 UK Law Reform Commission, *Shareholder remedies report*, 95, para 6.75.
62 Poole and Roberts, 'Shareholder remedies', 107.
63 [1995] BCC 362.
64 Poole and Roberts, 'Shareholder remedies', 107.
65 *Barrett v Duckett* [1993] BCC 778, 786.
66 [2002] NSWSC 583.

Lewison J, in the *Lesini* case, stated that an applicant would not be disqualified from bringing a derivative claim even if there are other benefits which the applicant would derive from the claim.[67] In the case, the dominant purpose of the claim was to benefit the company. Therefore, the existence of a collateral purpose, namely a benefit of an indemnity from a third party, did not establish lack of good faith. This benefit was not enough to convince Lewison J that the applicant lacked good faith.

Distinguishing between a dominant purpose and collateral purpose can be a difficult exercise.[68] This is reminiscent of the problematic principal or larger purpose exceptions in the law of financial assistance. Significant interplays between the different purposes often make it difficult to distinguish between the primary and secondary purpose. This is because disentangling the numerous strands can be evidentially difficult and even more so in allocating a relative weighting to each strand. The applicant's good faith test under Section 241(2)(a) is best encapsulated by the statement of Lewison J, that 'if the [applicant] brings a derivative claim for the benefit of the company, he will not be disqualified from doing so if there are other benefits which he will derive from the claim.'[69] The main prevailing advantage of pursuing a derivative claim has to flow to the company, while any other minor associated benefits that an applicant derives will be permissible.

Costs

The Act does not state who will incur the costs of a derivative claim.[70] Without prospective certainty as to whether the courts will order the company to pay the members' costs of litigation, members may be deterred from pursuing derivative claims.[71] Furthermore, members may be at risk of paying litigation expenses as well as the legal expenses of the defendant if the claim is unsuccessful. The use of derivative claims will rarely be rational in light of this deadly mix of financial disincentives.[72] Reducing costs is therefore crucial in overhauling the derivative claim and increasing the paucity of litigation. An alternative may also

67 [2009]EWHC 2526 (Ch).

68 Poole and Roberts, 'Shareholder remedies', 107.

69 [2009] EWHC 2526 (Ch).

70 See generally Part XI, *Companies Act* (Act No. 17 of 2015).

71 Poole and Roberts, 'Shareholder remedies', 107.

72 Reisberg A, *Derivative actions and corporate governance: Theory and operation*, Oxford University Press, Oxford, 2007, 222.

be where other concerned bodies take up the costs of the derivative claim rather than leave the aggrieved member of a company to bear the costs.[73]

Conclusion

While the statutory derivative action addresses some of the criticisms levelled against the rule in *Foss v Harbottle* and its exceptions, it is by and large a restatement of the common law principles that emanated from the landmark case. As evidenced by both the discussion of the cases preceding the enactment of the Act and the statutory derivative action under the Act, the common strand in both regimes is the preeminent position of judicial discretion as far the remedy of derivative action is concerned. While the common law principles arguably gave courts wider latitude in which to exercise their judicial discretion, the statutory derivative claim narrows the scope of the courts' discretion through providing confines in which such discretion is to be exercised. Therefore, one can only hope that the restrictive standing requirements in *Foss v Harbottle* will be replaced in effect by judicial control over the streamlined list of factors under Part XI of the Act. The article concludes that the statutory derivative claims/ actions are not necessarily more practicable, efficient and effective than the common law principles on derivative action. At best, the statutory derivative claim only gives greater power to the courts over derivative claims. As currently framed, statutory derivative action may not have the requisite potency to enable shareholders redress loss to a company due to failure by its directors to discharge their duties.

73 For instance, Reisberg notes that in Israel, the Israeli Securities Exchange announced that it would shoulder the financial burden of derivative claims in cases it believed were of general importance to the public. See Reisberg A, 'Shadows of the past and back to the future: Part 11 of the UK Companies Act 2006 in action' 6 *European Company and Financial Law Review*, 2-3 (2009), 219, 239.