PROTECTION OF DERIVATIVE ACTION CLAIMS UNDER THE COMPANIES ACT, 2015

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DECLARATION

I hereby declare that this Project Paper is my original work and that it has been submitted for award of a degree or any other academic credit in this or any other University.

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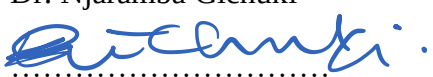
Signature: 

Date 23/11/2021

DEDICATION

To my parents Mr.David Kenei Ndoigo and Mrs.Ann Chelagat Kenei, I am forever grateful for your continued support .To my siblings Valencia Ndoigo,Kimberly Ndoigo and Teddy Ndoigo you challenge me every day to work harder.

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ABSTRACT

Derivative action claims are crucial in promoting the protection of the minority shareholders rights, and it is equally a necessary tool in promoting good corporate governance in a company. The Companies Act of 2015 provides for provisions which govern the institution and the principles applicable in derivative action claims. This study assesses the effectiveness of the provisions in the protection of minority shareholders while at the same time ensuring that the best interest of the company is upheld.

This study traces the origin of the concept of derivative action claims from the case of *Foss vs Harbottle* and subsequently the common law principles. The development of the principles of derivative action claims are assessed with a view of evaluating whether the codification of the said principles into the Companies Act have been effective in promoting the objective of derivative Action claims.

This study advances the argument that the provisions on derivative action claims under the Companies Act of 2015 are not as effective in the protection of the best interest of the company and the minority shareholders and in analyzing the provisions of the Companies Act of 2015 the study will provide practical solutions.

TABLE OF CASES

American Cyanamid v Ethicon [1975] AC 396

Amin Akberali Manji& 2 Others vs Altaf AbdulrasulDadani& Another [2015]eKLR

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Jane Wambui Weru V Overseas Private Investment Corporation & 4 Others [2012] eKLR

Lesini v Westrip Holdings Ltd[2010] BCC 420

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Mission Capital plc v Sinclair [2008] All ER (D) 225

Nurcombe v Nurcombe (1984) 1 BCC 99,269

Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2) [1982] Ch 204.

Re Kambrook Manufacturing LtdHC Wellington M505/95, 23 May 1996

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Wallersteiner v Moir [1974] 1 WLR 991

Vatcher v Paull [1915] AC 372

TABLE OF STATUTES

Australian Corporations Act of 2001

United Kingdom's Companies Act of 2006, Chapter 46

Practice Directions on Derivative Claims, Civil Procedure Rules (Rules and Directions) (UK)

New Zealand's Companies Act of 1993

Civil Procedure Act, Kenya

Companies Act of 2015, Kenya

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

One of the most common types of representative lawsuits initiated by shareholders is a derivative action claim. Derivative action claims can be referred to as claims brought by shareholders on behalf of the corporation. The word "derivative" is derived from the idea that a company's right of action stems from its ownership. Officers and directors are frequently included as defendants in these cases. However, a third party who was an accomplice to the crime of a director of the corporation might also be held liable. Thus, a derivative action protects the company and its shareholders when management fails to fulfill its responsibilities as part of the corporation's overall governance structure.

In Foss v Harbottle, 1843, the Court of Chancery set out the exceptions to the general rule, which led to the development of the theory. There was precedent in this case for the "appropriate plaintiff" theory, which holds that the rightful plaintiff in a lawsuit against another party is the firm that brought it. Moreover, Sir James Wingram in Foss stated that the Corporation can either file the claim in its own name or in that of a representative chosen by law to represent the company. Because of the court's pronouncement, the court would not accept claims brought by the firm's members on behalf of the corporation. By applying this idea one can avoid several claims brought by different members of the firm and a situation where a company has to litigate matters that should be resolved through a settlement.[1]

[1] Maloney, M. A, 'Whither the Statutory Derivative Action.' *Canadian Bar Review*, vol. 64, no. 2, June 1986, p. 309-341.

This principle was affirmed in *Edward v. Halliwell* [2]where the Court stated that the proper plaintiff is the company itself and where the wrong can be made binding on the company no individual member of the company can bring the suit in place of the company.[3] Further to the above, in *MacDougall v Gardiner* [4]the court stated that if the action raised has been ratified through the Company's internal mechanisms then no individual can institute the suit on behalf of the Company.

The strict application of the "proper plaintiff rule" was harsh to the minority shareholders; as a consequence, common law and case law established various exceptions to the rule.[5] The exceptions give leeway to an individual member to bring a claim in the following instances:

i. where the company enters into a transaction which is illegal or *ultravires;*
ii. where an officer purports to do through an ordinary resolution that which requires a special resolution;
iii. where individual rights of a shareholder are adversely affected by actions or inactions of officers of the company;
iv. any fraudulent activities and the company does not take the necessary step;
v. where the circumstances make it impossible for a company meeting to be called in time to redress the specific action or wrong; and
vi. where directors are might benefit in terms of profits as a result of their negligence.[6]

The above-mentioned exceptions led to the development of derivative action claims. The objectives of a derivative action are that: it serves as an avenue for shareholders to enforce their rights; secondly, they can enforce the rights of the company where the company directors or

[2]Edwards v Halliwell [1950] 2 All ER 1064.
[3] Ibid.
[4] MacDougall v Gardiner (1875) 1 Ch D 13.
[5] Supra Note 1.
[6] Ibid.

officers fail to file a claim. It is also a tool that can be used for accountability purposes.[7]This is because as stated earlier, actions can be brought against the board of directors if they have breached their duty.[8]

Derivative Action was for a long time a common law principle and it was until 2006 when the United Kingdom codified the same. [9]Other countries such as South Africa, the United States and Australia have also codified the principle in their legislations. In 2015, Kenya also codified the doctrine through the companies Act 2015. Since the enactment of the Act, it is evident through various case laws to be analyzed later in this paper that there are some loopholes in the laid down procedure for instituting derivative claims.

1.2. STATEMENT OF RESEARCH PROBLEM

Prior to the enactment of the Companies Act of 2015, Courts in Kenya relied on the exceptions to the general rule in the case of *Foss v Harbottle* in deciding derivative claims. Thereafter, the Companies Act 2015 adopted the provisions of the United Kingdom's Companies Act of 2006 and codified a two-stage process to govern the institution of derivative action claims.

However, there are still some challenges to this approach. The procedure as laid out in the Act still presents some barriers to potential claimants, and hence the goal of the Act in promoting efficiency and access to justice is not fully achieved. Firstly, the Act does not clearly set out the threshold for a prima facie case, therefore leaving it obscure and uncertain. This raises the question on whether the standard to be applied is that in *American Cyanamid v Ethicon Limited* [10]applied in granting injunctive reliefs, or a slightly lower standard. Secondly, in proving a

[7] Supra Note 1.
[8] Ibid.
[9] United Kingdom's Companies Act of 2006,Chapter 46 Sections 260-269. https://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf
[10] American Cyanamid v Ethicon [1975] AC 396.

prima facie case the Applicant could experience difficulty in accessing the relevant materials. Thirdly, the act does not outline any provisions as to indemnity cost orders.

This study examines the efficacy of the two-stage process as per sections 238 to 242 of the Companies Act 2015.[11]In so doing this study will examine the myriad of challenges a potential Applicant would face while instituting a derivative action claim in Kenya, owing to the shortcomings of the two-stage process set out under the Companies Act 2015.

1.3. JUSTIFICATION

The purpose of derivative action suits is to protect the company and the minority shareholders from the acts or omissions of directors, officers of the company or even third parties which may be detrimental to the company. Through codification of the provisions, the expectation is that the laws would be an improvement from its operation under common law. Therefore, the institution of such claims would be efficient and promote access to justice by a potential claimant.

Additionally, since the enactment of the Act, little academic literature has been written on the subject in Kenya and this begs the question as to how Kenyan Courts determine the cases since the issues not addressed in the Act are bound to arise time and again and thus this study is likely to open up valuable discussions around the subject.

1.4. AIMS AND OBJECTIVES

The overall aim of carrying out this research is to determine whether the provisions on derivative claims under the Companies Act 2015 are sufficient and effective in protecting the company and the shareholders.

[11] Companies Act 2015,Section 238-242.

The objectives of this study are:

1. To determine whether the two-stage procedure in the institution of derivative claims in Kenya is effective.
2. To assess the threshold in determining whether a potential derivative claim has satisfied the requirements of a prima facie case.
3. To recommend possible legal solutions to allow the objectives of derivative claims as envisioned in both common law and statutory law to be achieved.

1.5. RESEARCH QUESTIONS

1. To what extent is the two-stage procedure in the institution of derivative claims in Kenya effective? This question is addressed in Chapter 3 by looking at the statutory provisions relating to the process of instituting derivative claims and their development from common law as well as the issues that have arisen in recent case law.
2. What is the threshold in determining a prima facie case in derivative claims? This question is addressed in Chapters 2 and 3, focusing on common law and case law. By looking at the trajectory taken by case law, the elements that make up a prima face case in derivative claims can be glimpsed.
3. How does the process of instituting derivative claims in Kenya compare to other jurisdictions/commonwealth jurisdictions?) This question is addressed in Chapter 4, which breaks down the process of litigating derivative action claims in the UK, Australia and New Zealand and comparing the same to Kenya's Companies Act. From that comparative analysis, lessons can then be drawn as to what should be added or subtracted from the Kenyan Act.
4. What are the possible legal solutions to ensure that the aim of derivative actions as envisioned under common law and statutory law is achieved? This question is addressed in Chapter 5 by laying down recommendations, taking the preceding chapters

into account, on the specific changes that should be made to the Companies Act in order to achieve the goals and ends of statutory derivative action.

1.6. HYPOTHESES

This research is based on the following hypotheses:

a) That the procedure involved in the institution of derivative claim is key in achieving justice for the potential Applicant.

b) That the existing framework presents barriers to potential claimants which discourages institution of such suits)

c) That the existing provisions fail to achieve the objectives of a derivative claim suit as envisioned in common law.

1.7. THEORETICAL FRAMEWORK

The theoretical frameworks that will guide my paper are the Shareholder Primacy Theory, the Economic theory of Law and the theory of justice.

1.7.1 The shareholder Primacy Theory

The shareholder primacy theory was birthed in the 1970s following the rise of Chicago school of Free Market and the "Law and Economics" movement. In the 20th Century directors and managers of corporations viewed themselves as the stewards of the economy and this view slowly shifted when the "managerialist philosophy" started being viewed as being outdated and obsolete.[12] In 1976, a paper written by Michael Jensen and William Meckling[13] sparked a further discussion on the managerial philosophy and their main argument was that a company

[12] Stout, Lynn A. 'The toxic side effects of shareholder primacy.' *University of Pennsylvania Law Review* 161.7 (2013): 2003-2023.
[13] Michael, Jensen, and Meckling William. 'Theory of the firm: Managerial behavior, agency costs and ownership structure.' *Journal of Financial Economics* 3.4 (1976): pp.305-360.

is a nexus of contracting relationships and therefore the conflicting objectives of all the individuals should be brought to equilibrium. As a result, the rights of shareholders come from the terms they have negotiated in the contract forming the company.[14]An agency relationship is therefore created between the shareholders who own the company's capital and the directors who make the decision in running the company's affair. As such, directors as the shareholder's agents are expected to ensure shareholder wealth maximization.

From the foregoing, it can be glimpsed that this theory is the foundation of corporate governance and law, since the shareholders have an interest in both the economics and the governance of a company.[15] Therefore as per this theory, the company should at all times prioritize the rights of shareholders. One of the ways through which this is achieved is by shareholders holding the board accountable for their actions.[16] In the 1990's corporates started embracing shareholders' views and emphasis was put on maximizing shareholders' wealth.[17]

A conflict of interest is likely to arise in the agency relationship existing between the shareholders and the appointed managerial board.[18]The conflict may result in losses and additional costs that the shareholder might have to incur. As such, the shareholder needs a venue through which potential ineffectiveness can be addressed. This theory is therefore relevant to this thesis as it justifies the need for laws on derivative action claims, through which shareholders can institute suits against directors and officers of the company who run the company inefficiently.

[14] Frank Easterbrook and Daniel Fischel, 'The Corporate Contract' [1989] Chicago Law Review pp. 1416
[15] Rhee, Robert J. "A legal theory of shareholder primacy." *Minn. L. Rev.* 102 (2017): 1951.
[16] Safari, N. (2018). 'Reconsidering the role of the derivative claim in the United Kingdom. A comparative study with the United States and New Zealand. '(Unpublished Doctoral thesis, City, University of London) pg.39.
[17] Ibid.
[18]Supra note 19.

1.7.2. Economic Analysis of the Law

Economic Analysis of law employs economics in assessing the extent to which the common law is an efficient legal system.[19] In 1973, Richard Posner, through his work titled "Economic Analysis of the Law" claimed that common law ought to be efficient.[20] The theory suggests that efficiency of the law would result in justice achieved through a specific law.[21] Therefore judges should take into consideration the efficiency of a certain law when making judgments taking into account the costs involved in the legal procedures. [22]

The relevance of this theory to derivative claims was explained by Pardow Diego. According to him there are three factors to consider in determining the economic effect of any derivative action claim. When a derivative suit is filed, the first consideration is the company's best interests. [23]For instance, would the outcome be that the company could gain some structural benefits or it could lead to the exit of certain officers from the company who the derivative action was against.[24] Second, is on the ability of the derivative suit to deter managerial misconduct. The consideration here is whether the claim would increase the net corporate value if it deters the managers from future inefficient violations.[25] Finally, the third question is whether the shareholders can effectively sue. The shareholders would only sue if the proportional benefits arising from the suit exceed the cost of litigation. [26]

[19] Cohen, George M. 'Posnerian Jurisprudence and Economic Analysis of Law: The View from the Bench.' *U. Pa. L. Rev.* 133 (1984): p. 1117.
[20]Coleman, Jules,'The Normative Basis of Economic Analysis: a Critical Review of Richard Posner's" The Economics of Justice"." (1982): p.1105-1131.
[21] Ibid.
[22] Ibid.
[23] Pardow, Diego G, 'The Economic Theory of Derivative Actions.' 2011. Available at SSRN 1941209.
[24] Ibid p.9.
[25] Ibid.
[26] Ibid p.13.

Accordingly, the shareholders should have in place a set of procedural rules that encourage them to sue when the aim is clearly to protect the company and to prevent them from doing so when it is done in bad faith or when the aim is not clear. [27]

Therefore, this theory is important to my paper as it lays out the main considerations from an economic perspective when a derivative suit is filed. These factors should be taken in to account by courts when deciding derivative claims and legislators when formulating laws governing derivative claims. This theory is important to my analysis on whether the current provisions in Kenya are efficient enough for justice to be achieved by a shareholder who files a derivative suit.

1.7.3. Theories of Justice

Various scholars have developed important jurisprudence on the theory of justice. The following scholars' theories will guide my paper: Justice as fairness by John Rawls and Theory of entitlement by Robert Norzick.

i. Justice as fairness by Rawls

Rawls' theory of justice focuses on distributive justice, his theory advocates for just and equal distribution of the resources within a society. [28]He propounded that the equal distribution of the resources within a society is only achieved when it benefits everyone within a society. Rawls used the illustration commonly known as the "veil of ignorance" to show that any group of individuals who are rational and interested in furthering their interest would agree to the initial position of equality.

In the context of a company the least advantaged would be the minority shareholders who are at the center of a derivative claim. Therefore, the law makers should come up

[27] Baum, Harald, and Dan W. Puchniak. 'The derivative action: an economic, historical and practice-oriented approach.'*The Derivative Action in Asia: A Comparative and Functional Approach* 1 (2012).
[28] Bix, Brian. *Jurisprudence: theory and context*. Vol. 5. London: Sweet & Maxwell, 1999.

with laws that would bring a balance between the minority shareholders and majority shareholders. Derivative Claims being a leeway through which minority shareholders can champion for their rights, parliament should come up with laws that promote fairness amongst shareholders. At the center of this paper is whether the current statutory provisions promote fairness as compared to the common law principles on derivative claims.

ii. Entitlement Theory by Robert Nozick

Nozick theory on property rights , in a nutshell states that there should be justice in the process employed by individuals in acquiring property.[29]

In the context of a company the property are the shares and a derivative claim is one of the avenues through which shareholders can champion for their rights and the protection of the company in which they have an interest through the acquisition of shares. Therefore, the question is whether statutory derivative action allows for efficient rectification of any injustice that may affect the property right of the shareholder.

Lida Pitsillidou applied the above theories in coming up with the *Theory of Commercial Justice* while analyzing the UK's statutory derivative Action. [30] According to Lida, Parliament must pass legislation that protects individual rights while also ensuring fair treatment. The above-mentioned theories of justice also help in delimiting the role of courts in determining derivative claims.[31] The property in the case of derivative claims are the shares held by the shareholders

[29] Nnajiofor, Osita Gregory, and Chinedu Stephen Ifeakor. 'Robert Nozick's entitlement theory of justice: a critique.' *A New Journal of African Studies* 12.1 (2016): 170-183.
[30] Pitsillidou, Lida. 'The UK statutory derivative action: an opportunity to bring justice to minorityshareholders.' Newcastle University, 2016.
[31] Ibid.

in the company. As such, it is prudent that the laws provide an effective mechanism by which the property is protected.[32]

Relevance of the theories in this study

As discussed above, all the theories are important in this paper, but it is important to point out that of all the three theories discussed above, the shareholder primacy theory, as you will see in the subsequent chapters forms a very strong basis for the arguments raised in this paper as it is the foundation of corporate law and corporate governance and clearly explains nexus between the shareholders interest in a company and the governance of a company. The nexus which is very important in justifying the importance and the need for derivative action claims.

1.8. METHODOLOGY

The envisaged methodology is doctrinal research methodology, which will be through analyzing secondary sources of data including statutes, relevant textbooks, and journal articles by scholars. Additionally, since the statutory derivative action claims were codified earlier in jurisdictions like the United Kingdom some of its courts decisions and reasoning will be analyzed to help in the understanding of the subject.

In particular, since this study derives strength from common law principles, the cases which contributed towards the principles will be used, U.K cases after 2006 will also be useful as the concept was codified in UK in 2006.Further,the laws in New Zealand and Australia will also be relied on. Considering that the study is aimed at assessing the effectiveness of the provisions in Kenya, the Companies Act of 2015 and the decisions of Kenyan courts pre 2015 and post 2015 will provide a basis for this study.

[32] Ibid.

1.9. LITERATURE REVIEW

Various scholars have written on statutory derivative claims, critiquing and analyzing the effectiveness of laws governing statutory derivative action. This section will therefore appraise the significant literature on the subject.

Adas Reisberg,[33] highlights the changes in the United Kingdom Companies Act of 2006 and specifically the reforms on derivative claims. According to him, the procedure under the Act is still not favorable enough to convince a shareholder to institute a claim. The shareholder would be better off if he or she sold his or her shares rather than instituting a claim. The reforms in the UK are similar to the reforms introduced in the Kenyan Companies Act of 2015. Therefore, some of the criticisms raised in the paper are relevant to this thesis. Additionally, the paper also highlights the importance of codifying the procedure of filing the derivative claim in the Act.

Yohanna Gaddafi and Miriam Tatu, [34]explain some key changes in the Companies Act 2015 Kenya on derivative claims, focusing on the gaps in the statutory provisions. Amongst the gaps they identify is the lack of guidance of evidentiary threshold on what a *prima facie case* is. According to them the requirement to prove a *prima facie case* may be a deterrent to the filing of derivative claims. Central to their argument is that some barriers exist on the part of the Applicant in proving a prima facie case because most of the information required to do so may be out of the Applicant's reach. Additionally, the provision of section 144 of the companies Act on the duty of a director to promote the success of a company is a hindrance to one pursuing a derivative claim. This is because one of the factors under section 241(1) (a) that the Court will consider is whether the director's actions are in line with promoting the success of the

[33] Reisberg A, 'Derivative claims under the Companies Act 2006: much ado about nothing?.' (2009)
[34]Gadaffi, Yohana, and Miriam Tatu., 'Derivative Action under the Companies Act 2015: New Jurisprudence or Mere Codification of Common Law Principles.'*Strathmore LJ* 2 (2016).

Company. In promoting the success of a company the director exercises his own independent judgment and chances are that this will take us back to the common law principle laid out in *Lesini and Others v.Westrip Holding Limited and others* [35] in which it was held that one cannot institute a claim if the director, in exercising his own independent judgment, did not institute the claim. Therefore, the main issue is the standard courts will rely on in determining whether a claim should have been instituted by a director or through their independent judgment they should not have filed a claim on behalf of the Company.

Lida Pitsillidou,[36] analyses the UK statutory procedure in Derivative Action Claims and questions whether the codification of derivative action claims achieves commercial justice. The author derives the argument from the jurisprudential theories of justice by John Rawls and Robert Norzick. The paper analyses the efficiency of the statutory provisions on a case-to-case basis in terms of the cases handled by the UK courts after 2006 when the Companies Act codified the institution of the claims. The paper also expounds the important jurisprudential theories that explain the need for derivative claims, which is well developed in common law. Further, the concept of multiple derivative claims is expounded in this paper and its application in common law. This is where a parent company can bring a claim on behalf of a subsidiary Company and the argument in the paper is that the concept of multiple derivative Action is key in achieving commercial justice in derivative claims.

Pearlie M.C, [37]explains the importance of good faith in derivative claims, focusing on Singapore where the concept of derivative claims was codified in statute in 1993.The paper argues that in recent cases the requirement for a prima facie case does little in ensuring that good faith is upheld in the filing of the derivative action claims. Good faith was a requirement

[35] Lesini v Westrip Holdings Ltd[2010] BCC 420.
[36] Supra note 36.
[37] Pearlie M. C.,'Of Links and Legal Merits: Good Faith in the Statutory Derivative Action in Singapore' (2015). Oxford University Commonwealth Law Journal. 14, (2), p. 225-249.

when a party was seeking leave to file a derivative claim. However, most statutes have totally done away with the requirement and it is not even mentioned in most statutes. Therefore, this widened the court's discretion in determining whether to grant leave or not. The paper traces how the establishment of good faith was key in filing derivative suit at common law and how over time the departure is evident in the statutory provisions across various jurisdictions.

Julia Tang, [38]examines the two-stage procedure that cuts across most jurisdictions in the institution of derivative claims. According to Tang, the objective of the statutory derivative procedure was to ensure that the procedure was flexible and accessible. The first barrier in achieving this objective is information asymmetry, which can be a barrier at the leave stage and further the fact that the leave stage is based on factual analysis might lead to a mini-trial at this juncture. Further he argues that the rationale for the first stage could easily be achieved in the second stage since some claims have been thrown out at the second stage even after proceeding through the 1st stage. The paper also questions the role of good faith in derivative claims since the claimant is coming on behalf of the company and not on the claimant's behalf. Ian M Ramsey, [39]does an in-depth study of the effectiveness of Australia's statutory derivative action from the year it was codified and the effectiveness of the law in comparison to the common law provision. The study explains the rationale behind the statutory derivative action and further focuses on the key issue of the cost of litigation of such suits and how courts have over the years dealt with the examination of the case at its leave stage. This will give me an insight on the question of cost since one of the barriers raised in this paper is the lack of clarity on cost of the suit, which might affect the proactive filing of such suits by potential Claimants.

[38]Tang J, 'Shareholder Remedies: Demise of the Derivative Claim." *UCLJLJ* 1 (2012): p. 178.
[39] Ramsay, Ian M., and Benjamin B. Saunders,'Litigation by shareholders and directors: An empirical study of the Australian statutory derivative action.' *Journal of Corporate Law Studies* 6.2 (2006): p. 397-446.

Maleka Femida Cassim,[40] critiques the South African statutory provisions on derivative claims as he draws lessons from the United Kingdom, the United States, Australia and New Zealand. The paper raises a number of challenges experienced in the filing of derivative claims, among them the costs incurred in the institution of the suits, the focus being on the judicial discretion in making the orders as to cost. The paper suggests that there is need for judicial guidelines. Further, the paper also analyses the criteria that courts follow in granting leave to make the application in South Africa.

M.A Maloney Victoria[41]examines various case laws with a keen focus on the pre-conditions that courts take into consideration. According to his analysis judges place unnecessary burden on the Applicants in the interpretation of the statutory provisions. In particular, the paper proposes that the pool of Applicants should not be static; it should be expanded to include employees and also the registrar of companies, and this should be reviewed over time. The paper further raises the argument that the requirement for good faith is irrelevant in determination of derivative suits, as it has no bearing on the suitability of an applicant. In illustrating the irrelevance of good faith, the author uses *Anderson v Anderson* [42]where the case was thrown out because the shareholders who brought the case were children of the Director and therefore the judge in this instance concluded that the case was brought in bad faith.

Safari Neshat[43] analyses the UK statutory derivative Claim and explains clearly the aim of the English Law Commission at the time as ensuring that the reforms on derivative action claims are flexible, modern and accessible criteria for derivative action. Further, he analyses the reforms and his conclusion is that the approach to derivative action is overly restricted and the

[40] Cassim M F, '*The statutory derivative action under the Companies Act of 2008: guidelines for the exercise of the judicial discretion*.' Diss. University of Cape Town, 2014.
[41] Supra note 13, pg. 309-341.
[42]Anderson v. Anderson (1979), 105 D.L.R
[43] Supra note 22.

presence of a number of ambiguities acts as a barrier to potential Applicants. Further, the provisions are still structured to protect the shareholders as opposed to the company itself as a separate legal entity. Therefore, his proposal is that in formulating reforms the consideration should be both the protection of a company as a separate legal entity and the protection of an individual shareholder. As such one of his main proposals is that for efficient protection of the Company the locus standi for filing derivative Action claim should be broadened to include employees and other stake holders who invest their time and skill in the company since they would be highly affected should the company go down.

1.10. CHAPTER BREAKDOWN

This research will be divided into five chapters;

CHAPTER ONE: INTRODUCTION

This chapter introduces derivative action as a concept and briefly discusses the development of derivative action claims under common law and its transition to statutory derivative action. The chapter further sets out the statement of the problem, research questions and the objectives intended to be achieved by the study, the literature review on the topic, the justification, methodology and hypothesis of the study.

CHAPTER TWO: COMMON LAW DERIVATIVE ACTION

This chapter provides an in-depth understanding of the concept of derivative action claims and thereafter traces the history of derivative action claims with a focus on the institution of the claims under common law principles and the procedural steps under common law. The chapter also gives an insight of the shortfalls of derivative action under common law.

CHAPTER THREE: STATUTORY PROVISIONS ON DERIVATIVE ACTION IN KENYA

This chapter seeks to examine the statutory provisions under the Companies Act 2015 on derivative action claims. It thereafter gives insights into interpretation by courts in Kenya, both under the common law regime and after codification into statutory provisions. This chapter tests the hypotheses of this research.

CHAPTER FOUR: COMPARATIVE ANALYSIS OF STATUTORY LAWS ON DERIVATIVE CLAIMS

This Chapter seeks to examine legal regimes governing derivative action claims in the United Kingdom (UK), New Zealand and Australia. It also provides an analysis of their statutory provisions on derivative action claims and challenges faced in the implementation of the provisions of the laws with a view of obtaining the best practices.

CHAPTER 5: CONCLUSION AND RECOMMENDATION

This is the last chapter of this paper and it will contain the conclusion of the whole study and possible recommendations which could cure the defects in Kenya's legal regime governing Derivative Action Claims.

CHAPTER TWO

COMMON LAW PROVISIONS ON DERIVATIVE CLAIMS

2.0 INTRODUCTION

Derivative Action Claims stemmed from common law and over the years various countries have incorporated it as part of their statutory frameworks. 19th Century Common law courts took into consideration certain principles and pre-conditions in handling derivative Claims. Thereafter, statutory derivative claims came in to cure the inefficacies of common law derivative claims as experienced by courts in the 19th Century. This section will analyze the evolution of derivative action claims under common law and its metamorphosis into statutory derivative claims.

2.1 TRACING DERIVATIVE ACTION CLAIMS BACK TO COMMON LAW

The History of Derivative Action Claims can be traced back to 1843 when the landmark case of *Foss v Harbottle* was decided.

2.1.1 The case of *Foss v Harbottle*

They started legal action against five directors in October 1842 on behalf of themselves and other Victoria Park Company shareholders against three insolvent directors, a company proprietor and a solicitor and an architect who worked for the company. When a group of people came up with the concept of buying 180 acres near Manchester for the construction of Victoria Park, the Victoria Park Company was formed in 1835. "Laying Out and Keeping an Elegant Park inside the Townships of Rusholme, Charlton-upon-Medlock, and Moss Side, in the County of Lancaster" was the stated goal of the company's formation.

The two shareholders brought the suit on the ground that the purchase of the Land was as a result of a fraudulent arrangement by the following persons: Harbottle, Adshead, Byrom, Westhead, Denison, Bunting, and Lane, who aimed at deriving a benefit from the formation of

the Company. The arrangement was such that after the formation of the Company, a number of the above-mentioned persons would be appointed as directors who in turn procured the purchase of the land at exorbitant prices.

Due to the Defendants' alleged fraudulent and illegal transactions and misappropriation and waste of the business's assets, Foss & Turton filed a lawsuit claiming that there were not enough directors or a clerk, and that the corporation did not have an office or clerk. Foss basically argued that the owner didn't have the authority to acquire the company's property or wind up its affairs because of the conditions. Hence, the Plaintiffs argued that the Defendants should be ordered to compensate the corporation for the losses it suffered as a result of their actions. Additional to this, the Plaintiffs requested that a receiver be appointed by the Court to confiscate and use the company's assets to pay its debts and secure the company's assets.[44]

The court held that the injury was to the company and not to the Plaintiffs who were shareholders exclusively. Nothing prevented the company in the circumstances raised from bringing the suit in its own corporate name. Therefore, the plaintiffs could not sue in a form which assumed the dissolution of the corporation.[45]The court further stated that in order for the suit to be sustained as brought by the Plaintiffs, it had to be shown that the governing body of the Company had no such powers to bring the suit. Further, the Plaintiffs had to show that all means had been resorted to and the governing body was totally ineffective.[46] Two important principles were espoused from the case: the proper Plaintiff rule and the internal management rule as discussed below.

[44] *English Reports Full Reprint Vol. 67 - Vice-Chancellors' Courts. , . HeinOnline*, https://heinonline.org/HOL/P?h=hein.engrep/engre0067&i=198.
[45] Ibid.
[46] Kershaw, David, 'The Rule in Foss v Harbottle is Dead; Long. Live the Rule in Foss v Harbottle, LSE Law." Society and Economy Working Papers [online] 5 (2013). p.5

2.1.2 The Proper Plaintiff Rule

According to this regulation, the firm itself has the primary right to sue for damage or harm if a wrong is done to it. The basis of the rule is taken from the law of corporations principle, which states that once a company is lawfully incorporated, it must be recognized as a distinctly separate person with its own rights and duties. This means that if an outsider, director, or any other officer of the firm does a wrong, then the company must take care of it rather than its members. There are several exceptions to the appropriate Plaintiff rule, such as when a firm is unable to perform its duties. In the case of Gray v Lewis, James LJ ruled that if a corporation is capable of commencing an action for itself to reclaim property from a third party, its director or any other officers of the firm the body integral are the only competent plaintiffs. This rule therefore gives effect to the will of the majority and by allowing a company to litigate it eliminates the possibility of multiple suits.[47]Further, the shareholders will indirectly benefit from the institution of the suit if it the litigation is successful.

Various judges have relied on the notion of different legal entities to support the claim that a company should be the plaintiff. As an independent legal personality, the Company was able to suit in the case of Metropolitan Saloon Omnibus Co Ltd v Hawkins. Even more so, the notion of separate legal entity was upheld in Prudential Insurance Co Ltd v Newman Industries Ltd by the Court, who stated that the rule in Foss v Harbottle is the result of the fact that corporations are distinct legal entities independent from their stockholders.

The difficulty in the proper plaintiff rule was explained in *Wallersteiner v Moir*[48] by Lord Denning where he stated that proper plaintiff is applicable where the wrongdoers are outsiders, but in an instance where the company is defrauded by those who are officers of the company,

[47] Hargovan A, 'Under Judicial and Legislative Attack: The Rule in Foss v. Harbottle." *South African Law Journal*, vol. 113, no. 4, November 1996, p. 631-651. *HeinOnline* https://heinonline.org/HOL/P?h=hein.journals/soaf113&i=649.
[48] *Wallersteiner v Moir* [1974] 1 WLR 991

for example directors, then the proper plaintiff rule may not be very practicable. This is because in the case of directors they will sit and vote in board meetings against the institution of such a suit. As such, in theory the proper plaintiff rule may seem like a logical approach but it poses some difficulties.

2.1.3 The Internal Management Rule

This principle has its origin from a partnership doctrine. In the early years of the 19th century courts of equity were against interfering with the business of a partnership unless it involved dissolving a partnership.[49]The rationale of this rule was that the concept of good faith and mutual trust governed the partnership and hence interference by the courts in such a relationship would make the operation of the partnership difficult. [50]In 1812 in the case of *Carlen v Drudry* [51]the Chancellor declined to interfere with a matter involving a partnership on the ground that the articles of the partnership provided for a very effective mechanism of dealing with any form of mismanagement.[52] In Foss, the judge used this principle to demonstrate that the majority shareholders of a firm should decide on its internal issues rather than the courts. As a result, judges who presided over cases involving the internal affairs of corporations formed after 1844 began applying this precedent. As in *Burland v Earle*, the court held that it is a basic concept of joint stock corporations that the court has no jurisdiction to meddle with the internal affairs of a business while it is acting within its rights.

2.1.4 The Exception to the Rule in Foss v Harbottle

In as much as the rule in *Foss v Harbottle* is grounded on justifiable grounds stated above, the rule seems to be harsh to the minority shareholders.[53]Through common law and case law some exceptions were developed to mitigate the harshness of the rule and the first exception was

[49] Supra note 8.
[50] Ibid.
[51] (1812) 35 ER 61
[52] Boyle, A. J., 'The minority shareholder in the nineteenth century: a study in Anglo-American legal history.' *Mod. L. Rev.* 28 (1965): pg. 317.
[53] Bamigboye, Mike. 'The True Exception to the Rule in Foss v. Harbottle: Statutory Derivative Action Revisited. Harbottle: Statutory Derivative Action Revisited (2016)'

raised in the case *Foss v Harbottle* itself where the court stated that a derivative claim will succeed if the company is incapable of acting through its directors or if the governing body is not in a position to institute the suit.[54]The other exceptions include:

2.1.4.1 Fraud on Minority shareholders

The rationale for this exception was in *Edwards v Halliwell*[55] where the court of appeal stated that if the minority shareholders were denied the right to file the suit in cases of fraud, such cases would never be addressed by courts as the wrongdoers themselves are in control of the company. In order for an Applicant to rely on this exception, they needed to show that first there is proof of fraud and secondly, that the wrongdoers are in control of the company. In *Burland v Earl* [56]fraud was termed as an instance where the majority either through indirect or direct actions appropriated themselves either money, property or other advantages which rightfully should be for the company. This exception was also raised in *Prudential Assurance Co Ltd v Newman Industries Ltd*[57] where the court stated that in order for a derivative claim to succeed the Plaintiff must show that there was a fraud by the company on the minority shareholder. However, as opposed to the *Burland case*, Vinellot J in *Prudential Assuarance Co. Ltd* held that in relying on this exception, the Plaintiff does not have to show that the defendant was acting for the benefit of himself or herself.

Over time this exception was extended to facts related to fraud in equity, and this would include any unfair or discriminatory actions towards the minority. Case in point is in *Vatcher v Paull*[58] in which the court stated that fraud does not mean conduct on the part of the appointor amounting to fraud in the common law sense of the term; it merely means that the director or

[54] English Reports Full Reprint Vol. 67 - Vice-Chancellors' Courts. HeinOnline, https://heinonline.org/HOL/P?h=hein.engrep/engre0067&i=198.
[55] Edwards v Halliwell [1950] 2 All ER 1064
[56] Supra note 53.
[57]Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2) [1982] Ch 204.
[58] Vatcher v Paull [1915] AC 372, pp. 378

officer in charge exercised power for intentions not justified by the instrument creating the power.

2.1.4.2 Inteference with personal Rights

In *Pender v Lushington*[59] Lord Jessel MR stated that a member, whether a majority or minority can institute legal proceedings where a personal right is being interfered with. Therefore, where an act or an omission affects individual rights, he or she can institute a claim. An example is where the directors fail to comply with the company's constitution.[60]

2.1.4.3 Illegal or Ultravires

An individual member may also bring a claim to restrain the company or an officer of the company from: entering into a transaction which is illegal or *ultra vires*; purporting to do through an ordinary resolution that which requires a special resolution; any fraud on either the company or minority shareholder and the company fails to take the necessary step; where a company meeting cannot be called in time to redress the specific wrong; and where directors are likely to derive profits as a result of their negligence.[61]

2.1.4.4 An irregularity in the passing of a resolution which requires a qualified majority

This applies in a situation where as per the Companies Constitution or under the law a certain decision has to be ratified by the special majority. Therefore, if such decisions are passed by the less than ¾ of the shareholders then a shareholder can bring an action on behalf of the Company. In *Nagappa Chettiar And Anr. vs The Madras Race Club*[62] the court held that a shareholder or shareholders are entitled to bring an action in respect of matters which are *ultra vires* in relation to the company and which the majority of shareholders, were incapable of sanctioning.

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[59] (1877) 6 Ch D 70.
[60] Safari, N. 'Reconsidering the role of the derivative claim in the United Kingdom. A comparative study with the United States and New Zealand. (Unpublished Doctoral thesis, City, University of London) 2018.
[61] Bamigboye M, 'The True Exception to the Rule in Foss v. Harbottle: Statutory Derivative Action Revisited. Harbottle: Statutory Derivative Action Revisited '(2016).
[62] (1949) 1 MLJ 662

Further to the above, another exception was raised in the case of *Hogson v N.A.G.L.O* [63]where the judge held that the rule in *Foss V Harbottle* should not be applied if the result of the rule would lead to the majority being deprived of their will. If the constitutional body of the company cannot operate in time to be of practical effect.[64] In this particular case it would have been impossible for N.A.G.L.O to go through the necessary procedure of convening a special meeting.[65]

2.2 PRE-REQUISITES IN FILING OF DERIVATIVE ACTION CLAIMS UNDER COMMON LAW

In practice courts took into account the following pre-requisites before allowing the institution of derivative action claims.

2.2.1 Prima facie Case

Prima facie case test is commonly used in the determination of interlocutory injunctions, reliance being placed on *Giella v Cassman Brown*[66]. Although the nature of a prima facie case is still uncertain, courts have not examined the word in detail or what exactly an Applicant needs do to build a prima facie case in arbitrability in detail. In order to file a claim, a party had to demonstrate that they had a reasonable basis for doing so. According to the court in the case of Prudential Assurance Company Ltd v. Newman Industries Ltd, the Plaintiff must prove that there is a prima-facie case showing that the company is entitled to the remedy sought and that the action fits within the bounds of Foss v Harbottle. In cases involving fraud, the Plaintiff must prove that the Defendants (the officers of the company or the directors) were in control in the company and had perpetrated the fraud.

[63] [1972] 1 All E.R.15
[64] Prentice, D. D., 'Another Exception to the Rule in Foss v. Harbottle.' *The Modern Law Review*, vol. 35, no. 3, 1972, pp. 318–321. www.jstor.org/stable/1093797. <Accessed 30 May 2020>.
[65] Ibid.
[66] (1973) EA 358.

Following the codification of derivative claims in the United Kingdom courts have had varied opinions on the determination of a prima facie case which is in the first stage. In *Lesini v Westrip Limited Holdings* [67]the judge stated that in the determination of a prima facie case the judge takes into consideration the evidence presented by the Applicant only without taking into consideration the position of the Defendant.[68] The rationale of this stage is to filter the cases that proceed to the hearing stage. In *LangleyWard Limited v Gareth Wynn Trevor, Seven Holdings* [69]the court expressed its disappointment when the parties by-passed the prima facie stage stating that this was a breach of the procedure in the institution of derivative claims.

On the other hand, some courts have not put so much emphasis on the first stage. In *Stimpson v Southern Landlords Association* [70] the court held that it was not relevant to consider the first stage for the court to decide whether the derivative claim should be heard or not. Julia Tang [71]supports the position in this case stating that the aim of this first stage of proving a prima facie case can easily be achieved in the second stage of the hearing. The court can know whether a company has a good cause of action or not at the second stage and this would in turn save the Applicant unnecessary hurdles and additional costs incurred in the first stage. In *Franbar Holdings Ltd v Patel* [72]the court handled the application in a single stage and the counsel for the Applicant accepted that the application should be dealt with in its entirety in order to determine if the court should continue hearing the suit. In *Mission Capital plc v Sinclair* [73]the parties agreed to combine the two-stage process into one and the judge considered the approach as being sensible.

[67] [2009] EWHC 2526 (Ch).
[68] Tang J, 'Shareholder Remedies: Demise of the Derivative Claim.' UCLJLJ 1 (2012): pp.178.
[69] [2011] EWHC 1893 (Ch) para 62.
[70] [2009] EWHC 2072 (Ch).
[71] Supra Note 68
[72] Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch)
[73] Mission Capital plc v Sinclair [2008] All ER (D) 225

2.2.2 Good Faith

Good faith in derivative action claims requires the Applicant to show that the claim is not brought for any other collateral purpose.[74] The Case of *Barret v Duckett and others*[75] best explains the concept of good faith in derivative action claims. Peter Gibson LJ stated that from the facts of the case one would see that the shareholders were indeed bringing an action against the directors for a wrong done to the company. However, the circumstances under which the suit was filed involved a bitter matrimonial dispute between the Plaintiff's daughter and the Defendant. Further, in *Nurcombe v Nurcombe*[76] Lawton LJ stated that derivative action is more than just a procedural device through which justice is achieved for a company. The court must consider whether the person bringing the claim is bringing it for the benefit of the company or for other ulterior motives. [77]

2.2.3 Shareholder Ratification

The commonly accepted position is that ratification of a director's acts automatically cures a breach.[78]In corporate law, ratification is a mechanism through which a wrong can be put right and thereafter the wrongdoer released from the liability.[79]An example would be where a director entered into an invalid contract with a third party and the company later decides to ratify the contract and therefore the contract is deemed valid. As such, in the case of derivative claims ratification would be in the instance where a shareholder is not pleased by the conduct of the director or the officer however, the conduct is ratified by the company. In common law derivative claims the court took into consideration the aspect of ratification when deciding the

[74] Mukondo, Vimbainashe John., '*A comparative discussion of the regulatory provisions for the protection of shareholders in the United Kingdom and South Africa* '(2018) pg.15
[75] Barrett v Duckett [1995] 1 BCLC 243
[76] Nurcombe v Nurcombe (1984) 1 BCC 99,269 at pg. 99.
[77] Ibid.
[78] R. J. C. Partridge., 'Ratification and the Release of Directors from Personal Liability.'The Cambridge Law Journal, vol. 46, no. 1, 1987, pg. 122–149. JSTOR www.jstor.org/stable/4506981. <Accessed 3 June 2020.>
[79] Supra note, pg.139-140

claims. Therefore, if the company has ratified the actions of a director that would mean that there is no claim that the company could bring against the director.[80]

2.3 THE SHORTCOMINGS OF COMMON LAW DERIVATIVE ACTION

2.3.1 The Scope of Derivative Action

As espoused above, a derivate suit is brought by a minority shareholder on behalf of the company. One of the objectives of derivative action claims is to protect the company and to ensure that the company is run efficiently. The common law provisions put the shareholder at the center of derivative action claims and therefore apart from the company itself bringing the claim the only other party that can bring the claim is the shareholder. Safari Neshat criticizes the shareholder primacy theory as it assumes that it is only shareholders who are in a position to protect the Company. As such, the scope on who can file the suit in a derivative claim is narrow. Further, from the reading of the exception under common law, those exceptions are the instances under which a minority shareholder can file a suit on behalf of the company.

The argument here is that derivative action claims should not only take into account shareholders but other stakeholders whose interests are tied to the success of the company such as employees. Derivative action claims under common law fail to take into account the stakeholder theory which provides that the company is run for the benefit of all its stakeholders.[81]From the narrow approach under common law only the minority shareholders can bring the claims and as such can make an assumption that derivative action claims are only geared towards the protection of the Minority Shareholder and not necessarily the Company.

[80] Riley, Christopher (2013)'Derivative Claims and Ratification: Time to Ditch some Baggage.' Legal studies. 34(4).pp.582-608.
[81] Edward Freeman,'A Stakeholder Theory of the Modern Corporationin Tom L Beauchamp and Norman E Bowie (eds), Ethical Theory and Business '(5th ed,Prentice Hall 1997) pp. 69.

2.3.2 The Challenge of Proving Fraud by the Minority Shareholder

The interpretation of fraud was wide thus making it difficult to prove fraud and this is evident through varying definitions of the term fraud by various courts. For example in *Cook v Deeks*[82] the court examined fraud from the angle of dishonesty or bad faith on the part of the defendant and this therefore meant that gross negligence could not be termed as fraud.[83] On the other hand in *Daniels v Daniels*, the court construed the term fraud to include negligence or breach of duty which amounted in a profit to the director.[84]Further in the *Prudential Assurance* [85]Vinelot J held that it was necessary for the Plaintiff to show that the officers acted with a view of enriching themselves.

Therefore, some courts have interpreted fraud to mean situations where directors directly benefit from their actions in terms of profits and this leaves out instances where the actions of directors amounted to negligence even though they never benefitted from their actions. In order to remove such a barrier, the consideration ought not be of fraud only but any willful act that is detrimental to the company, whether fraud or gross negligence where such director was hired for his expertise.

2.3.3 The Prima Facie Challenge

As a matter of principle, during the first stage of a derivative action a party merely has to prove to the court that they have a prima-facie case. However, under common law, there was no clear threshold that an Applicant had to meet to prove the existence of a prima facie case.[86]Different judges set different standards of proof for a prima-facie case in different cases largely depending on the circumstances in the cases. As a consequence, the first stage easily resulted into a mini-trial, making it lengthy and ineffective. Additionally, in the application stage in

[82] Cook v Deeks 1916 1 AC 554.
[83] Safari, N. ,'Reconsidering the role of the derivative claim in the United Kingdom. A comparative study with the United States and New Zealand. (Unpublished Doctoral thesis, City, University of London) pp.66.
[84] Ibid.
[85] Supra note 58.
[86] http://www.lawcom.gov.uk/app/uploads/2015/03/cp142_Shareholder_Remedies_Consultation.pdf pp.149-171 <Accessed on 25th July 2020>

most cases the claimant would barely have access to the defendant's documents and thus would be prejudiced during the "mini-trial".[87]

2.3.4. The challenge on costs

One of the predominant challenges was on costs; a member had no option but to financially sustain the derivative action. This was unfair because if a suit was successful, the company benefitted and the claimant on the other hand could not recover the costs and expenses incurred.[88] The same was the case even if the suit was unsuccessful. This would therefore act as a deterrent against ensuring that the objectives of derivative actions are achieved, since a shareholder would be discouraged from filing the suit.

2.4 CONCLUSION

The case of Foss v Harbottle was invaluable as a step towards the protection of the minority shareholders. By holding a meeting, the majority shareholders could confirm internal wrongdoings or vote not to take legal action against the minority shareholders. As a result, the minority shareholders' rights were asserted to be preserved, but there was still a struggle in retaining the company's autonomy in the face of such an unfavorable situation for them.

Courts in the United Kingdom and throughout the Commonwealth have continuously relied on the principles as laid down in Foss v Harbottle and some courts have even gone ahead to develop on the exceptions. For example, the issue of fraud, is one of the most common exceptions which as discussed above has received numerous interpretations from the courts. In my view, fraud occurs only when the wrongdoers are in charge of the organization, making it improbable that they would use their power to benefit the minority. As a result, for the court's interpretation to be advantageous to shareholders rather than a hindrance, any purposeful act

[87] Ibid pp.160
[88] HS Cilliers et al Cilliers and Benade Corporate Law 3rd Edition pg.305.

that is detrimental to the company, whether fraud or gross carelessness, should be considered, regardless of whether the director was appointed for his skill.

The statutory provisions in the companies Act 2015 largely adopt the common law provisions in terms of both the procedural and the substantive requirements in the institution of derivative claims. The expectation was that the statutory provisions would deal with the inefficiencies under common law.

The next chapter will look at various derivative claims in Kenya and how the Kenyan Courts have handled them. Thereafter we can be able to conclude whether the provisions in the Act made the process more efficient and further, identify any challenges and gaps that the statutory provisions have not dealt with in ensuring that the process is efficient.

CHAPTER THREE

STATUTORY DERIVATIVE CLAIMS IN KENYA

3.0. INTRODUCTION

Over the years Kenyan Courts have been faced with derivative action claims both under the common law regime and after the enactment of the Companies Act in 2015. Prior to 2015 Kenyan Courts relied on common law provisions on derivative action claims. This chapter will analyze the provisions of the Companies Act 2015 on derivative action claims explaining both the substantive and the procedural requirements in filing the application in the Kenyan Courts. The second part of this chapter will shed light on how Kenyans courts have handled the applications at the first stage and the evidentiary thresholds they set in determining a prima facie case. This thesis argues that in spite of the codification of derivative action claim provisions under the Act, the approach in filing a derivative suit is still ineffective from various angles which are highlighted in the last section of this chapter.

3.1. STATUTORY LAW PROVISIONS: COMPANIES ACT, 2015 KENYA

3.1.1. Definition and Scope of Derivative Claims

As defined by Section 238 of the Companies Act, the term "derivative action" refers to any action taken by a member of the company on behalf of the company. The term "member" encompasses anybody who has received a share of the company's stock as a result of the statute. Members can also bring claims even if the cause of action dates back to before they joined the organization.[89]

An individual member of a company can also initiate an action against a company director if his or her conduct or projected actions constitute carelessness, default, violation of duty, or

[89] Ibid Section 238(5).

breach of trust by the director. Additionally, a derivative action might be taken on behalf of the company's ex-directors or a third party.[90]

3.1.2. The Two-Stage Procedure

The first stage in the filing of derivative suits in Kenya is by the Applicant making an application to the court for permission to continue with the suit.[91]In order for the court to grant the Applicant permission the application should be supported by evidence disclosing the existence of a case. In case the evidence does not disclose a case, the court shall dismiss the application or make any other consequential orders that it considers appropriate going by the evidence presented.[92]

On the other hand, if a case is disclosed through evidence supporting the application the court may give directions on the evidence that the company will be required to give; [93] and adjourn proceedings to allow the evidence asked for to be obtained.[94]The court will then proceed and hear the application after which it may dismiss the application depending on the evidence presented by the company.[95]The court may also refuse to grant permission and dismiss the claim or adjourn the proceedings on the application and give such directions as it considers appropriate.[96]

3.1.3. Application to continue with an instituted claim

Under the statute, a company member may be allowed to pursue a claim that was originally initiated by the company. Such an application will be made on these grounds: The company's actions were an abuse of the judicial process; the company has not pursued the subject thoroughly; and it is more appropriate to continue the case as a derivative claim. An application may be dismissed by the court if the evidence submitted does not support it, or it may be

[90] Ibid Section 238 (4).
[91] Ibid Section 239(1).
[92]Ibid Section 239(2).
[93] Ibid Section 239(3)(a).
[94] Ibid Section 239(3)(b).
[95] Ibid Section 239(4).
[96] Ibid.

allowed to proceed. The court may then seek for evidence from the firm, and based on such evidence, it may dismiss the application. This could include dismissing or adjourning proceedings based on a court's decision to grant or deny authorization to proceed.

It is also possible for an individual to continue an action started or taken over by another member of a firm. There are a number of grounds under which an application might be made, including: the claim was brought in an improper manner and continues to be an improper means of bringing a claim; a claimant has not prosecuted the matter diligently, and the Applicant should litigate it. If the application does not reveal a case, the court has the option of dismissing the lawsuit or making any other orders that it sees fit. [97]The court may allow the application if it discloses a case, it may then give directions on the evidence that the company will be required to give; and adjourn proceedings to allow the evidence asked for to be obtained. Thereafter, the court proceeds to hear the application after which it may dismiss the application depending on the evidence presented by the Company. This could include dismissing or adjourning proceedings based on a court's decision to grant or deny authorization to proceed.[98]

3.1.4. Substantive considerations in granting or refusing to grant permission

This section looks into the factors that the court looks into before granting or striking out an application for leave. First, the court may refuse to grant permission to the Applicant if the director or the officer of the company in not bringing the claim was acting in accordance with section 144 of the Companies Act.[99]Section 144 of the Act provides for the duty of the Director to exercise independent judgment.[100]Therefore, if the director did not bring the claim because in exercising his independent judgment he found it fit not to bring the claim then the courts will not grant the Applicant permission to file the suit. Second, the court will determine if the

[97] Ibid Section 242(3).
[98] Ibid Section Section 242 (4).
[99] Ibid Section 241(1)(a).
[100] Ibid Section 144 (1).

Company has allowed or confirmed the action at issue in the application. The court will evaluate whether the conduct was sanctioned by the firm before it transpired or if the company has authorized acts that have not yet occurred if the civil action stems from a conduct that has already happened or is about to occur. Further, for acts that have already occurred whether the company has ratified the actions of the director.[101]

Thirdly, the court will consider whether the member who brought the claim was acting in good faith.[102]Further, what is considered as acting in good faith as per section 143 of the Act will be taken into consideration as the suit continues.[103] Fourth, whether the company itself has considered instituting the claim or not.[104] Fifth, whether the claim could be pursued by the Applicant in his own right without having to pursue it on behalf of the company.[105] Finally, the court will consider any evidence on the views of members of the company who have no direct or personal interest in the matter.[106]

3.2. SHORTCOMINGS OF THE COMPANIES ACT, 2015 ON DERIVATIVE ACTION CLAIMS

3.2.1. Confusion on filing of leave applications

Through court decisions in Kenya it is evident that there is still some confusion at the leave stage and the same has not been addressed under the Act. The first issue before courts has been on the filing of leave applications. Some courts have held that one can file the application after the suit has started and other judges have stated that an Applicant can file the leave application at any stage of the suit. The other issue in contention is whether an Applicant files this application at the same time with the suit. In the *Matter of CMC Holdings 2012* [107] the issues

[101] Ibid Section 241 (1)(b) and (c).
[102] Ibid Section 241 (2)(a).
[103] Ibid Section 241(2)(b).
[104] Ibid Section 241(e).
[105] Ibid Section 241 (f).
[106] Ibid Section 241(3).
[107] In The Matter Of Cmc Holdings Limited[2012]eKLR

of contention were how one should file an application for leave and how the same should be heard. The Respondents in this case filed an application for leave to institute a derivative claim and leave was granted. Subsequently, the Applicants in this case filed a miscellaneous application for the court to set aside the order granting leave. The argument by the Applicant was that the leave was not properly granted.

On whether the application for leave ought to be brought inter partes or *ex parte*, the Applicant argued that the application ought to be argued inter partes and the application should be filed together with the plaint. However, the court held that requiring an Applicant to file the plaint together with the application could result to waste of resources by the Applicant should leave not be granted. On whether the matter should be heard inter partes or *ex parte* the court held that grant of such leave *ex parte* cannot amount to condemnation of the directors unheard because they still stand a chance to bring their defenses at the main hearing and the court would determine the matter accordingly. Additionally, it is notable that the judge heavily relied on the United Kingdom's and Nigeria's statutes in coming to this decision stating that it is time that Kenya came up with clear provisions on institution of derivative claims.

The other case decided prior to the Companies Act 2015 is *Altaf Abdulrasul Dadani v Amini Akberazi Manji & 3 others [2004] eKLR*[108] which was also decided in 2012 and the Applicant submitted that leave should be sought after the suit has already been filed as held by Mwera J in *Dadani Vs. Manji & 3 Others [2004] Klr 94*. Further the Applicant submitted that leave applications should be heard inter partes because derivative actions are cemented in equity. Justice D. Musinga, however, held that on the filing of derivative claims the position by Mwera J could only be applicable if by then our Companies Act had such provisions. As such, he held that before the suit is filed a party should first file an application for leave *ex parte*. Therefore,

[108] Altaf Abdulrasul Dadani v Amini Akberazi Manji & 3 others [2004] eKLR

the application should only be filed with a well-detailed affidavit which would establish the existence of a prima-facie case. Decisions in Dr. Jane Wambui Weru v OPI Corp & 3 Others declared that the plaint and the application for authorization to proceed with vicarious liability must be delivered before any hearing can begin. This ruling was in direct opposition to that judgement. According to the court in this case, an inter-party hearing was necessary in order for the plaintiff to establish a prima-facie case in this instance.

These three cases illustrate that there has been confusion in courts as to the time of filing leave applications, whether the application ought to be heard inter partes or *ex parte*, and what accompanies the application. The expectation was that this issue would be addressed in the Act, taking into consideration the fact that it had arisen in courts prior to 2015. However, the true position is that issues at the leave stage are still being litigated. A case in point is *Hotstar Investments Ltd v Peter Kuria [2019] eKLR* [109]where the Applicant filed the derivative suit without applying for leave and as a result the Respondent filed a preliminary objection. The Applicant submitted that in the case of *Amin Akberali Manji& 2 Others vs Altaf Abdulrasul Dadani & Another [2015] eKLR****[110]*** the court held that leave of court shall be obtained before filing a derivative suit, but may also be obtained to continue with the suit once filed. The court dismissed the Preliminary Objection and held that the derivative claim was properly filed even though leave was not sought before the suit was filed.

From the above, it is clear that there is some contention on the stage that a party should seek leave and also on the hearing of the application. Additionally, courts and Advocates in Kenya have time and again relied on a text by Joffe titled *Minority Shareholders Law, Practice and Procedure* [111]in justifying that there is no approved pre-action protocol on filing of a derivative

[109] Hotstar Investments Ltd v Peter Kuria [2019] eKLR
[110] Amin Akberali Manji& 2 Others vs Altaf AbdulrasulDadani& Another [2015]eKLR
[111] Joffe, V., Drake, D., Richardson, G., Collingwood, T., & Lightman, D. (2011). *Minority shareholders: law, practice and procedure*. Oxford University Press.

claim. Courts have recognized that the law is not clear on the time of applying for leave and specifically in 2018 Justice Tuiyott stated that: *"Whilst there is no time prescribed within which leave should be sought, the practice of an early plea avoids an argument that no substantive motions or steps can be taken in the proceedings before leave is granted."*

3.2.2. The Challenge in setting the threshold for what constitutes a prima facie case in Derivative Actions

The term *prima facie case* is well known in litigation when courts are determining injunction applications and the evidentiary standard in such applications is as set out in the case of *Giella v Cassman Brown and Mrao Limited versus First American Bank*. Under common law and statutes for a derivative claim to be heard, the claimant has to establish the existence of a *prima facie* case. However, unlike in injunction cases in derivative cases there is no set standard; therefore courts have taken different approaches in determining the existence or lack of a prima facie case.

Prior to 2015 in *Tash Goel Vedprakash v Moses Wambua Mutua & another [2014] eKLR* [112]the court in establishing the existence of a prima facie case purely looked at whether there was evidence of wrongs being committed by existing directors of the company which may not be resolved through internal mechanisms. The Court further stated that since the matter was still at the leave stage, there was no requirement of establishing the existence of fraud.In *Morris and Company (2004) Limited v Diamond Trust Bank & 4 others [2018] eKLR* [113]the court's view was that the threshold applied in determining prima facie cases in derivative claims is as addressed under the provisions of section 241 of the Companies Act 2015. As a consequence, permission will be granted if the evidence adduced does not fall within the grounds of refusal

[112] Tash Goel Vedprakash v Moses Wambua Mutua & another [2014] eKLR
[113] Morris and Company (2004) Limited v Diamond Trust Bank & 4 others [2018] eKLR

under section 241(1) and discloses factors set under section 241(2) of the Act. The court further relied on the case of *Ghelani Metals Limited & 3 Others vs. Elesh Ghelani Natwarlal & Another (2017) eKLR* [114] in which the court stated that the application needed to demonstrate through evidence that there was a prima facie case without the need to show that it would necessarily succeed if leave was granted. This is clearly a departure from the prima facie threshold in injunction applications where an Applicant has to show that the case has a probability of success.

This challenge was also raised by the English Law Commission as stated in the previous chapter and the problem is still evident under Statutory Derivative Action provisions, and this creates confusion as to how far claimants have to go in proving the existence of a case at the first stage.

3.2.3. Burden of cost of litigation for derivative action suits

The Companies Act of 2015 is silent on who is to bear the cost of the litigation. Cost is important because the institution of derivative suits is in two stages, leading to high litigation costs.[115] Court of Appeal in Wallersteiner V Moir stated that in cases where an individual shareholder has brought a derivative claim, and the benefit of that claim accrues to their company, that would be appropriate for a judge to exercise his or her discretion in deciding whether to order the company to pay for the plaintiff's legal fees and expenses.

There is a claim that the court will not issue leave since the Applicant has requested fees. An investigation conducted by Lyne Taylor found that some applicants do not request that their employer pay their legal fees. [116]In a further study by Watts the rationale for this is that if the

[114] Ghelani Metals Limited & 3 Others vs Elesh Ghelani Natwarlal & Another (2017) eKLR.
[115] Safari, N. (2018). Reconsidering the role of the derivative claim in the United Kingdom. A comparative study with the United States and New Zealand. (Unpublished Doctoral thesis, City, University of London) pg.109.
[116] Taylor L, 'The Derivative Action in the Companies Act 1993' [1999] CanterLawRw 5; (1999) 7 Canterbury Law Review 314.

Applicant makes an application for costs the court might take this as a consideration when granting leave to continue with the derivative claim.[117]

In as much as the question of cost in derivative claims has not been litigated, this has been an issue in courts in the United Kingdom both under common law and after codification in statute. In 1996 *Re Kambrook Manufacturing Ltd* [118]the court ordered that no costs should be made against the company. On the other hand in *Smith v Croft*[119]**,** the court held that a percentage of the costs should still be paid by the shareholder as this would act as a tool to ensure that the plaintiff proceeds diligently with the case. Additionally, after the enactment of the Companies Act of 2006 of UK the Court has in very rare instances ordered for the company to indemnify the Applicant for the costs of filing the derivative suit.

3.2.4. Ratification consideration

One of the considerations taken into account by the Kenyan courts court is whether the acts raised as the basis of the application have been ratified by the directors of the company. This might act as a barrier to most shareholders because the law is not clear on what can be ratified and what cannot be ratified. Derivative action claims should be used as a tool to promote good corporate governance, however, such a provision is clearly a barrier,as the company or its directors might abuse this provision .

3.3. CONCLUSION

An examination of statutory derivative Claims in Kenya has demonstrated that there are still some gaps in the Companies Act 2015 on derivative claim provisions and this still presents a challenge to the Courts. In my view, the codification of derivative action under the Act should

[117] Supra note 127.
[118] Re Kambrook Manufacturing LtdHC Wellington M505/95, 23 May 1996.
[119]Smith v Croft [1986] 2 All ER 551.

have addressed the challenges under common law.It is interesting to note that the same challenges that were under common law are still the same challenges that might still be experienced despite the codification. Case in point, is the confusion as to the leave stage, the challenge in proving of a prima facie case and litigation costs.

Courts are viewed as a leeway through which citizens of a country including shareholders in any given company can get a recourse on behalf of the company. However, the reality is that the court is also guided by the laws in place in its decision making .Thus, any short coming in the law such as demonstrated above will have a ripple effect on the challenges experienced by courts in its decision making.

The end-goal of filing derivative action claims is to ensure that companies are adequately protected and in case of any form of abuse by its directors/officers the minority shareholders can file a suit on behalf of the company. Ironically, as the law is, litigants are in a state of confusion right from the time of filing the case and this goes all the way to the point where a claimant might possibly be asked to incur the costs of the suit. The challenges raised above could possibly discourage a potential claimant from instituting a suit and thus the purpose of a derivative claim fails.

CHAPTER FOUR

LESSONS FROM THE UNITED KINGDOM, NEW ZEALAND AND AUSTRALIA

4.1 INTRODUCTION

As discussed in chapters 1 and 2, derivative action claims can be traced from common law and it was not until the 1990s that jurisdictions codified the principle hence Statutory Derivative Action. The main objective of statutory derivative action was to ensure that the filing of derivative suits was efficient. As such, the expectation was that it would be an improvement from provisions under common law. Some jurisdictions formulated more comprehensive and detailed provisions governing the filing and determination of derivative suits than others. The purpose of this thesis was to consider the role and effectiveness of derivative claims in Kenya and this chapter will focus on a comparative study with a specific focus on the United Kingdom, New Zealand and Australia and the lessons thereof.

The jurisdictions relied on are important to this study for the following reasons: for the United Kingdom, our laws including provisions on derivative action claims are largely borrowed from the UK and it was important to do the comparison so as to see how the same has developed over years in UK as compared to Kenya. As for New Zealand and Australia , as will be discussed it is evident that the two jurisdictions have unique and important provisions which though not in the Kenya's Companies Act, the provisions could be important in promoting Derivative action claims in Kenya.

4.2 STATUTORY DERIVATIVE ACTION IN THE UNITED KINGDOM

When the English Law Commission was made aware of the challenges of derivative action under common law, the beginning of the path to Statutory Derivative Claims was made. An investigation into shareholder remedies, with a focus on Foss v. Harbottle exclusions, was mandated by the Securities and Exchange Commission in 1995. Among the shortcomings cited

in the commission's report were the following: the rules could not be based on a coherent body of law since they were based on outdated case laws; second, no action could be brought until the action was regarded fraud; and third, the first stage appeared lengthy and ineffectual because it was not apparent what parties required to do to find proof of a prima facie case. Thus, they described the common law provisions on derivative claims as inflexible and outmoded.

The Commission presented its recommendations and as a result the statutory scheme which came into force in 2007 provided that derivative claims in the United Kingdom may only be brought under part 11 of the companies Act of 2006.[120]The provisions on derivative claims are divided into two parts: the first dealing with derivative claims in England and Wales and the second part deals with derivative claims in Scotland.

4.2.1 Derivative Claims in England and Wales

Under this clause, anyone can file a claim against the firm or on behalf of the corporation, as long as they have a valid cause of action against them. As stated in the act, a member may make a claim in accordance with an order for the protection of members against undue disadvantage, or if a director's actions or omissions amount to negligence, default, failure to perform, breach of duty, or violation of trust. You may have a current or ex-director in charge of the project in this situation.[121]

When a member plans to submit a derivative claim, they must first apply for authorization from the court to do so before they may proceed with their case. Finally, the court can either give or deny permission to proceed with a lawsuit, depending on whether or not there is sufficient evidence to indicate that there is a prima-facie case to proceed. Courts have the option of

[120] Companies Act of 2006.
[121] Ibid Section 260(5).

directing the firm to provide additional evidence before hearing and deciding on the application.

Before granting leave, the court will look at the following factors: whether the action benefits the company, whether the act or omission has been allowed or ratified by the company, whether the action is likely to be ratified by the company, whether the member has contacted the court in good faith, whether the company has decided not to pursue the claim, and whether the member could prosecute the case on his own initiative.[122]

Section 264 of the act also provides for instances under which one member can continue a claim which was instituted by another member .The member in this case, while making the application, must demonstrate to the court that either: the manner in which the matter is being conducted amounts to abuse of the court process; the claimant has failed to prosecute the matter diligently or that it is more appropriate that the matter be continued by another member. [123]If the court is satisfied that the matter should be continued by another member then it will proceed and allow the application. In the alternative, the court will require additional evidence from the company before making its decision. [124]

4.2.2 Derivative action claims in Scotland

Derivative action in Scotland is provided for under sections 265 to 269 of the Companies Act of 2006. Just like the provisions in England and Wales, the process in Scotland envisages a two stage process, the first being the leave stage and the second being the hearing of the main suit. The grounds under which leave can be granted are similar those in England and Wales.

[122] Ibid Section 263(2) and (3).
[123] Ibid Section 264(2).
[124] Ibid Section 264(5).

The point of departure in the provision is the requirements when a member is filing the application. In Scotland, in making an application for leave the potential claimant must specify the cause of action and summarize the facts upon which the suit is brought. Further, there is a requirement that if the court allows the application at the first instance the Claimant has a duty to serve the company with the application. Additionally, the act is specific that the company is entitled to take part in the proceedings on the application.

In addition to the above section 239 of the Companies Act on ratification of acts of directors is key to derivative action. Section 239 guards the ratification process, such that the voting disregards the vote of the director whose action is being ratified if he or she is a member and the vote of any other member connected to him.[125]

4.2.3. United Kingdom's Civil Procedure Rules-Practice Directions 19C

In an effort to resolve the gaps in derivative action provisions under the Companies Act of 2006, the U.K updated its civil procedure rules through including section 19C on practice directions on derivative claims. To begin, the amendment stipulates that the defendant must be served with the claim form, the application notice, and the formal notice in support of the claim no less than 14 days prior to the court dispensing with the case. Further, the practice directions provides that when the court is making a decision on the existence of a prima-facie case the defendant (the company) will not make submissions and their attendance is not required.[126]However, if the company volunteers to make submissions then they should not pray for costs.[127]

In addition, from the above analysis the act was also silent on the question of cost. Section 19.9 (7) of the practice rules provides that the court may order the company to indemnify the

[125] Ibid, Section 239.
[126] Ibid Section 19C (5).
[127] Ibid.

claimant on costs incurred in the claim.[128]Finally, the rules provide that should a party discontinue the proceedings, it should be through the approval of the court. [129]

4.2.4. Lessons from U.K

The provisions of the U. K's Companies Act of 2006 are largely similar to the Companies Act of 2015 in Kenya. However, it is evident that in an effort to smoothen the procedure under the Companies Act, the Civil Procedure Rules provides for some critical amendments. The question on costs and the involvement of the company at the leave stage is well-addressed by the practice rules.

The main criticism of the U. K statutory derivative Action is that the definition is narrow and is largely geared towards the protection of the shareholder as opposed to the Company. According to Safari Neshat, for the objective of derivative action in the protection of a company to be achieved, the locus standi to file derivative claims should be extended to other stakeholders who might be affected by the actions of company's officers. The second critique is that the procedure is still ambiguous because of the uncertainties of the prima facie requirement.[130]

4.3. STATUTORY DERIVATIVE ACTION IN NEW ZEALAND

Derivative action in New Zealand is provided under the Companies Act of 1993 from section 165 to 168 all the way to sections 179 from the common law perspective.[131]

Similar to Kenya, the first step in the filing of a derivative suit is that the potential claimant must first seek leave to file the suit. In New Zealand the potential claimant could either be the director or shareholder. If the applicant is a shareholder in a firm, they can file a derivative suit

[128] Ibid Section 19.9(7).
[129] Ibid Section 19C (7)
[130] Supra note 22, pp.50.
[131] Companies act of 1993.

on their behalf. The provisions also extend to a suit that was already commenced by the company or a related company.[132] the likelihood of a suit advancing; anticipated costs; the company's or a linked company's previous conduct, and the company's interests in the matter are all elements that courts take into consideration when deciding whether or not to issue permission. If the company does not plan to pursue the claim, or if it is in the firm's best interest to have the subject decided by the shareholders or directors, the court will grant leave.[133]

The requirement under section 165(4) is that the notice of the application must also be served on the company. The resulting effect of the notice being served is that the Company may be heard during the application hearing and they must inform the court on whether it has any intentions of bringing, continuing or defending the suit.[134]

In instances where the court finds it fit and just to grant leave, the court will grant either of the following orders: it could authorize the shareholder or any other person to be in conduct of the proceedings; it could give directions on how the proceedings will be conducted; the court could also issue an order that the company provides additional information which will be useful in the proceedings, or it could order that the defendant do pay a specified amount to the shareholders instead of the company. Further to the above, the court must approve the discontinuance, settlement or withdrawal of a derivative suit.

In most jurisdictions including the UK and Kenya, the issue as to who is to bear the cost is not provided for in the Act. Under section 166 of the Companies Act of New Zealand, the company is expected to bear the cost of the derivative suit. [135]The Court shall therefore order that the company meets the cost of bringing or intervening the derivative suit, costs relating to any

[132] Ibid, Section 165(1).
[133] Ibid Section 165(3).
[134] Ibid Section 165(4).
[135] Ibid Section 166.

settlement or compromise or discontinuance. The only instance that the company may be exempted from bearing the cost is if they demonstrate to the court that it would be unjust and inequitable for the company to bear the costs of the suit.[136]

4.3.1. Personal Actions by Shareholders

Another interesting feature of the Act is that it provides separately for personal actions by shareholders. Under the common law provisions on derivative action claims, one of the exceptions under which a derivative action could be brought is when an action by the directors infringes on their personal rights of the shareholders. The New Zealand Companies Act is specific on how personal actions against a company's Director may be brought. The Act provides that the shareholder can only bring an action against the director where the director fails to uphold the duties they owe to the shareholders as set out in the Act.[137] On application by the shareholder, the Court may order that the director takes an action under the constitution or under the act or make an order granting a consequential relief to the shareholder.[138] In cases where the personal action is against the company as opposed to the director then the court may direct that the board of the company take action, or grant any other consequential relief as it deems fit[139]. Further, in an instance where a matter could be of interest to various shareholders as opposed to a single shareholder, the court will appoint one of the shareholders to have control of the proceedings on behalf of the other shareholders with a similar claim. [140]

The other aspect that was under common law was on ratification of the actions of a Director. As stated under chapter 1 and 2 of this thesis, where an action of a director was ratified then the director could not be held liable for such actions. Section 177(2) of the Act recognizes that

[136] Ibid.
[137] Ibid Section 169(1)
[138] Ibid Section 170.
[139] Ibid Section 171.
[140] Ibid Section 173.

ratification has always been deemed to be a valid exercise of the powers of shareholders. However, section 177(3) of the Act provides that the ratification of the actions of directors does not in any way prevent the court from the exercise its power vis-à-vis such actions.[141]

4.3.1. Lessons from New Zealand

The features that stand out is that first, the provisions distinguish personal actions from derivative action which is important to both the courts and the applicant. Secondly, the provisions make it mandatory that notice must be served on the company which the applicant intends to bring the suit against, which means that the leave application would be heard inter partes. Finally, the question of costs which is not addressed in the Kenyan jurisdiction is well addressed under the New Zealand's Companies Act.

4.4 DERIVATIVE ACTION IN AUSTRALIA

The Common law approach was used by Australian courts prior to 2001. In most instances, the rule in *Foss v Harbottle* was used as a restriction on the ability of shareholders to intervene on matters corporate mismanagement.[142] Statutory Derivative Action in Australia is provided for under the Corporations Act of 2001 under Part 2F.1A.[143]

A member, a former member, an officer or a former officer of the company is entitled to bring a claim on behalf of the company.[144] Derivative Action suits in Australia must be brought in the name of the company.[145]This is a feature that is very different from both Kenya and the United Kingdom; in fact, in Kenya it is evident through case law that derivative claims are brought in the name of the shareholder.

[141] Ibid Section 177.
[142] Griggs L, 'The Statutory Derivative Action: Lessons that May be Learnt from its Past!'(2002).'University of Western Sydney Law Review 6, pg.63.
[143] Corporations Act of 2001 part 2F.1A.
[144] Ibid Section 236(1)(a).
[145]Ibid 236(2).

Similar to other jurisdictions, for an individual to file a derivative claim he or she must first seek the court's leave. The court must grant leave if it is satisfied that: it is probable that the company will not bring the claim; the applicant is acting in good faith; it is in the company's best interest that the suit is filed and that there is a serious question to be tried.[146] The other consideration that courts 'may' take into account is that the applicant has served the notice of the intention to file the application 14 days prior to filing the application.[147]

The provisions put an emphasis on the aspect of best interest of the company. Therefore, while considering the question of best interest of the company, the following are considered: whether the suit is against a third party or by a 3rd party against the company; second, if the company demonstrates that it was in its best interest that the suit not be brought or did not defend the suit or to discontinued or settled the suit. [148]Third, the court will consider whether all the directors who made the decision were acting in good faith, did not have any material interest in the matter, they informed themselves about the subject matter before making the decision, and they rationally believed that the decision they made was for the best interest of the company.[149]

The initial applicant can also be substituted by another member, former member, officer or former officer. In this case, the court will consider whether one is acting in good faith and whether it is appropriate for the suit to be taken over by another person. The effect of a substitution is that the initial grant of leave is taken to have been made to the party substituting the other applicant and the substituted person is taken to have brought the proceedings.[150]

[146] Ibid Section 237(2).
[147] Ibid Section 237(2e).
[148] Ibid Section 237(3)
[149] Ibid.
[150] Ibid Section 238.

Section 239 of the Act makes provisions on the effect of ratification of a director's acts by members. Unlike in common law, ratification does not bar a person from bringing or intervening in a suit on behalf of the company against the directors. Further even if the action of the director was ratified it does not mean that the case will be determined in favour of the defendant or that leave will not be granted for the filing of the derivative suit.[151] The ratification by members will only have effect at the time when the court will be issuing its judgment of the derivative suit. The court will consider the following factors on ratification: how well-informed the members of the company were as they made the decision and whether the members were acting for proper purposes at the time of making the decision.[152]

It is envisaged that during the proceedings, a party may decide to withdraw the suit and should such a circumstance arise the provision is clear that it should be with the court's leave. [153]The Court therefore has the following powers during the continuance of the suit: the court could issue directions on proceedings including giving orders on mediation, and the court could also issue injunction orders to the company or a specific director.[154] Further, in an effort to ensure that a just and fair decision is reached, the court could also order that specific investigation be carried out by an independent person. The investigations could be in relation to: the financial affairs of the company; the facts that led to the cause of action and the costs those parties incurred in the proceedings. The court will also make orders as to who will foot the remuneration of the investigator. [155]

The Act also gives power to the court to determine who will shoulder the costs of the suit. The court could make orders regarding costs of the company, the applicant or any other person in

[151] Ibid Section 239(1).
[152] Ibid Section 239(2).
[153] Ibid Section 240.
[154] Ibid Section 241.
[155] Ibid Section 241(3).

the suit. However, the orders made earlier in the suit on the investigator's remuneration does not in any way affect the orders as to costs of the whole suit.[156]

4.4.1 Lessons from Australia

When courts decide whether to give leave of continuance under the Australian Act, the company's best interests are taken into account. In the case of *Swansson v R A Pratt properties pty limited,* the court emphasized that aside from a party proving the existence of a prima facie case, a party must demonstrate that the action is in the company's best interests. Second, the act effectively addresses the issue of cost, and it goes on to say that, in cases of any investigations that might need to be done before the final judgment is issued the court has powers to determine who will foot such costs. Third, the lack of ratification does not automatically prevent a derivative claim from being filed. The issue of ratification is only a consideration when issuing a judgment but not at the point when leave is being sought.

4.5 CONCLUSION

This comparative study largely shows that the procedural steps followed by courts around the world when deciding derivative action claims are almost similar but there are still some evident varying features. In as much as courts play an important role in the decision making of such cases, they are still guided by the provisions in the legislations as they exercise their discretion. As established above, the Kenyan law is largely borrowed from the U.K. On the other hand, the Australian and New Zealand provisions are detailed and address various issues that have not been addressed in the Companies Act of 2015.We can therefore draw some lessons from these jurisdictions to ensure that derivative claims are addressed in a just and fair manner.

It can be glimpsed from the Australian and New Zealand legislation that there is room for more focus in achieving the ends of derivative action claims, as well as clearing up ambiguities. The

[156] Ibid Section 242.

principle that governs derivative action claims in both jurisdictions as well as Kenya is the same; incorporation on locus and costs can therefore be made seamlessly. The provisions on costs can be adopted into the Companies Act through regulations on the same. This will guide courts on the factors to consider when deciding how cost is to be shared. Naturally, such regulation would also distinguish between costs in personal claims and derivative claims.

CHAPTER FIVE

FINDINGS, CONCLUSION AND RECOMMENDATION

5.1. Introduction

This is the last chapter of this paper and it will provide the findings, recommendations and conclusion of the study. The aim of this study as outlined in chapter 1 was to find out the efficiency of the current legislative provisions on derivative action claims in Kenya, to identify any possible gaps and more importantly, suggest possible recommendations that could be incorporated into our framework. The recommendations shall identify the gaps that need to be addressed and how the proposal will bolster confidence to the shareholders and other company stakeholders at large while at the same time promoting the interests of the company.

5.2 Findings

The need for statutory derivative action and its evolution from common law derivative action provisions are acknowledged in the paper.The study's major goal was to determine how effective the law controlling statutory derivative action claims is in protecting minority shareholders and the firm as a whole.

The study made a finding that the procedure in Kenya is largely borrowed from the laws in the United Kingdom.As such, most of the gaps that have previously been identified by scholars in the UK are quite similar to the Kenyan position. However, from the analysis in chapter 4 it also comes to light that in the UK some gaps that were not dealt with under their companies Act of 2006 was addressed through their civil procedure practice rules.

One of the main issues that is in contention through court decisions is how the application seeking continuance of the suit should be filed. The act seems to imply that the application should be heard *ex-parte* but from the above court analyses courts have had varied positions

on the same. Additionally, there is also some confusion on the time that application should be filed. The question is whether the application should be filed with the main suit or an applicant should first file the application then later file the suit. The varied positions taken by courts present some confusion to applicants and advocates representing them.

The study also found that there are various barriers in the establishment of a *prima-facie* case. The question of what amounts to prima-facie is largely left to the court's discretion. As discussed above, some jurisdictions such as Australia have well-detailed requirements that the court has to look at when a party presents an application to the court. Further, the shareholders might experience some challenges in proving the existence of a prima-facie case because they might not have access to critical documents which are in the defendant's custody. This would therefore mean that the shareholder might not meet the requirements needed by the court in proving the existence of a prima-facie case.

The applicant's other roadblock is the issue of costs. When a shareholder files a derivative claim, he or she is acting on behalf of the corporation. As a result, even when orders are placed, they are for the company's profit. As a result, a shareholder may be hesitant to file a claim if they are unsure that the corporation would cover the costs of filing the litigation. Furthermore, the act fails to distinguish between personal claims and claims submitted on behalf of the firm, a distinction that would be critical in determining cost.

5.3. Recommendations

5.3.1. Provisions centered towards the success of the Company

A derivative action is a lawsuit brought on behalf of the company by a shareholder. As a result, the rules should be targeted toward the company's protection while also safeguarding the claimant as a shareholder. However,the best interest of the company should come first. As it stands, section 238(1) vests the power to institute or continue derivative claims on members of the company, i.e., shareholders. In its current state, that section falls short of the objective of

protecting the company, since it leaves out persons who may have an interest and who may be in a better position, in terms of information asymmetry, to institute such claims. Section 238(1) should therefore be amended to achieve the objective of protecting the company as a whole.

Some recommendations in achieving this include:

a) I propose that the Act distinguishes personal claims from derivative claims. Under common law, personal claims and claims filed on behalf of the company were not distinguished; therefore, the exceptions for the proper plaintiff rule included claims protecting both the shareholders and the company. There are some claims which though brought on behalf of the company are by extension for the benefit of the minority shareholders. The distinction would be important to the court in ensuring that the orders given are geared towards the protection of the company.

b) Expounding the class of persons who can file derivative claims under section 238(1). Currently, derivative claims can only be filed by shareholders on behalf of the company. There are some actions that might be at the detriment of the company but the same might not be in the knowledge of the shareholders. The reality is that most of the time, there are some shareholders who could be totally clueless on what exactly goes on in a company.

   Additionally, the outcome of the court's directions might not only have an impact on the shareholders and the company but also on other stakeholders. Therefore, as recommended by other scholars such as Safari Neshat, the class of persons who can make the application should be extended to other important

stakeholders of the company such as the employees. Section 238(1) should therefore be amended to include such class of persons.

5.3.2. Cost

This study has established that the lack of clarity on costs is a barrier to potential applicants filing claims. In all the above analyzed jurisdictions, the legislations provide for detailed provisions on how the court is to issue directions on costs. Currently, the plaintiff might end up catering for the costs whereas the suit was filed on behalf of the company. Further, the general rule on costs under section 27 of the Civil Procedure Act in Kenya is not adequate, because even if the decision is not in favor of the plaintiff the fact remains that it was filed on behalf of the company. Therefore, the act should be clear on who bears the cost of such suits with an aim to encourage filing of derivative suits which would protect the company. I recommend that an additional section should be added in the Companies Act 2015, providing for costs and the considerations to be made in reaching that decision.

5.3.3. Notice to Company and Application-Hearing

The main confusion in courts is how the application should be heard, should it be heard *ex-parte or interpartes.*Under the United Kingdom's practice rules, the applicant must serve the company with the notice before applying for the court's leave. Further, UK's Act provides that the company should not make submissions in proving the existence of a prima-facie case but should they choose to make submissions then the company should not pray for costs.

Therefore, the provisions should be clear on whether the Company should be involved in the application stage. This would clear up the issue in contention as witnessed in the Kenyan courts. The targeted section of the Act would be section 238; a further section 238A should be added laying down the form that the application should take; whether it is to be *ex parte* or to be

served, the period limited for such service if any, and the timeline within which the court is to decide on the application.

5.3.4. The test to be applied in proving a prima facie case

As discussed above, the requirement that a party must prove the existence of a prima facie case was a requirement under common law and is still a requirement under the Companies Act of 2015.However, the same presents a barrier in a number of ways;first,the reality that the Applicant might lack critical information at this stage and secondly, there are the varying thresholds applied by courts in determining a prima facie case.

In my view, courts should allow a claim to go through to the second stage as long as a party can show that indeed there is a cause of action. As such, courts should not consider the chances of success at this point majorly because the claimant lacks the information which might be necessary in proving the case. In my opinion, having the claimant prove the chances of success of the suit is a higher standard that applicants might not meet.

5.3.5. Ratification

The provision under the Companies Act of 2015 is such that if the company has ratified or authorized the action in question then the court will not grant leave to the applicant. There is however need for the requirement to be scrutinized. As we have established, derivative action claims should be for the purpose of protecting the company. The court should not simply accept actions because they were ratified. The consideration should be on the impact of the ratification on the success of the company and the shareholders' level of knowledge at the time of ratification. Further, the interest of the directors in the ratification should be questioned; if the directors ratified the actions for their own good as opposed to the good of the company then that should be considered. As such, the relevant sections on ratification should be revised to require ratification by a majority of shareholders, and not simply authorization by the company.

This will help in eliminating the chance of shooting down a legitimate derivative claim at the behest of the board.

In the alternative, the Act should introduce a new section clearly laying out what can be ratified and what cannot be ratified, this would be a great tool for accountability by the board of directors and as a way of improving the principles of corporate governance generally.

5.4. Conclusion

Th first objective of this study was to assess the effectiveness of the two-stage procedure of filing derivative action claims in Kenya; this has been achieved as the study has pointed out the gaps that are possible barriers in the institution of derivative claims. The second objective was to assess the threshold in determining a prima facie case in Kenya and chapters 2 and 3 of this study has clearly pointed out with clear case examples how courts have given different thresholds to be applied in the determination of a prima facie case.

The final and most important objective of this study was to recommend possible solutions which, have clearly been set out under chapter 5 of this study. The recommendations set out in this paper are aimed at balancing the interests of the company while at the same time ensuring that the potential claimants do not encounter barriers which could possibly discourage the institution of such claims. The end goal of all the recommendations set out above is to ensure adequate protection of the Company from all angles. For the above-mentioned recommendations, first, if the judiciary applies the purposive approach in its reasoning then over time some of the recommendations can easily be achieved. Other recommendations such as costs can be introduced to the Companies Act through the laws being amended.

As it is evident from chapter 3 of this paper, Kenyan courts have not rendered many decisions on the subject. However, it is important that some reforms such as those suggested above are

implemented to prevent any possible future barriers in derivative action claims. Further, as we move along, it is also important for courts and even the legislative drafters to consider to what extent do the common law remain relevant to Kenya and how practical and useful are our laws in the protection of derivative action claims.

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