REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT NAIROBI

COMMERCIAL AND TAX DIVISION

HCC CIVIL CASE NO E 473/2020

NEXTGEN OFFICE SUITES LTD.....1st PLAINTIFF/APPLICANT

RAMESHKUMAR KANTILAL AMLANI....2nd PLAINTIFF/APPLICANT

VERSUS

NETCOM INVESTMENTS LTD.....1st DEFENDANT/RESPONDENT

NAVINCHADRA NATHOO SHAH.....2nd DEFENDANT/RESPONDENT

AND

SHAH MINAKSHI NAVINCHANDRA.....INTERESTED PARTY

RULING

Introduction

1. Before me for determination are **4** applications, namely; the Plaintiffs'/applicants' application dated **16th** November 2020 and **3** other separate applications filed by each defendant and the Interested Party all dated **30th** November 2020. Whereas the Plaintiffs' application seeks leave for the **2nd** Plaintiff to continue with this suit as a derivative action against the defendants, the **1st** defendant in its application prays that it be struck out from this suit with costs, while the **2nd** defendant and the Interested Party in their respective applications pray that the Plaintiff's suit be struck out with costs.

2. I will first address the Plaintiffs' application. In order to put the application into a proper perspective, it is useful to highlight, albeit, briefly, the Plaintiffs' claim as enumerated in their Plaint dated **16th** November 2020 filed simultaneously with their application.

3. The nub of the Plaintiffs' suit as enumerated in the Plaint is that the **1st** defendant was and is the Sub-lease holder of all that Property Known Unit **G** on the Ground Floor and Unit **M** on the Mezzanine Floor, (the Units) at the Nextgen Commercial Center erected on Land Reference Number **209/18648.** It is common ground that the **1st** defendant purchased the said Units from the **1st** Plaintiff vide a Sale Agreement in or about May 2017. The point of departure is that the **1st** Plaintiff maintains that it was a term of the sale that **2** Travellators and Hoist lift (the Travellators and Hoist) would remained the **1st** Plaintiff's property until the **1st**defendant purchased it after **3** years from the date of the Offer Letters. The Plaintiffs contend that by entering into the said agreements, the **1st** defendant accepted to purchase the Travellators and Hoist after **3** years, now past, hence, the **1st** defendant is obligated to pay for the same subject only to valuation.

4. The Plaintiffs state that the Travellators and Hoist were valued at **170,752.00** Euros at the time of the Letters of Offer and Agreements for sale, but in breach of the Agreements, the **1st** defendant with the connivance of the **2nd** defendant has failed/refused to pay for the same occasioning the **1st** Plaintiff loss and damage. They pray for specific performance of the contract and recovery of the said sum. They state that the special circumstances of this case could not allow them to send a formal demand note because the **1st** Plaintiff could not obtain a resolution/authority from the **2nd** Plaintiff (a director of **1st** Plaintiff) and the **2nd** defendant (director of the **1st** Plaintiff), since they are at loggerheads. They pray for judgment against the defendants jointly and severally for:

a. Specific performance of the contract.

b. Special damages and interest thereon.

c. Valuation of the Two (2) Travellators and Hoist lift.

d. General damages against the 2nd Defendant for breach of his fiduciary duty as a director of the 1st Plaintiff Company.

e. Costs of this suit

f. AND any other relief that this Honourable Court deems fit to grant.

The Plaintiffs application

5. Contemporaneous with the Plaint, the Plaintiffs filed the application dated **16th** November 2020, seeking an order that the **2nd** Plaintiff, Mr. Rameshkumar Kantilal Amlani be granted leave to continue the instant suit as a derivative action on behalf of the **1st** Plaintiff against the defendants and that the costs of the application be awarded to the **1st** Plaintiff.

6. All the grounds in support the application are basically a replica of the averments in the Plaint, hence, it will add no value to rehash them here. It will suffice to highlight briefly that the applicant maintains that in breach of the terms of the Letters of Offer and Agreements for Sale, the **1st** defendant failed to communicate its intention not to purchase the Travellators and Hoist. Further, on or about **22nd** September 2020, the **2nd** Plaintiff wrote an internal confidential Memo to his Co-Director, the **2nd** defendant, seeking his opinion on the recovery of the said sum, but the communication (s) elicited no response. Further, on or about **19th** October 2020, the **2nd** Plaintiff received a letter from the **1st** defendant's advocates giving him **7** days' notice to remove the said items from the **1st** defendant's premises in default, the **1st** defendant would remove them at the **2nd** Plaintiff /applicant's expense. Further, the applicants state that the **1st** defendant's letter ought to have been addressed to the **1st** Plaintiff as opposed to the **2nd** Plaintiff, in view of the fact that the said agreement was between the **1st** Plaintiff and the **1st** defendant. Further, that the **2nd** defendant abused his position by sharing the **1st** Plaintiffs confidential communication with the **1st** defendant to the detriment of the **1st** Plaintiff/applicant. The **2nd**Plaintiff contends that a dispute has arisen pitting the **1st** Plaintiff/applicant against the **1st** defendant with the connivance of the **2nd** defendant, to the sole benefit of the **1st** defendant.

7. The **2nd** defendant states that he is a director of the **1st** Plaintiff holding 5**0%** shares and therefore he has direct interest in the dealings, assets and liabilities of the company. He also states that the **2nd** defendant is a non-shareholder/director of the **1st** Plaintiff and a spouse to the interested party and as such has direct interest in the **1st** Plaintiff and **1st** defendant resulting in an apparent conflict of interest. And, that the Interested Party is a **50%** shareholder in the **1st** Plaintiff and a non-shareholding director in the **1st** defendant. Also, the applicants state that it has become imperative for the **2nd** Plaintiff to seek this court's leave to institute a substantive suit by way of a Derivative action on behalf of the **1st** Plaintiff, its shareholders and Creditors against the defendants for the recovery of the cost of the aforesaid items and an order of specific performance of the contract.

8. Further, the **2nd** Plaintiff states that as a director of the **1st** Plaintiff, he cannot influence or make decisions without the approval of the **2nd** defendant who is also a director of the **1st** Plaintiff, and in the derivative suit, the **2nd** Plaintiff/applicant intends to enjoin the interested party because she holds **50%** shares in the **1st** Plaintiff/applicant and she is also a non-shareholding director of the **1st** defendant, hence, any orders issued in the suit will affect her. Further, that the orders sought are necessary because without the orders, the suit will be struck out and the **1st** Plaintiff is apprehensive that the **1st** defendant will dismantle, remove and cart away the aforesaid items as threatened in their letter dated **19th** October 2020 to the detriment of the **1st** Plaintiff bearing in mind that the lifts were custom built for use in the subject premises in which event the **1st** Plaintiff, its shareholders and creditors will suffer irreparable loss.

9. They also state that the **1st** Plaintiff cannot institute a suit or protect its interests, or its shareholders/creditors interests without the concurrent resolution/authority of both the **2nd** Plaintiff and the **2nd** defendant who are at loggerhead with the **1st** Plaintiff, hence the reason for the application to commence and sustain a recovery suit through a derivative action. Lastly, that the **2nd** Plaintiff/applicant seeks this court's leave to maintain this suit on behalf of the **1st** Plaintiff, as a derivative action against the defendants jointly and severally, in order to protect the **1st** Plaintiff's interests, its shareholders and Creditors and that the suit has been brought in good faith without undue delay and for the sole benefit of the **1st** Plaintiff, its shareholders and Creditors.

The defendants' Response

10. The **1st** and **2nd** defendants' Response and the Interested Party's response is contained in the separate affidavits of Mr. Abhinav Navinchandra Shah, a director of the **1st** defendant, Mr. Navinchandra Nathoo Shah, the **2nd** defendant and Shah Minakshi Navinchandra, the Interested Party, a shareholder of the **1st** Plaintiff. Their affidavits are all dated **30th** April 2021 and their contents are substantially identical; so, it will add no value to rehash all of them here. It will suffice to highlight the salient points in the three affidavits.

11. Fundamentally, the striking points in the three affidavits are that there is no conflict of interest as alleged; that the **1st** defendant admits buying the two Units; that the **1st** defendant owes no binding obligation to purchase the Travellators and Hoist; that the subject agreement is binding and there is no agreement for the purchase of the same. Further, that the clause in the agreement relied upon by the applicants is vague and unenforceable because it relates to a letter of offer which does not create a binding obligation and that the terms of the transaction are stipulated in the Agreement for Sale.

12. They aver that there is no obligation on the part of the **1st** defendant to notify the **1st** Plaintiff that they have no intention of purchasing the same; and, that the Plaintiff has not adduced adequate evidence to sustain proceedings nor does the alleged obligation to purchase the Travellators and Hoist constitute a binding contract. Additionally, they depose that the Plaintiffs mode of communication offends corporate practice; that the **2nd** defendant has not abused his position; that the **1st** Plaintiff will not suffer any detriment if the Travellators and Hoist are not purchased by the **1st** defendant; that the **1st** defendant is not privy to terms of purchase of the said items nor can the **1st** Plaintiff coerce it to buy the same.Further, that there is no dispute between the **1st** Plaintiff and the **1st** defendant and that the **1st** Plaintiff is still the sole owner of the Travellators and Hoist and the **1st** defendant will benefit nothing if the chattels are not sold to it.

13. Also, the defendants and the Interested Party maintain that during the leave stage the burden of proof is beyond a *prima facie* case; that the **2nd** Plaintiff must show that the costs of the suit will not disrupt the **1st** Plaintiffs operations but must be of benefit to the company and that the costs of the suit to the company must outweigh any loss suffered if the prayers sought are not granted. Additionally, they state that the Plaint does not disclose a *prima facie* case against the **1st** defendant; and, that a reading of the subject agreement shows that the sale was for the units only, and, had the parties intended to create an obligation to buy the said items, the agreement would have expressly stated so. Further, that clauses **8.30 (b)** in both agreements are vague and that the items remain property of the **1st** Plaintiff.

14. Additionally, the defendants and the Interested Party state that the instant suit is a claim for alleged breach of contract disguised as a derivative claim because the **2nd** Plaintiff intends to sue the defendants on account of alleged breach of contract, hence, no derivative cause arises therefrom. Further, that the **2nd** applicant has not exhausted the remedies under the dispute resolution clause in Article **40** of the Articles and Memorandum of Association of the **1st** Plaintiff, which stipulate that all differences are to be referred to arbitration. Also, that the **1st** defendant has not committed any wrong against the **1st** Plaintiff and that the instant suit is commenced in the name of the **1st** Plaintiff yet a derivative suit cannot ensue from the proceedings and in any event no loss has been occasioned to the **1st** Plaintiff. Further, they state that the application is malicious, frivolous, vexatious and an abuse of court process and that the application dos not meet the grounds for leave to institute a derivative action.

The submissions

15. The Plaintiffs' counsel essentially rehashed the averments in the Plaint, the application and the supporting affidavit and argued that as a prudent director, the **2nd** Plaintiff/applicant seeks leave to institute a suit on behalf of the **1st** Plaintiff against the defendants for recovery **170,752.00** Euros. He argued that the orders sought are necessary to sustain the substantive suit due to the fact that the directors of the **1st** Plaintiff are at loggerheads and as such, the **1st** Plaintiff cannot recover from the defendants, unless leave is granted as prayed to sustain the substantive suit through a derivative action.

16. He submitted that the **2nd** Plaintiff/applicant intends to enjoin the Interested Party in the suit who holds **50%** shares in the **1st** Plaintiff and is a non-shareholding director of the **1st**defendant, and any orders obtained by the Plaintiffs/applicants will be binding on her and/or have a bearing on her as an Interested Party in both the **1st** Plaintiff and the **1st** defendant. He also argued that the orders sought are crucial because subsequent to the filing of the Plaint, the Respondents, their agents or assigns have since dismantled and taken possession of the Travellators and Hoist lift, and, the only legal recourse available to the applicants is an order for specific performance and damages which can be pursued after grant of leave.

17. The defendants and the Interested Party filed separate written submissions. However, the line arguments in the three submissions are essentially the same. Accordingly, to avoid replication, I will combine the three submissions. On behalf of the defendants and the Interested Party, it was submitted that the applicant has no company resolution authorizing the Plaintiffs' counsel to institute this suit nor is there evidence that the Board of Directors ratified the filing this suit. It was argued that there is no further pending obligation from either party regarding the subject contracts, and that the applicant has no cause of action against the defendants, but the application is aimed at coercing the **1st** defendant to purchase the **1st** Plaintiff's assets, that is, a hoist and travelator. It was argued that the application is premised on a misapprehension of facts and that the applicant is trying to force a dispute where there is none.

18. Counsel argued that the process of obtaining leave to institute a derivative action as prescribed in the Companies Act is a two-tier process. Counsel cited *Ghelani Metals Limited & 3 others v Elesh Ghelani Natwarlal & another*[1] which held that: -

> *44. Statutory procedure is now the exclusive method of pursuing derivative claims. The Act sets out what sorts of company claims may be pursued and is also explicit that derivative claims may only be pursued under the Act. The question must only be the factors the court ought to consider before approving a derivative claim.*

45. There appears, in my view, to exist a two-stage process. The court must first satisfy itself that there is a prima facie case on any of the causes of action noted under s.238(3). S.239(2) of the Act provides that the application for permission will be dismissed if the evidence adduced in support "do not disclose a case" for giving of permission. The essence of judicial approval under the Act is to screen out frivolous claims. The court is only to allow meritorious claims. All that the applicant needs to establish, through evidence, is a prima facie case without the need to show that it will succeed.

46. The second stage entails a consideration of statutory provisions and factors which ordinarily guide judicial discretion albeit in the realm of derivative action.

19. Counsel also cited Sections **238** and **239** of the Companies Act which provides as follows:-

"238. Interpretation: Part XI

(1) In this Part, "derivative claim" means proceedings by a member of a company—

(a) in respect of a cause of action vested in the company; and (b) seeking relief on behalf of the company.

(2) A derivative claim may be brought only— (a) under this Part; or

(b) in accordance with an order of the Court in proceedings for protection of members against unfair prejudice brought under this Act

(3)A derivative claim under this Part may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.

(4) A derivative claim may be brought against the director or another person, or both.

(5) It is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company.

(6) For the purposes of this Part—

(a) "director" includes a former director;

(b) a reference to a member of a company includes a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.

239. Application for permission to continue derivative claim

(1) In order to continue a derivative claim brought under this Part by a member, the member has to apply to the Court for permission to continue it

(2) If satisfied that the application and the evidence adduced by the applicant in support of it do not disclose a case for giving permission, the Court—

(a) shall dismiss the application: and

(b) may make any consequential order it considers appropriate.

(3) If the application is not dismissed under subsection (2), the Court—

(a) may give directions as to the evidence to be provided by the company; and (b) may adjourn the proceedings to enable the evidence to be obtained.

(4) On hearing the application, the Court may—

(a) give permission to continue the claim on such terms as it considers appropriate;

(b) refuse permission and dismiss the claim; or

(c) adjourn the proceedings on the application and give such directions as it considers appropriate. "

20. Counsel submitted that the application grossly violates the above statutory procedure and it should be dismissed with costs to the defendants and Interested Party. He submitted that the prescribed procedure is one of substance which cannot be cured by Article **159 (2) (d)** of the Constitution. He cited *Joshua Werunga v Joyce Namuyak**[2]*** which held that the provisions of Article **159(2)(d)** of the Constitution should not be used by litigants as a panacea to all irregularities and procedural technicalities and clarified that in *Raila Odinga v I.E.B.C &*

*Others**[3]*** the Supreme Court said that Article **159(2)(d)** simply means that a Court of Law should not pay undue attention to procedural requirements at the expense of substantive justice. In addition, counsel cited *Assia Pharmaceuticals v Nairobi Veterinary Centre Ltd* [4]which held that where a suit is to be instituted for and on behalf of a company there should be a company resolution to that effect.

21. Also, counsel submitted that the court has inherent power to jealously guard against any abuse of court process which the court in *Satya Bhama Gandhi v Director of Public Prosecutions & 3 others**[5]*** citing authorities defined it as a proceeding which is wanting in *bona fides* and is frivolous, vexations and oppressive or abuse of process or improper use of the legal process.

22. Additionally, counsel submitted that the **1st** defendant filed a suit on behalf of the **1st** Plaintiff without authorization from the board members as required by Order **4** Rule **1 (4)** of the Civil Procedure Rules of Kenya 2010, (Revision 2020). Counsel argued that Directors of a company are its agents through which a company act. To buttress his argument, he cited *Halsbury Laws of England**[6]***thus: - *"a company, not being a physical person, can only act either by resolution of its members in general meeting, or by its agents. It is not the agent of its member and a member as such is not the agent of the company, the company being a separate entity or legal person apart from its members, who are not even collectively, the company".* He also cited *Yussuf Abdi Adan & Another v Hussein Ahmed Farah & 3 Others**[7]*** for the holding that a board resolution must be issued authorizing commencement of a suit on behalf of a company. He further cited *Moir v Wallersteiner*[8] which held: -

> *"It is a fundamental principle of our law that a company is a legal person with its own corporate identity, separate from the directors or shareholders and with its own property rights and interests to which alone it is entitled. If it is defrauded by a wrong doer, the company itself is the one person to sue for the damage. Such is the rule in Foss v Harbottle [1843] 2 Hane 461. The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only one who can sue. Likewise, when it is defrauded by insiders of the minor kind, once again the company is the only person who can sue."(Per Lord Denning)*

23. Counsel also cited *Airways Ltd v Bowen & Another* for the proposition that once it is clear that the action was improperly instituted, it cannot be allowed to proceed. Additionally, he argued that a Plaint verified by an affidavit executed by an unauthorized person is a nullity and relied on *East African Portland Cement Ltd v Capital Markets Authority & 4 others* [9] in which the court declared a Petition to be a nullity for want of an affidavit approved by the minimum number of the required directors.

24. Additionally, counsel argued that the application does not meet the requisite threshold for grant of leave because no *prima facie* case has been established as defined in *Mrao Ltd. v First American Bank of Kenya Ltd and 2 others.**[10]*** He argued that the facts disclosed in the Plaint do not disclose any cause of action against any of the defendants. He cited the *Black's Law Dictionary*[11] which defines a right as something that is due to a person by just claim, legal guarantee, or moral principle. He singled out the clause in the sale agreement relied upon by the Plaintiffs and argued that the subject clause refers to a letter of offer and submitted that no subsequent letter of offer or contract were executed between the parties nor was any loss occasioned to the **1st** Plaintiff nor can the **1st** defendant be coerced to purchase the said assets. He submitted that a letter of offer is extinguished upon execution of a contract and cited I*saiah Waweru Ngumi & 2 others v Muturi Ndung'u**[12]*** which held that the purpose of leave is to sieve frivolous suits. Also, he cited *Ghelani Metals Limited* which held that the essence of judicial discretion is to screen out frivolous claims.

25. He submitted that the Plaint seeks to enforce an ambiguous and/or vague clause and it further prays for grant of general damages as against the **2nd** defendant yet it is trite law that general damages are not recoverable under a contract and relied on *Peter Umbuku Muyaka v Henry Sitati Mmbasu.**[13]***

26. Additionally, he submitted that there is no privity of contract between the **1st**Plaintiff and the **1st** defendant in relation to the travellator and hoist to warrant any cause of action between them. He placed reliance on *David Njuguna Ngotho v Family Bank Limited & another**[14]*** for the proposition that a contract cannot confer rights or impose obligations on any person other than the parties to the contract. He also cited *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd*[15]where Lord Haldane, LC reiterated that only a person who is a party to a contract can sue on it, a principle he submitted was has been affirmed in a chain of decisions among them *Agricultural Finance Corporation v Lengetia Ltd, Kenya National Capital Corporation Ltd v Albert Mario Cordeiro & Another and William Muthee Muthami v Bank of Baroda*.

Determination

27. For starters, a fundamental principle of corporate law is that one who becomes a shareholder in a company generally undertakes to be bound by the lawful decisions of the majority shareholders on the affairs of the company.[16] The principle of majority rule must, however, be balanced against the need for the protection of minority shareholders. Effective protection of minority shareholders is widely recognized as a cornerstone of a sophisticated corporate law system. Pivotal to the minority shareholder's armoury is the statutory derivative action provided in the Companies Act.

28. In the legislative intendment, the court is entrusted with a key function of serving as the gatekeeper to derivative actions. It plays a vital screening role in the exercise of its discretion to grant or refuse permission to a minority shareholder (or other suitable stakeholder) to pursue derivative litigation on behalf of the company, when those in control of it improperly fail or refuse to do so. The discretion of the court is a filtering mechanism designed to screen out claims that are frivolous, vexatious or meritless.

29. It must be borne in mind that a derivative action is brought by an applicant (such as a minority shareholder,) on behalf of a company, in order to protect the legal interests of the company. The derivative action is so called because the shareholder 'derives' his right of action from that of the company, to redress a wrong done to the company.[17] In other words, the shareholder is seeking to protect not his own rights but the company's rights. This is distinct from the situation where shareholders wish to enforce their own personal shareholder rights, in which case they would have personal redress and would thus rely on a personal action rather than a derivative action. Confronted with a situation in which the same wrongful act was both a wrong to the company and a wrong to each individual shareholder the Ontario Court of Appeal stated in *Goldex Mines Ltd. v. Revill**[18]***

In one sense every injury to a company is indirectly an injury to its shareholders. On the other hand, if one applies the test:

> *"Is this wrongful act one in respect of which the company could sue?", a shareholder who is personally and directly injured must surely be entitled to say, as a matter of logic, "the company cannot sue for my injury; it can only sue for its own."*

30. The corollary must surely be that when both the company and the shareholder have the same standing to sue for the same relief on the basis of the same facts the company must be entitled to say the shareholder has no need in the interests of justice to litigate in the corporation's name when he can do so in his own. In *Goldex Mines* the court answered the question '*Where the same acts of directors or of shareholders cause damage to the company and also to shareholders or a class of them, is a shareholder's cause of action for the wrong done to him derivative?*' in the negative.

31. It is trite that where a wrong is done to the company, the 'proper plaintiff' to take legal action in respect of the wrong is the company itself, and not individual shareholders. As stated by Lord Davey in *Burland v Earle*[19] '*in order to redress a wrong done to the company … the action should prima facie be brought by the company itself.*' The proper plaintiff rule stems from *'the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C.'*[20] The basis of the rule is the cardinal tenet of company law that a company is a separate legal entity, distinct from its shareholders.[21]

32. Hoexter JA gave the following exposition of the derivative action in *Francis George Hill Family Trust v South African Reserve Bank and Others: -**[22]***

> *"It is trite that a company with limited liability is an independent legal person and separate from its shareholders or directors. In general, therefore, when a wrong is alleged to have been done to a company the proper plaintiff to sue the wrongdoer is the company itself. In English law a derivative action constitutes an exception to that general rule. The exception is recognised when (1) the wrong complained of involves conduct which is either fraudulent or ultra vires and (2) the wrong has been perpetrated by directors or shareholders who are in the majority and so control the company. See, for example: Burland and Others v Earle and Others **[1902] AC 83** (PC); Edwards and Another v Halliwell and Others **[1950] 2 All ER 1064** (CA) at 1066-7; Prudential Assurance Co Ltd v Newman Industries Ltd and Others (No 2) **[1982] 1 All ER 354** (CA). The principle underlying the exception to the general rule is expounded thus by Lord Denning MR in Wallersteiner v Moir (No 2); Moir v Wallersteiner and Others (No 2) **[1975] 1 All ER 849** (CA) at 857d-f:*
>
> *"If it is defrauded by a wrongdoer, the company itself is the one person to sue for the damage. Such is the rule in Foss v Harbottle. The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs - by directors who hold a majority of shares - who can then sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorise proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue them themselves. Yet the company is the one person who is damnified. In one way or another some means must be found for the company to sue. Otherwise, the law would fail in its purpose. Injustice would be done without redress."*

33. Closely related to the proper plaintiff rule is the democratic principle of majority rule and the internal management principle, that the affairs of a company are decided by the rule of the majority and that the courts will not intervene in the internal affairs of the company at the instance of an individual shareholder when the majority acts lawfully. As stated in *Sammel v President Brand Gold Mining Co Ltd*[23] *"by becoming a shareholder in a company a person undertakes … to be bound by the decisions of the prescribed majority of the shareholders, if those decisions on the affairs of the company are arrived at in accordance with the law, even where they adversely affect his own rights as a shareholder."* The proper plaintiff principle and the principle of majority rule are compositely[24] referred to as the rule in *Foss v Harbottle*.

34. The classic case or the genesis of the derivative action is where the alleged wrongdoers who have harmed the company are the controllers of the company, so that the wrongdoers subsequently use their control to prevent the company from instituting legal proceedings against them to remedy the wrong that they themselves have perpetrated on the company. The danger is particularly acute when the wrongdoers have control of both the board of directors as well as the shareholders in general meeting. This occurs, for instance, where the wrongdoers are the majority on the board of directors (or are otherwise able to dominate or influence the board of directors) and are concurrently the majority shareholders of the company—so that the wrongdoers are able to exploit both their dominant position on the board as well as the shareholders in general meeting to frustrate any decision or resolution by the company to institute legal proceedings against them. For this purpose, the wrongdoers need not even hold a majority of the company's voting rights themselves; the spectrum could extend to control of a majority of the votes held in combination by the miscreant directors themselves and those voting with them as a result of their influence, support or simply apathy. This is the classic case for a derivative action.

35. The need for a minority shareholder to bring a derivative action on behalf of the company, to redress a wrong done to the company, generally arises where the company itself does not institute legal action to redress the wrong done to it. As elucidated by Lord Denning in *Wallersteiner v Moir (No 2):**[25]***

> *"The [proper plaintiff] rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs—by directors who hold a majority of shares—who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorize proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue themselves. Yet the company is the one person who is damnified. It is the one person who should sue. In one way or another, some means must be found for the company to sue. Otherwise, the law would fail in its purpose. Injustice would be done without redress."*

36. The statutory derivative action is thus a paramount protective measure for minority shareholders. It enables a minority shareholder, who knows of a wrong done to the company that has remained unremedied by management (often because they are the wrongdoers), to institute proceedings on behalf of the company. The derivative action is directed not only at enabling the minority shareholder to recover damages or property for the company when the directors have improperly refused to do so, but is regarded progressively as a fundamental corporate governance tool to monitor corporate conduct and to deter managerial or directorial wrongdoing.

37. The court is thus entrusted with a pivotal role in the statutory derivative action under sections **238** to **242** of the Companies Act. It has a crucial filtering function or screening function in deciding whether or not to permit the applicant to institute derivative proceedings on behalf of the company. This judicial screening mechanism is essential, since the company itself has chosen not to sue and the institution of a derivative action would involve the company in litigation against its will. The requirement of the leave of the court provides a safeguard against unwarranted interference by disgruntled shareholders, individual directors or other applicants in the internal management of the company, and prevents them from improperly arrogating the management function which is vested in the board of directors. This approach, moreover, averts opening the floodgates to a multiplicity of actions—if the leave of the court were not required, multiple actions could be brought by a multitude of individual shareholders and other applicants concerning the same wrong inflicted on the company.[26]

38. The test for leave to commence a derivative action is generally accepted as requiring the applicant to establish, at a minimum, good faith and that its proposed derivative action is in the company's best interests. The onus to prove good faith in applying for leave to commence a derivative action is borne by the applicant. A plaintiff whose conduct is tainted is barred from pursuing a derivative action. The Courts should be alert in dealing with speculative suits and shoot down such litigations at an early stage. The principle as laid down is as simple as under: -

> *"Derivative action is subject to the doctrine of clean hands, it is an equitable invention and cannot be used to do injustice", Palmer's Company Law, 24th Edition, page 978.*

39. The court must be satisfied, that the applicant is acting in good faith. While the merits of a proposed derivative action are a factor in assessing the good faith requirement, the good faith requirement cannot be subsumed by an analysis of the merits. Hence, a lack of demonstrable good faith may justify the denial of leave, even if the applicant's proposed derivative action is *prima facie* meritorious. In *Mouritzen v Greystone Enterprises and Another*, Ndlovu J citing similar legislation in New Zealand, Canada and Australia and decided cases on statutory derivative actions in Australia suggested the following factors which South African courts must consider when determining whether or not the 'good faith' requirement in derivative suits has been fulfilled. These are (a) whether or not the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success; and (b) whether or not the applicant is seeking to bring the derivative suite for such collateral purpose as would amount to the abuse of court process.

40. 'Good faith' is an elusive concept, the precise meaning and ambit of which is difficult to pinpoint. The concept of good faith may be interpreted with reference to well-established common law principles on the meaning of good faith. Just as a director has a duty to act in good faith in conducting the affairs of the company, so an applicant who wishes to pursue litigation on behalf of the company ought to act according to a similar standard of good faith. The principal of good faith looks at the motives behind a member bringing an action. It can appear on face value that an application is in good faith, but the repercussions of the action could have a beneficial outcome for the member at an individual level. The Court in *Swansson v RA Pratt Properties Pty Ltd* [27]set out the two important factors for identifying good faith: -

> *a. Honest belief – the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success; and*
>
> *b. Collateral purpose – whether the applicant is seeking to bring the derivative suit for such a collateral purpose as would amount to an abuse of process.*
>
> *Good faith does not mean that an individual cannot benefit from an action, but this cannot be the driving factor behind the action.*

41. The other test is the Best Interests Requirement. The best interests of the company must be simply that. It is a high threshold to meet. It considers the relationship between the applicant and the other members of the company, the effect an action would have on the company's business, and if there would be any practical benefit to the company. Under this test, a court should consider the merits of the proposed derivative action and also determine whether the relief sought is outweighed by the resulting cost and inconvenience. The court may dismiss a leave application that technically satisfies the statutory requirements for leave if, overall, the evidence on the merits is thin. The discretion of the court to grant leave to institute derivative proceedings entails a conflict between two equally important principles; *first*, the benefit of a right of redress by a stakeholder on behalf of the company and, *secondly*, the prevention of nuisance actions by stakeholders. The act is designed to lay the foundation for a proper balance between the use of the remedy for the protection of minority shareholders and the abuse of the remedy by minority shareholders. The Australian case of *Swansson v RA PRATT Properties Pty Ltd**[28]* in the context of a provision similar to section **241 (2) (a)** held that the section requires the court *"…to be satisfied, not that the proposed derivative action may be, appears to be, or is likely to be, in the best interest of the company, but, that it is in the best interests."*

42. In *Charles Meto v Amos Kosgey & 3 Others*[29] is illustrative of the principle that leave to bring a derivative claim before the courts will only be granted where the alleged wrong was suffered by the company and not the individual shareholder. The principle discernible from this case is that the applicant must demonstrate the wrong suffered by the company. The courts have also defined the evidentiary threshold required to establish the *prima facie* case in order to found a derivative suit. In *Tash Goel Vedprakash v Moses Wambua Mutua and Rabbit Republic Limited*,[30] the Court held that, *"at the stage of leave, there is no requirement that full proof of fraud be established by the applicant. **What is needed is prima facie evidence** …"*

43. The other hurdle is whether there is a serious question to be tried. There needs to be a real question to be tried. Namely, there must be a solid foundation for the action, meaning the member must have an arguable case. As was held in *Smith v Croft (No 2)* [31]:-

> *"That, although it was not appropriate to conduct an interim trial as to the truth of the Plaintiffs' allegations, the court should have*

regard to both the agreed and disputed facts in order to assess whether, applying the test of standard of care exercised by the prudent businessman in the conduct of his own affairs, the action should be allowed to continue at the company's expense; that, accordingly, since it was clear from the undisputed facts that the Plaintiffs' action had little chance of success and was being prosecuted against the wishes of the holders of the majority of the independently held shares, it would be unjust to grant the plaintiffs an indemnity for the costs incurred in bringing the action."

44. A further demonstration of the evidentiary threshold to establish a *prima facie* case in order to found a derivative claim is illustrated in *Altaf Abdulrasul Dadani v Amini Akberazi Manji & 3 others* ***[32]*** where the High Court held that in a situation where the plaintiff shareholder owns **50%** of the shares in a company and thus such shareholder cannot establish that the 'majority' shareholders are in control of the company, all that such a plaintiff has to do in order to be allowed leave to institute a derivative action is to demonstrate that a board resolution was not possible.[33] Once this is established, the plaintiff will have demonstrated his *locus standi* to institute the derivative action.

45. Because an applicant is premising its action on an alleged failure by the directors to remedy the situation, he must demonstrate that he served an appropriate notice to the directors or shareholders to remedy the situation and a notice of intention to lodge the application detailing the reasons for the application. An applicant cannot wake up one morning and decide to file an application for leave without demonstrating that despite notice, the persons accused of the failure have refused to act or persisted in their breach.

46. In *David Langat v St Luke's Orthopaedic & Trauma Hospital Limited & 2 Others*,[34] the issue for determination before the court was whether a shareholder who held 50% of the shares in a company can be granted leave to institute a derivative action as one of the exceptions to the rule in *Foss v Harbottle*. The court held that the need to establish a majority or minority before being granted leave to institute a derivative action may lead to injustice. According to the court, the paramount function of the court is to ensure that justice is done. Consequently, the court stated that it would allow leave for the applicant to institute the derivative claim since despite owning **50%** of the shares of the company, the applicant had demonstrated that the company had been injured by the acts of one of its shareholders.

47. Applying all the tests discussed above to the facts and circumstances of this case, it is my view that the facts and circumstances presented in this case do not meet the threshold to establish any of the tests discussed above to trigger the discretion of this court in allowing the leave sought. *First*, I am not persuaded that the applicant has demonstrated any loss suffered or likely to be suffered by the company. The clause upon which the entire claim is premised reads that the items in question shall remain the property of the vendor until it is purchased. Even though at this leave stage I am not conducting an interim trial as to the truth of the Plaintiffs' allegations, having regard to both the agreed and disputed facts in before me, my reading of the said provision is clear, that the ownership remains in the hands of the vendor until it is purchased. The clause does not make it obligatory for the purchaser to buy. We cannot strain the language deployed and agreed by the parties. A *prima facie* case cannot be founded for the purposes of the application before me on such a provision.

48. *Second,* it has not been demonstrated that the intended suit is in the best interests of the company. *Three,* there is no notice calling upon the defendants to remedy the situation hence the alleged failure to remedy the situation (if at all there was a wrong) has not been demonstrated. *Four,* there is nothing before me to show that the company has suffered any loss. More so, the agreement states that the items shall remain the property of the vendor. The applicant did not demonstrate that the company has been injured by the acts of the other directors or shareholders.

49. *Five*, the **2nd** Plaintiff claims that he holds **50%** shares in the **1st** Plaintiff and also in the **1st** defendant. Nothing was said to demonstrate that the **2nd** Plaintiff tried to call a meeting to discuss the alleged dispute or to obtain a company resolution. A notice requesting the meeting(s) and the outcome would have assisted to demonstrate the alleged failure by the other directors and inability to obtain a company resolution. *Six,* the clause in the agreement upon which the complaint is founded is contested and from the material before me, it cannot be said that a prima *facie case* has been established. *Seven*, the applicant failed to invoke the dispute resolution clause clearly provided in the Articles of Association which should have been the first port of call or provide exceptional circumstances to show that the dispute resolution mechanism contemplated under the said Article was not available or could not resolve the dispute.

50. My findings and conclusions herein above are summarized in the succinct test for granting permission to continue a claim for derivative action laid down in *Airey v Cordell and Ors* ***[35]*** as follows: -

a. The claimant must first establish a prima facie case that the company is entitled to the relief claimed and that the claim falls within one of the exceptions to the rule in Foss v Harbottle.

b. The court must then determine whether an independent and honest board of directors might reasonably have decided to bring the claim. If no reasonable board would have brought the proceedings, then the court should refuse permission to continue, otherwise it should grant permission. As long as the decision to litigate was within the reasonable range of decisions an independent board might make, the court should not go further and impose its own view of what such a board should have done.

51. Flowing from my analysis of the law, authorities and the applicable tests in applications of this nature, the conclusion becomes inevitable that the Plaintiffs'/applicant's application does not pass the above tests. Accordingly, I dismiss the Plaintiffs'/applicant's application dated **16th** November 2020 with costs to the defendants and the Interested Party.

52. The effect of the above finding is that the Plaintiffs' Plaint also dated **16th** November 2020 which was filed without leave cannot stand. Accordingly, the Plaintiffs' Plaint dated **16th** November 2020 is struck out. Having so held, it is my view that it will serve no utilitarian value to address the defendants' and Interested Parties applications dated **30th** November 2020 on ground that they are now overtaken by events.

Orders accordingly.

SIGNED AND DATED AT NAIROBI VIA E-MAIL THIS 29TH DAY OF JULY, 2021.

John M. Mativo

Judge

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[1] {2017} e KLR.

[2] {2013} e KLR.

[3] {2013} e KLR.

[4] HCCC No. 391 of 2000.

[5] {2018} e KLR.

[6] 4th Edition, Butterworths, 429.

[7] {2017} e KLR.

[8] {1975} 1 ALL ER 849 at p. 857.

[9] {2014} e KLR.

[10] {2003} KLR 125.

[11] 9th Edition.

[12] {2016} e KLR.

[13] {2018} e KLR

[14]{2018} e KLR.

[15] {1915} AC 847.

[16] Sammel v President Brand Gold Mining Co Ltd 1969 (3) SA 629 (A) at 678.

[17] Schiowitz v IOS Ltd (1971) 23 DLR (3d) 102; see also the English case Estmanco (Kilner House) v Greater London Council [1982] 1 WLR 2 QBD.

[18] (1974) 1974 CanLII 433 (ON CA), 7 O.R. (2d) 216.

[19] [1902] AC 83 (PC) at 93.

[20] Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204 at 210.

[21] As laid down in Salomon v Salomon & Co [1897] AC 22.

[22] 1992 (3) SA 91 (A), at 97B-G.

[23] 1969 (3) SA 629 (A) at 678.

[24] KW Wedderburn, *'Shareholders Rights and the Rule* in *Foss v Harbottle'* (1957) 194 Cambridge Law Journal 194 at 198.

[25] [1975] All ER 849 (CA) at 857.

[26] RP Austin & IM Ramsay Ford's Principles of Corporations Law 14ed (2010) 729.

[27] {2002] NSWSC 583.

[28] {2002} NSWSC 583.

[29] {2014} e KLR.

[30] [2014] e KLR.

[31] {1988} Ch 114.

[32] {2004} e KLR

[33] [2004] e KLR.

[34] 2013] e KLR.

[35]{2007} EWHC 346.