REVISITING THE STATUTORY SCHEME FOR DERIVATIVE ACTIONS UNDER THE NIGERIAN COMPANY LAW*

Abstract

Derivative action permits a minority shareholder, to institute proceedings on behalf of the Company in an attempt to redress a wrong perpetrated by the majority shareholders on the Company. Derivative action is therefore a departure from the Foss v Harbottle rule. As such, individual shareholders, by virtue of being members of the company, must be given a right, not only to participate in the proceedings of the company, but also to voice their concerns regarding the management of the company. This paper therefore examines derivative action in Nigeria under the Companies and Allied Matters Act.[1] It highlights the procedures laid down by CAMA for bringing derivative action in Nigeria and recommends that the requirement of notice on the directors should be excused in cases where the majority of the directors are the alleged wrongdoers since it is unreasonable to expect that a man will vote to bring a suit against himself. In such a case, a demand notice is unnecessary.

Keywords: Derivative actions, Company Law, Companies and Allied Matters Act, Nigeria, Foss v Harbottle

1. Introduction

It is a fundamental principle of company law that a company is a juristic person with its own separate corporate identity, separate and distinct from the directors or shareholders,[2]and as such, if it is defrauded by a wrongdoer, the company is the only one to sue for the damage. This principle of law of has been laid down in the English case of *Foss v Harbottle,*[3] to the effect that if an actionable wrong has been done on the company however arising (statute, contract, tort, equity), it is the company that can seek redress in court of law or ratify the irregular conduct, as the company is the one who suffers such injury and not its members, who are distinct and separate from it by operation of law.[4] The rule has been codified in section 299 of CAMA. Although this common law rule as codified in section 299 of the CAMA helps to curb a number of frivolous actions that may be instituted by shareholders or other stakeholders, and also ensures that the court is not interfering with the affairs of the corporation at the slightest chance,[5] nevertheless, it may serve as a hindrance to the protection of shareholders' rights. The rule is also 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 the shares- who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorize the proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestions that the company should sue them 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.[6] Indeed, a strict application of this general rule may restrict the access of minority shareholders to remedy a corporate wrong. However, in the appropriate circumstances, a shareholder is therefore entitled to bring the action as a representative of the company through a derivative action. This paper therefore examines derivative action in Nigeria under CAMA. It highlights the procedural obstacles for the commencement of derivative action.

2. The Nature of Derivative Action

Derivative action as stated by Bruce Welling is essentially 'a claim asserted by a shareholder on behalf of the corporation'.[7] Again, the Supreme Court in *Agip (Nig) Ltd v Agip Petroli Int'l*[8] defined derivative action as a 'lawsuit brought by a shareholder on behalf of a company against a third party.' In a shareholder derivative suit the law recognizes that corporate directors may not be acting in the best interests of the corporation when they refuse to assert the corporation's legal right to enforce the directors' fiduciary duty to the corporation[9]. It is therefore an action brought by minority shareholders to enforce the company's rights against another person.

*** By Onyeka Christiana ADUMA, LLB, LLM,** Lecturer, Faculty of Law, Nnamdi Azikiwe University, Awka, Nigeria.

[1] Cap C20, LFN, 2004.

[2] *Salomon v Salomon & Co* (1897) AC 22.

[3] (1843) 2 Hare 461.

[4] N C S Ogbuanya, *Essentials of Corporate Law Practice in Nigeria (*Lagos: Novena Publishers Ltd, 2000) p.190.

[5] *Mac Dougall v Gardiner* (1875) 1 Ch.D, 13.

[6] *Wallersteiner v Moir (No.2* (1975) 2 WLR 389,395.

[7] B Welling, *Corporate Law in Canada: The Governing Principles* (2nd edn, Toronto: Butterworths, 1991) p. 544; G K Sahu, 'Investors Protection: The Derivative Action', (2017) 3(3) *International Journal of Law*, 101.

[8] (2010) 5 NWLR (pt 1187) 348, 397.

[9] E C Lashbrooke, , 'The Divergence of Corporate Finance and Law In Corporate Governance' (1995) 46 *SC L Rev*. 449.

Being a corporate action, the real purpose of instituting it is to protect the interest of the company or remedy a wrong done to the company. In this action, the shareholder sues on behalf of the company against the wrong doers, the company being a nominal defendant. The term 'derivative' is used to emphasize the fact that the action is an equitable device to enforce the rights of the company. In other words, the action is derived from the need to permit shareholders to stand in for the company and enforce certain rights belonging to it. According to Welling, 'it is the minority shareholder's sword to the majority's twin shields of corporate personality and majority rule.'[10] With derivative action, minority shareholders might have some chance to hold the wrongdoers often directors or majority shareholders liable.[11] The action is different from a personal action where the shareholder sues on his own behalf or a representative action where he sues on behalf of himself and other shareholders.

3. Who can be an Applicant for Derivative Action?

The following persons may apply to Court under a derivative action:

(i) Registered holder (member) or beneficial owner (by transfer or transmission of shares) and former registered holder /beneficial owners of the company's security (debenture holder);
(ii) Present or past director or officer of the company;
(iii) Corporate Affairs Commission;
(iv) Any other person the court can permit to make the application.[12]

Indeed, the inclusion of former registered holders or beneficial owners of a security of a company as one of the applicants for derivative action reflects the fact that the rights being enforced are those of the company rather than those of the member. However, the former registered holders of security of a company are more likely to be acting in their own interests, given that they are no longer directly associated with the company. The writer is therefore of the opinion that it may not be appropriate to allow a person to become an applicant where he is no longer entitled to receive a share in a possible future compensation. Thus, in the case of *Chief Akintola Williams & ors v Edu*[13] the Court of Appeal was of the view that a non-member of a company cannot institute a derivative action under the section in spite of the provisions that allows anybody to apply at the discretion of the court. The courts had also refused to allow former shareholders and former directors[14] because they lack sufficient interest in the outcome of derivative action, when in fact the Act expressly permits them to bring the application. Also, a shareholder cannot bring derivative action if his conduct is such as to disqualify him. For example, where he was party to the wrong about which he complains.[15]

4. Conditions for Successful Application for Derivative Action

Section 303(2) CAMA set out the basic conditions an applicant would fulfill to ground a successful application for derivative action. According to the section:

The Action can only be brought with the Leave of the Court

Section 303 CAMA also requires the leave of the court before a derivative action can be commenced. Derivative action is an innovation of equity as such; it is subject to the discretion of the court and not automatic like a personal action. Where the applicant's hands are soiled in equity, he may be disqualified from bringing the action. For instance, in *Whitwam v. Watkin,*[16] the court held that where the plaintiff has participated in the wrong which is being complained of, he is disqualified from bringing such action. It needs be stressed that in considering whether to grant leave to the applicant, the court may consider a host of factors which may include the strength of the applicant's case, the applicant's good faith, the interest of the company, whether the wrong was ratifiable or had been ratified, the views of any independent organ of the company and the availability of alternative remedies. The action may be brought in the name of the company or on behalf of the company or it may be to intervene in an action to which the company is a party for the purpose of prosecuting, defending or discontinuing the action on behalf of the company.

Wrong Doers Control of the Company

It must also be shown that the wrong doers control the company and they will not take necessary action. Section 303(2) (a) of CAMA provides to the effect that no action may be brought unless the court is satisfied that the

[10] Welling, *op cit*, p.526.
[11] *Ibid.*
[12] CAMA, ss. 303 & 309.
[13] (2002) 3 NWLR (Pt 754) 400.
[14] *Schafer v International Capital Corporation* (1997) 4 WWR 99.
[15] *Towers v African Tug* (1904) 1 Ch 558.
[16] (1898) 78 LT 188; see also *Towers v African Tug, supra.*

wrong doers are the directors who are in control, and will not take necessary action. In *Heyting v Dunpont,*[17] a minority shareholder had instituted an action against another shareholder. The other shareholders filed a counter claim against the plaintiff shareholder. The counter claim was dismissed because the plaintiff was not in control of the company. Again, in *Sparkles Electric Ltd v Ponmile,*[18] the Supreme Court dismissed the plaintiff's action on ground that there was no evidence that the defendant was in control of the company. Indeed, control is not confined to cases where the wrong doers have voting control of the company but extends to the situation where, though not holding the majority of the shares in the company, the wrong doers are able by manipulating their position in the company to ensure that the majority will not allow a claim to be brought by the company for the alleged wrong, in brief, where the wrongdoers are in factual though not necessary in legal control. [19] The learned justices also observed that control embraces a broad spectrum extending from an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy.[20] In effect, the wrong doers would be held to be in control if it would be futile to call a general meeting because they would directly or indirectly dominate it, or if they are shown to be able by any means of manipulation of their position in the company to ensure that the action is not brought by the company.

Perhaps, it seems from the wordings of section 303(2) (a) of CAMA that derivative action can only be brought against directors who are in control of a company. The writer is of the opinion that it is desirable that a claim against third parties should be permitted in certain circumstances. For instance, where by reason of a breach of duty by the director, a third party has come into possession of property of the company which it should be required to hand back (for example, the property has been transferred in breach of trust or the individual has been giving knowing assistance) or where the director has acted in cahoots with a third party, or there may simply be a conspiracy between the third party and the director. It would be necessary in such circumstances that proceedings be brought against both the director and third party or either as appropriate. That would certainly meet the justice of the case and there would not be any advantage in restricting, limiting or barring that derivative process against the third-party conspirator who, on this hypothesis, is not a director of the company. The writer therefore recommends that derivative action should be brought against the director whether in control or not or against a third party, or both.

Reasonable Notice to the Directors of the Company

The applicant must have given reasonable notice of his intention to apply to the court if the directors of the company do not bring, diligently prosecute or defend the action. In other words, directors must be notified of the applicant's intention to apply if they had failed to do so. There is no period specified under section 304 of CAMA within which the action should be brought by the directors. This is an important component of American derivative action where there must be a pre-suit demand on the board by the shareholder, explaining the claim he wishes, investigated and remedied. If the board reaches a decision not to bring an action, the shareholder may challenge the decision as a breach of fiduciary duty but has no right to directly litigate on the claim unless the directors' action in refusing not to sue is not protected by the business judgment rule. However, American law exempts a pre-suit notice to directors if the demand would be futile, for instance, where the directors lack the independence to impartially consider the demand.[21]

The Applicant must be acting in Good Faith

The applicant must be acting in good faith in making the application. Where the action is brought for ulterior motive, it will not be entertained.[22]

The Bringing of the Action appears to be in the Interest of the Company

The action will be in the interest of the company, for instance, where the applicant can establish that the directors' refusal to bring the action is because of their personal interest in the matter. This requirement is not part of the common law requirement and has been described as a welcome development[23]. The court will have to ensure that the bringing of the litigation will not bring more harm to the company. As Paul Davies, puts it:

> The test, it is submitted, is whether it is in the best interest of the company that litigation be instituted, and that question can be answered only on the facts of a particular case.

[17] *Supra.*
[18] *Heyting v Dunpont, supra.*
[19] *Prudential Assurance Co. Ltd* v *Newman Industries Ltd,* (No2) (1982) Ch 204..
[20] *Ibid.*
[21] Model Business Corporation Act 2002, s 7.42.
[22] *Knight v Frost* (1989) BCLR 364.
[23] P L Davies, *Gower & Davies' Principles of Modern Company law* (7th edn, London: Sweet & Maxwell, 2003) p 443.

> It is easy to imagine many reasons why litigation would actually leave the company worst off than it was before. There may be doubts about whether a verdict in favour of the company will be obtained, either because of disputes about the law or because of difficulties of proving the events said to constitute the breach of duty. Or the defendants may not be in a position to meet the judgment even if the litigation is successful. Or the senior management time spent on the litigation might more profitably be used elsewhere or, finally while winning the legal argument and obtaining an enforceable remedy, the company may suffer collateral harm which outweighs the gain from litigation.[24]

Furthermore, an application, action or intervention under section 303 will not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the company has been or may be approved by the shareholders. But evidence of such approval by the shareholders may be taken into account by the court in making an order. [25] It follows that the shareholders' approval is not inclusive of the matter, an action by the minority in respect of breach of a right or duty or abuse of power by the directors or the majority will be entertained by the court whether or not such breach is ratifiable. In furtherance of this, section 306 makes it clear that it is for the court to decide whether or not ratification or approval by the majority can validly put an end to the minority's complaint. Accordingly, proceedings under section 303 shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the rights of any applicant may be substantially affected by such stay, discontinuance, settlement, or dismissal, the court may order any party to the proceedings to give notice to the applicant. Be that as it may, by section 306 of CAMA, the moment a derivative action is commenced, plaintiff cannot withdraw such action except with leave of court. A derivative action is therefore court controlled and cannot be negotiated out by the plaintiff without the consent of the court. This is to ensure that the plaintiff does not negotiate a settlement that is meant to benefit him or her as against the company. Section 307 of CAMA also stipulates that an applicant shall not be required to give security for costs in any application made or action brought or intervened in under section 303 of CAMA. Section 308 allows the court to order the company to pay to the minority shareholder an interim cost before the action is concluded. This provision reflects the principle in *Wallersteiner v Moir (No 2)*[26] where Lord Denning MR held thus:

> The minority shareholder, being an agent acting on behalf of the company, is entitled to be indemnified by the company for all costs and expenses reasonably incurred by him in course of the agency. This indemnity does not arise out of contract, expressed or implied but it arises on the plainest principles of equity. It is analogous to the indemnity to which a trustee is entitled from his cestui que trust who is sue juris…seeing that if the action succeeds, the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf. If the action succeeds, the wrongdoing director will be ordered to pay the costs: but if they are not recovered from him, they should be paid by the company…but what if the action succeeds? Assuming that the minority shareholder has reasonable grounds for bringing the action- that it was reasonable and prudent course to take in the interests of the company-he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself. In addition, he should himself be indemnified by the company in respect of his own costs even if the action fails. It is a well known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails….

It follows that the company must reimburse the costs assumed by the minority shareholder acting on behalf and for its benefit. This issue is usually dealt by the court at the preliminary stage if the applicant shows his good faith and reasonableness of the action. The rationale behind this rule is that the rights, applicant is seeking to vindicate, are those of the company and the addressee of the potential remedy is the company. Lord Denning also made it clear in *Wallersteiner* case that 'seeing that, if the action succeeds, the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf'.[27] This rule works even when the action is unsuccessful as noted in the same case.

[24] *Ibid*, p.443.
[25] CAMA, s. 305.
[26] (1975) QB 373.
[27] *Wallersteiners* v *Moir* (No 2), *supra*, p.392.

5. Procedural Hurdles for Commencement of Derivative Action in Nigeria

Section 303 (1) of CAMA provides to the effect that an applicant may apply to court for leave to bring an action in the name or on behalf of the company or to intervene in an action to which the company is a party for the purpose of prosecuting, defending or discontinuing the action on behalf of the company. While Rule 2 (1) & (2) of the Companies Proceedings Rules 1992 also provides that:Except in the case of the application mentioned in rules 5 and 6 of these rules and application made in proceedings relating to the winding up of companies, every application under the Act shall be by originating summons. An originating summons under these Rules shall be in form 1 specified in the schedule to these rules.

Again, Rules 5 of the Companies Proceedings Rules 1992 also provides that:

(1) after presentation of a petition by which any such application as is mentioned in rule 6 of these rules is made, the petitioner, except where the application is one of those mentioned in paragraph (2) of this rule, shall take out a summon for direction under this rule.

(2) the applications referred to in paragraph (1) of this rule are:
   (a) an application under section 121 (2) of the Act to sanction the issue by a company of shares at a discount;
   (b) an application under section 591 (3) of the Act to sanction a compromise or arrangement, unless there is included in the petition for such sanction an application for an order under paragraph (a) to (f) of that subsection;
   (c) an application under section 525 (6) of the Act for an order restoring the name of a company to the register.

While Rule 6 of the Companies Proceedings Rules 1992 provides for inquiry as to debts of the company pursuant to an application to confirm a reduction of the share capital, the share premium account or the capital redemption reserve fund of a company. A cursory look at these provisions particularly Rule 2 (1) & (2) shows that they are silent on the nature, type or form of the originating summons by which an applicant seeking leave to commence a derivative action is to adopt. There is no indication whether the originating summons should be by motion ex parte or on notice. While section 303 (1) of CAMA merely states that an applicant may apply to the court for a leave to commence the action, the Companies Proceedings Rule 2(1) apart from stating that every application under CAMA[28] is to be by originating summons, is equally silent on the nature or form of the originating summons in an application for leave to commence a derivative action.

Again, the Companies Proceedings Rule seems to be silent as whether the application for leave to commence a derivative action should be by originating summons on notice or by originating summons ex parte. Also the forms of originating summons contained in schedule of forms (form 2) to the rule does not help matters as they are equally silent as to the form of the originating summons to be adopted in an application for leave to commence a derivative action. Moreover, the Companies Proceedings Rules provide under Rule 19 that in all proceedings in or before the court concerning the operations of the Act, where no provision is made by the Rules, the Federal High Court (Civil Procedure) Rules shall apply. Order 3 of the Federal High Court (Civil Procedure) Rules 2009 therefore provides for originating summons and referred to various forms of originating summons including originating summons ex parte and originating summons not inter parte. Sadly, these provisions in the two rules (the Companies Proceedings Rules and the Federal High Court (Civil Procedure) Rules 2009 do not completely cure the omission created in the Company Proceedings Rules as there are no specific provisions that an application for leave to commence a derivative action must be made, either by originating summons ex parte or originating summons on notice. Although, the Companies Proceedings Rules 1992 were specific in Rule 2 (3) in providing for applications that may be made by originating summons ex parte, an application for leave under section 303 (1) of CAMA was not among the listed applications to be made by way of originating summons *ex parte.* However, the Supreme Court in *Agip (Nig.) Ltd v Agip Petrol Int'l* [29]case stated the procedure for commencement of derivative action thus:

A minority shareholder who intends to bring derivative action in the name of the company must first and foremost apply for leave of court by way of originating summons on notice to the company. The shareholders will require the courts consent to sue. The derivative action must be commenced with the claim form referred to in Rule 2 (2) of the Companies Proceedings Rules, 1992, and an application by the shareholder for the court's permission or leave to continue the claim. The company must be made a defendant for the technical requirement of ensuring that the company is bound by any judgment given. The hearing of the shareholder's application will thereafter proceed in the manner of an ordinary interim application with both sides being afforded the opportunity to submit

[28] except applications mentioned in Rules 5 & 6. And applications mentioned in Rules 5 & 6 did not include application under section 303 (1) CAMA.

[29] Agip (Nig.) Ltd v Agip Petrol Int'l (2010) 5 NWLR (pt 1187) 349.

evidence and address. The company must be given notice of such hearing so that the company or the directors may be able to appear to present their view of the shareholders' case.

It follows that from the decision of the Supreme Court in *Agip* case, an application for leave to commence a derivative action must be brought by way of originating summons on notice and not by motion ex parte. As such, Rule 2(1) of Companies Proceedings Rules 1992 by incorporating the supreme court decision as regards the mode of applying for leave to commence derivative action. Again, section 303(2) of CAMA that requires the applicant to give reasonable notice to the directors of his intention to apply to the court if the directors do not take necessary action provides no specification as to the number of days that will constitute a reasonable notice, the term is therefore unclear and lacking exactness. CAMA do not also give any exception to pre-action notice, unlike some other jurisdictions like the United States, where a shareholder must serve the board of directors with a demand prior to the pursuit of a derivative action. The demand will be excused when it is futile to expect the directors make a reasoned and unbiased decision on the matter, for instance, where the directors themselves are the persons whose actions are being questioned[30].

6. Remedies for Successful Derivative Action

Section 304 (1) of CAMA provides that when derivative action is brought with the leave of the court under section 303, the court may at any time make any such order or orders as it thinks fit, including one or more of the following orders:

(a) authorizing the applicant or any other person to control the conduct of the action;
(b) giving directions for the conduct of the action;
(c) directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part directly to former and present security holders of the company instead of the company;
(d) requiring the company to pay reasonable legal fees incurred by the applicant in connection with the proceedings.

An applicant is not required to give security for cost but the company may be ordered to pay interim cost to the applicant during the proceedings.[31]

Conclusion and Recommendations

The vagueness in the derivative action provision and the strict interpretation adopted by the courts may have a significant impact on the protection of minority shareholders' rights. For instance, the pre-action notice required to be provided by the applicant does not stipulate the number of days, weeks or months required. Also, the rigid interpretation and rules of the courts in including the 'locus standi' test and insisting upon a particular procedural mode of commencement of the action can frustrate the use of the derivative action as a remedial tool for minority shareholders' protection. Also, the lengthy proceeding arising from the tactical delays orchestrated by the directors or their counsel as a result of the vague statutory provisions could be burdensome for minority shareholders who do not want to incur legal costs chasing a matter for which they are not certain to a reasonably probable degree that they will obtain a remedy. The situation is even worse where the legal costs to be incurred over a long span of time are enormous and unreasonable compared to the minority shareholders' returns on investments unless the court gives an order for the company to pay the interim costs of the applicant. In the absence of such an order for interim costs, the best business decision for the aggrieved minority shareholders will then be to discontinue the matter, or not institute the action in the first place having calculated the estimate.

7. Conclusion and Recommendations

There is no doubt of the importance of derivative actions as a tool for corporate governance and management accountability of the directors. Derivative action is a departure from the *Foss* rule since it allows since it allows the very action which *Foss* rule aimed at preventing. However, the strict interpretation adopted by the courts may have a significant impact on the protection of minority shareholders' rights. For instance, the pre-action notice required to be provided by the applicant does not stipulate the number of days, weeks or months required. Also, the rigid interpretation and rules of the courts in including the sufficient interest test [32]can frustrate the use of the derivative action as a remedial tool for minority shareholders. As such, the writer therefore recommends that the requirement that the applicant must give reasonable notice to the directors of his intention to apply to the court if they do not take necessary actions should be excused in cases where the majority of the directors are the alleged wrongdoers since it is unreasonable to expect that a man will vote to bring a suit against himself. In such a case,

[30] Welling, *op cit*, p527.
[31] *Omisade v Akande* (1987) 2 NWLR (pt 55) 155.
[32] In *Adenuga v Odumeru* (2003) 8 NWLR (pt 821) 163, the court held that the applicant must disclose sufficient interest to justify the bringing of derivative action

a demand notice is unnecessary. Also, it is recommended that section 304 of CAMA be amended to provide for recovery of all litigation expenses whether the action succeeds or not from the company. This is because an applicant may not be able to shoulder the litigation expenses. Again, derivative action should be brought against the director whether in control or not or against a third party or both. The writer further recommends that Companies Proceedings Rules 1992 undergoes an amendment to provide for application for leave to commence derivative action by way of originating summons on notice. In other words, the Companies Proceedings Rules should be amended to incorporate the decision of the Supreme Court in *Agip* case by specifically stating that an application under section 303 of CAMA shall be made by way of originating summons on notice.