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Common law derivative action survives for close corporations despite Companies Act



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11 Feb 2022

In the recent decision in [Naidoo and Another v The Dube Tradeport Corporation and Others](#) the Supreme Court of Appeal yet again had cause to consider two issues which have long occupied the minds of corporate lawyers: (i) the common law derivative action by means of which members of a company or close corporation may take legal proceedings on behalf of the entity in circumstances where such entity fails to institute the necessary proceedings to protect its interests; and (ii) the doctrine of constructive notice. In the present instance, however, the court had to make its decision against the background of the [Companies Act 71 of 2008](#) which specifically abolished the common law derivative action and replaced it with a statutory derivative action.

One Sagadava and his brother Sivaraj both held members' interests in Odora Trading CC, albeit that Sagadava was not registered as such, but had a claim to be treated as the true beneficial owner of a 50% member's interest in the CC, registered in the name of Sivaraj. Sagadava together with Odora sued Sivaraj and Dube Tradeport to have the sale of certain farms by Odora to Dube set aside. It was alleged by Sagadava that Sivaraj had no authority to sell the properties to Dube without his consent. On this basis he purported to institute a derivative action on behalf of Odora to have the sale of the properties set aside.

It is further relevant to note that, prior to bringing the application in the present matter, Sagadava had instituted action in the High Court against Sivaraj to have the 50% member's interest transferred into his name. Whilst such action was pending, Sivaraj, purporting to have the authority to act on behalf of Odora, sold the properties to Dube. It is clear on the facts that Dube was aware of the litigation in respect of the disputed member's interest. The impugned sale agreement in fact included a so-called escape clause in favour of Dube, which stipulated that, should Odora be unable to deliver the properties to Dube for any reason, whether as a result of the said dispute or for any other reason, Odora would repay the purchase price and interest

to Dube, no occupational rental would be paid by Dube and Odora would refund any costs and rates paid by Dube in respect of the properties.

Dube, as second respondent, argued that because of section 165 (1) having abolished the common law derivative action for companies and replaced it with a statutory derivative action, there was no longer a common law derivative action available in respect of close corporations. It further argued that by virtue of the provisions of section 49 and 50 of the [Close Corporations Act](#), both Sagadava and Odora were barred from bringing a derivative action. These sections are similar in nature and purpose to sections 266 – 268 of the repealed [Companies Act 61 of 1973](#) and confer rights on members to take legal proceedings or cause legal proceedings to be taken on behalf of a company (or close corporation) where the relevant juristic person, acting through its directors or members (in the case of a close corporation), fails to take such proceedings. The court considered this and found that these statutory rights had always been parallel and complimentary to the common law derivative action and were not meant to oust those common law rights. The new Companies Act of 2008, however, specifically abolished the derivative action available to companies and substituted it with a statutory right. The court came to the view that this does not affect the common law rights in respect of close corporations which were incorporated prior to the commencement of the Companies Act of 2008 but which had not converted to companies. The court stated that “not only is the abolition of common law derivative actions expressly stated in section 165 (1) of the Companies Act, section 165 (2)(d) provides for a third party right, which is not found in sections 49 and 50 of the Close Corporations Act.”

The court accordingly concluded that the common law rights of members of close corporations to bring a derivative action are still available. It had only been abolished specifically in respect of companies.

A further argument raised by Dube was that it was protected under section 54 of the Close Corporations Act as it had transacted with a member of the close corporation, Sivaraj, who, on the basis of section 54 was an agent of Odora and therefore had the authority to bind it, more so because he was the sole registered member of the CC.

Section 54 of the Close Corporations Act reads as follows:

“(1) subject to the provisions of this section, any member of a corporation shall in relation to a person who is not a member and is dealing with a corporation, be an agent of the corporation.

(2) Any act of the member shall bind a corporation ...unless the member so acting has in fact no power to act for the corporation in the particular matter and the person with whom the member deals, has or ought reasonably to have knowledge of the fact that the member has no such power.”

The purpose of this section is clearly to protect third parties who transacted with a member of a close corporation in good faith, against the possible impact of the ultra vires doctrine and the doctrine of constructive notice. The ultra vires doctrine in essence provides that if the acts of a person purporting to act on behalf of a close corporation fall outside the actual authority of such person, the act is ultra vires and the close corporation is not bound by the actions of such person. In terms of the doctrine of constructive notice, persons dealing with a corporate entity such as a close corporation are deemed to have knowledge of the contents of the statutory documents of incorporation of that entity, and accordingly of any restrictions placed on the authority of persons purporting to act on behalf of that entity.

In the present matter the court found that on the facts, Dube was aware of the dispute between Sagadava and Sivaraj (as was evident from the escape clause written into the agreement of sale for the properties) and accordingly knew or ought to have known that Sivaraj may lack the necessary authority to conclude the sales agreement on behalf of Odora without the consent of Sagadava. Dube could therefore not claim to be a bone fide possessor who was unaware of Sagadava’s claims. The court specifically stated that Dube did not have to know the truthfulness of these claims but that it was sufficient that it subjectively foresaw the possibility of the truthfulness and nonetheless proceeded with the impugned sale agreement.

The court referred to the decision in Dhayanunth v Narain where it was pointed out that if “a purchaser who has been apprised, prior to purchasing the property, of the existence of some right in the property vested in a third party in such a way as to make it incumbent upon him to enquire, before purchasing the property, precisely what that right comprised... does not do so, he cannot be heard... to say that he did not know the precise nature of the third party’s right. The imperfection of his knowledge is attributable to his own act in wilfully shutting his eyes and failing to see what was perfectly obvious.”

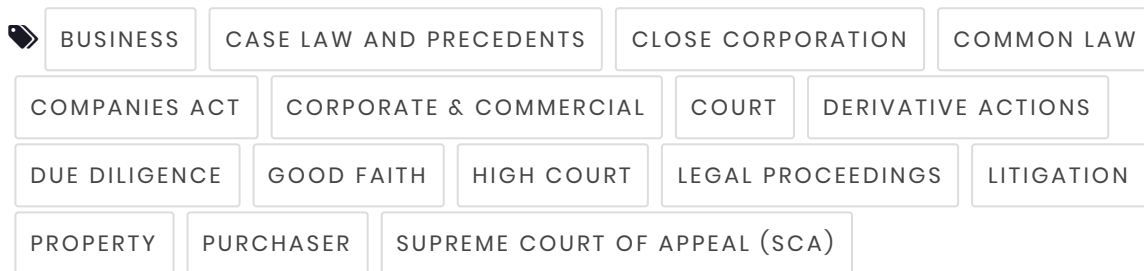
The court accordingly ruled that Dube was not a bona fides innocent purchaser, it had the imputed knowledge envisaged in section 54(2) of the Close Corporations Act and therefore could not rely on the protection of section 54(1).

The decision is welcomed for providing certainty as to the common law derivative action's continued application in respect of close corporations. It also provides a clear illustration of the manner in which the court will consider the knowledge which can be imputed to a third party dealing with those persons ostensibly having authority to bind a corporate entity. It is a stark reminder that in business transactions, if all does not appear to be above board, it is prudent to do further due diligence to ensure one is dealing with a person having the necessary authority to enter into the relevant transaction.

See also:

- [Understanding a trust's ownership rights in close corporations](#)
- [The Companies Amendment Bill, 2021 for public comment](#)
- [Litigation against your business!](#)
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