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SHAREHOLDERS DERIVATIVE ACTIONS: A REVIEW OF THE TANZANIAN LEGAL FRAMEWORK

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Abstract

This article critically examines the efficacy of Tanzania's legal framework for shareholder derivative actions. Established under the Companies Act Cap 212 R.E 2023, the derivative action was intended to empower minority shareholders and strengthen corporate governance by providing a direct avenue to redress wrongs committed by company controllers. This review systematically analyses the statutory provisions against their practical application in Tanzania. It argues that while the legislation provides the necessary procedural doorway, its operationalization is hindered by significant ambiguities and obstacles. Key issues explored include the procedural intricacies that may deter legitimate claims, the overly broad judicial discretion in granting leave and the financial burden on shareholders (i.e., minority). The article posits that these challenges potentially render the remedy inaccessible and undermine its intended purpose as a check on directorial misconduct. By highlighting the gaps between legislative intent and practical reality, this review contributes to the discourse on corporate law reform in Tanzania and suggests targeted amendments to create a more robust and effective derivative action regime.

Keywords: Shareholders Protection, Derivative Action, Corporate Governance.

INTRODUCTION

The modern corporation is characterized by a separation of ownership and control,ⁱ a structure that, while efficient, inherently creates the potential for agency problems where the interests of controlling directors (agents) may diverge from those of shareholders (principals).ⁱⁱ Directors and managers entrusted with the stewardship of the company may sometimes act in a way that benefits themselves at the expense of the company. To mitigate this risk and hold controllers accountable, robust legal mechanisms are essential. Among the most critical of these mechanisms is the shareholder derivative action, a unique legal remedy that permits a shareholder to initiate a lawsuit on behalf of the company to redress a wrong done to it, typically by its own controlling directors.ⁱⁱⁱ

From common law jurisdiction, the derivative action has a rich in historical pedigree, originally evolving from the English common law principles, most notably the rule in *Foss vs. harbottle*^{iv} and its exceptions. However, these common law rules were often restrictive, fraught with procedural complexities, and posed

significant barriers for shareholders.^v A pivotal movement in Tanzanian corporate law was the enactment of the Companies Act,^{vi} which statutorily codified the derivative action under section 237, thereby aiming to demystify the process and enhance its accessibility as a tool for corporate governance.^{vii}

This article seeks to provide a comprehensive analysis of the legal framework governing shareholder derivative actions in Tanzania. It explores the conceptual foundations and common law origins of the derivative actions, its statutory regime under the Companies Act,^{viii} dissecting the procedural pre-requisites for initiating an action. This includes identification and critically persistent impediments within the framework, offering conclusions on its overall effectiveness and potential avenues for reform.

DERIVATIVE ACTION: CONCEPT AND ORIGIN

At its most fundamental level, a derivative action (or derivative suit) is a lawsuit brought by a shareholder (or group of shareholders) of a corporation to enforce a legal right or remedy a wrong that has been done to the corporation itself, but which the



corporation's management refuses to pursue.^{ix} The key conceptual point is that the shareholder is not suing for a direct personal injury. Instead, they are "*deriving*" their right to sue from the corporation's right.^x They are stepping into the corporation's shoes to litigate on its behalf, for its ultimate benefit.^{xi}

To understand why derivative actions are necessary, one must understand two foundational principles of corporate law. One is *Separate legal personality*. A corporation is a legal entity distinct from its shareholders and officers. It can sue and be sued in its own name; the principle established in cases like *Salomon vs. Salomon & Co. Ltd.*^{xii} Two is *managerial prerogative*, which is the fundamental legal principle providing that the power to manage the day-to-day operation and make business decisions of a corporation rests exclusively with its board of directors and the officers they appoint (like the CEO).

This structure creates a potential problem: what if the wrongdoer is the director or a controlling shareholder themselves? For example, if a director uses corporate funds for personal benefit, the corporation has a right to sue that director to recover the money. However, the board of directors (which may include those benefited from the funds, or the wrongdoer themselves) will understandably refuse to authorize a lawsuit. The corporation is helpless, and the shareholders suffer an indirect loss as the value of their shares decreases due to the misappropriated funds. Derivative action is the legal mechanism designed to solve this exact problem. It is an exception to the rule of managerial prerogative and separate legal personality allowing shareholders to bypass a passive or conflicted board to protect the corporation's interest, and by extension their own.^{xiii}

From Foss's Rule to Modern Statutory Remedies: Tracing the Derivative Action's Trajectory

The derivative action, now a cornerstone of modern corporate governance, was not born from legislative design but emerged, like many common law principles, from a foundational case that created a problem necessitating its own solution. Its trajectory is a fascinating journey from judicial restraint and the primacy of the corporate entity towards the empowerment of the individual shareholder as a private enforcer of fiduciary duty. This journey begins in 19th-century England with the seminal case of *Foss v. Harbottle*.^{xiv} The case involved two shareholders of a company called the "Victoria Park Company" who sued the company's directors, alleging they had misapplied company assets and had improperly mortgaged company property for their own benefit. The court's dismissal of this suit established two enduring principles, often referred to collectively as "the rule in *Foss v. Harbottle*":

The Proper Plaintiff Principle:

This principle states that, when a wrong is committed against a corporation, the "proper plaintiff" to sue for that wrong is the corporation itself.^{xv} Basically, the corporation acts through its decision-making organs primarily its board of directors. Individual shareholders lack the legal standing to sue for a corporate injury. According to this rule, a company is a legal person distinct from its

members (shareholders).^{xvi} Therefore, any rights that belong to the company, any injuries are suffered by the company and any cause of action (the right to sue) is vested in the company. Since a company is an artificial entity, it must act through its human agents.^{xvii} The power to manage the company's affairs, including the decision to initiate litigation, is vested by law in the Board of Directors.

The Majority Rule Principle

The majority rule principle asserts that, if the alleged wrong is something that the corporation could itself ratify or approve by a simple majority of its shareholders, then the court will not interfere at the behest of a minority shareholder.^{xviii} The logic is that it would be a waste of judicial resources to litigate a matter that the majority of owners could simply approve.

The Legal Rationale for this principle is rooted in the courts' historical reluctance to interfere in the internal management of a company. It respects the democratic structure of corporate governance where the will of the majority prevails. If the majority of owners, acting in good faith, are content with a decision or are willing to forgive a wrongdoing, a single dissenting shareholder cannot hold the entire company hostage with litigation.^{xix}

On its face, this rule is logically consistent with the core concept of a corporation as a separate legal entity. It promotes judicial economy and respects the internal decision-making processes of the company. However, it immediately created a glaring and profound problem: what if the wrongdoers themselves control the majority of shares or the board of directors? In such a scenario, the corporation (controlled by the wrongdoers) would never sue to enforce the legal right, and the majority would never ratify the lawsuit. The very perpetrators of the harm would be immunized from judicial accountability. *Foss's* rule effectively created a shield for fraud and mismanagement by controlling shareholders and directors.

The Judicial Carve-Out: Exceptions to the Rule

The English courts quickly recognized the injustice and practical impossibility created by a strict application of *Foss's* rule. To mitigate its harshness, they began to craft narrow exceptions, acknowledging that in certain circumstances, a minority shareholder must be permitted to bring a "derivative" action on the company's behalf. These exceptions, developed over decades of case law, formed the common law foundation of the derivative action. The key exceptions were:

Ultra Vires or Illegal Acts

If the act complained of was illegal or beyond the corporation's legal power (*ultra vires*), it could not be ratified by any majority.^{xx} A shareholder could sue to restrain or remedy it. The *ultra vires* exception applies when a company's directors engage in an act that falls entirely outside the legal scope of the company's powers, as defined by its constitution or governing corporate legislation. Such an act is void and incapable of being ratified by any majority of shareholders.

Simultaneously, the illegal acts exception covers conduct that violates statutory law. Since both types of acts are fundamentally invalid, the normal rules of corporate majority rule are suspended. This allows a single shareholder to seek an injunction to stop the action or to sue derivatively to recover losses, protecting both the company and public policy from unauthorized or unlawful corporate behavior.^{xxi}

Fraud on Minority or Company

The exception for “fraud on the minority by those in control” is the key that unlocks the courthouse door for minority shareholders when the corporate governance system fails.^{xxii} It applies when two conditions are met: *A Fraud is Committed*: The term “fraud” here is interpreted broadly in equity. It encompasses not only common law fraud (deceit) but also acts of bad faith, abuse of power, misapplication of funds, or any breach of fiduciary duty that benefits the wrongdoers at the company’s expense. *The Wrongdoers are in Control*: “Control” means the alleged wrongdoers hold sufficient voting power to dictate the company’s actions.^{xxiii} This includes both numerical majority shareholding and de facto control (e.g., where directors dominate the board and influence shareholder votes, preventing the company from suing in its own name).^{xxiv}

Where controlling directors are likely to benefit or derive profit or have benefited or profited for their negligence or breach of duty

This scenario falls squarely within the “fraud on the minority” exception. If directors in control are negligent or breach their duty in a way that personally enriches them, they have committed a fraud against the company.^{xxv} Their control prevents the company from suing them. Therefore, a minority shareholder is permitted to bring a derivative action to recover the illicit profit for the company, as the wrongdoers cannot be allowed to use their control to sanction their own misconduct.^{xxvi}

Where a company meeting cannot be called in time to be practical use in redressing a wrong

Where a Company meeting cannot be called in time to be practical use in redressing a wrong done to the Company or to the minority shareholder, a minority action on behalf of the Company or the Individual shareholder can stand.^{xxvii} This exception applies in cases of extreme urgency, such as an imminent transaction that would irreparably harm the company. If the procedural delay of calling a shareholders’ meeting would render any subsequent legal action useless, the court permits an immediate derivative suit.^{xxviii} This prevents wrongdoers from using time and formalities to their advantage, ensuring a remedy remains practically available.

Special Majorities

This exception prevents a majority from bypassing strict constitutional safeguards. If the company’s articles or the Companies Act mandate a special resolution for a specific action, a simple majority cannot validly approve it.^{xxix} A minority shareholder can sue to restrain this procedural fraud and uphold the mandatory legal or constitutional requirements designed for their protection.^{xxx}

PROCEDURAL AND SUBSTANTIVE REGULATION OF DERIVATIVE ACTIONS IN TANZANIA

The common law principles governing derivative actions including the exceptions to the rule in *Foss vs. Harbottle*, have been comprehensively codified in Tanzania under section 237 of the Companies Act.^{xxxi} This statutory adoption it marks a significant shift from the uncertain and restrictive nature of common law position to a more structured, accessible and court-supervised process. The provision meticulously outlines the substantive criteria an applicant must meet and the procedural steps they must follow.

The Leave Application

The derivative action process is initiated by an ex parte application for leave to the court as mandated under section 237(1) of the Companies Act.^{xxxii} This preliminary application is a distinct proceeding from the main substantive suit and it acts as an important judicial filtering mechanism. At this stage, the applicant bears the burden of satisfying the court on the statutory pre-requisites demonstrating that reasonable was given to the directors, establishing a prima facie case of good faith and proving that the proposed action appears to be in the company’s best interests.

The court’s role at this stage is not to adjudicate the merits of the underlying claim but to exercise its discretion as a gatekeeper, preventing frivolous and vexatious litigation. Only upon successfully crossing this threshold does the applicant obtain the right to use the company’s name and proceed to the full trial on the merits. This leave requirement thus ensures that the derivative action remains a remedy of last resort, preserving the balance shareholder protection and corporate autonomy.

The Issuance of notice

A cornerstone of the statutory derivative action is the mandatory obligation for an applicant to provide reasonable notice to the directors of the company.^{xxxiii} This pre-requisite is not a mere procedural formality but a deliberate legislative mechanism designed to uphold the foundational principles of corporate governance. This requirement is fundamentally rooted in the doctrine of internal management, a long standing principle in company law which asserts that the board of directors, not individual shareholders, is vested with the primary authority to manage the company’s affairs.

A seminal case is that case of Hamad Masauni & Others vs. Mohamed Abdillah Nur & Others^{xxxiv} in which the petitioners sought leave of the court to bring a derivative suit against the directors and the companies (the 3rd and 4th respondents) for alleged oppressive conduct and mismanagement. Inter alia, the issue of contention was whether the petitioners had fulfilled the mandatory condition of giving a reasonable notice to the directors of the company as required by law. The ruling underscores the importance of the applicant’s ability to prove that the notice was not only sent but also received by the directors.^{xxxv}

Good Faith Requirement

Another statutory pivotal condition for granting leave to pursue a derivative action is that the court must be satisfied the applicant is acting in good faith.^{xxxvi} The requirement serves as a crucial substantive filter designed to ensure that the potent remedy of a derivative suit is not abused for personal gain or ulterior motives but is instead pursued for its intended purpose to redress a wrong done to the company. This requirement delves into the motives and intentions of the applicant, it is a substantive standard but one that must be objectively proven to the court.

The good faith requirement was discussed in Justine Marwa Range & Another vs. Range Boaz Range & Another^{xxxvii} as the most significant prerequisite for a derivative suit as the court had to determine whether the applicants were genuinely seeking to protect their rights as shareholders and the health of the company, or whether the application was motivated by a collateral purpose. As with a derivative action, the burden is on the applicants to satisfy the court of their bona fides.

Best interest of the Company

The most significant substantive condition for a derivative action is the requirement that the action must be in the best interests of the company or its subsidiary that the action is brought.^{xxxviii} This objective test moves beyond the applicant's motives to a dispassionate, pragmatic assessment of the lawsuit's net value to the corporate entity itself. It is the court's ultimate gatekeeping function, ensuring that the remedy protects, rather than the harms, the company it is designed to serve.

The "interests of the company" test is intrinsically linked to the "good faith" requirement. An applicant acting in good faith should, by definition be advocating for a cause of action they genuinely believe benefits the company. *Range's* case^{xxxix} in particular, highlights how a personal or family feud (suggesting bad faith) would almost certainly not be seen as advancing the company's interest. The two prerequisites work in tandem to filter out unsuitable claims.

The Hurdle to Effective Shareholder Litigation in Tanzania

The statutory framework for derivative action as encapsulated in section 237 of the Companies Act,^{xl} establishes a crucial mechanism for shareholder protection. Despite this statutory recognition, the practical enforcement of shareholder litigation remains fraught with procedural and interpretive challenges. These obstacles often serve as significant hurdles, obscuring the path for claimants and protecting errant management. This part critically examines the key hurdles embedded within the statutory framework, with particular emphasis on the ambiguity surrounding the reasonable notice requirement.

The requirement for a shareholder to issue a reasonable notice to the company directors is not merely a procedural formality. It is a significant and often prohibitive hurdle that fundamentally obscures the pass to justice. This requirement while ostensibly designed to give the company's board an opportunity to rectify the wrong itself before a shareholder resorts to litigation, operates in practice as a formidable barrier. Its inherent vagueness and the

strategic disadvantages it imposes on the shareholders create a procedural impediment that can effectively shield alleged misconduct from judicial scrutiny.

The core of the problem lies in the profound ambiguity of the term "reasonable notice." The Act provides no legislative definition, no guidelines regarding the timeframe, content or form that such notice must take, leaving shareholders uncertain about the reasonability of the notice, how to properly draft and serve such notice. This lack of clarity places potential claimants in an immediate and precarious position. They are forced to make a critical legal decision how to issue notice without any certainty that their efforts will be deemed sufficient by a court at later stage. Is a notice reasonable if it provides the directors with 14 days to respond? 30 or 60? Must it be a comprehensive legal brief, detailing all evidence and legal arguments or a simpler letter of intent? This uncertainty exposes shareholders to potential challenges from directors who may claim unreasonable and inadequate notice, as a result claimants may face costly and time consuming preliminary disputes before substantive issues can be addressed, discouraging them from pursuing claims.

Furthermore, the notice requirement creates a "Catch-22" because shareholders need evidence of director misconduct which is controlled solely by the directors themselves. The law lacks provisions for pre-action discovery, leaving shareholders unable to access crucial company information beforehand. As a result, shareholders must make serious allegations based on incomplete or circumstantial evidence. This exposes their intentions to the directors early, allowing management to prepare a defense while shareholders remain disadvantaged. This imbalance unfairly favours directors and obstructs shareholders from effectively protecting the company's interests.

Not only that, the notice requirement also empowers directors to engage in strategic gaming and tactical delay. Upon receiving a notice, a board may have every incentive to avoid a lawsuit that would scrutinize their own conduct. In essence, the requirement may act as obstacle that exceedingly difficult to pass. It may transform the derivative action from a right into a privilege that is granted only after navigating a vague and hostile procedural landscape.

CONCLUSION AND RECOMENDATION

The Tanzanian legal framework for derivative actions, as codified under the Companies Act,^{xli} reflects a statutory commitment to shareholder empowerment and corporate accountability. However, the practical enforcement of this remedy is undermined by procedural ambiguities and substantive hurdles that disproportionately affect potential claimants. Chief among these is the requirement to issue reasonable notice to company directors, a provision that lacks definitional clarity and invites judicial inconsistency, strategic delay and procedural obstruction.

The absence of statutory guidance on what constitutes reasonable notice, coupled with the burden of proving good faith and corporate interest, renders the derivative action mechanism



inaccessible shareholders. This discretionary nature of judicial intervention further compounds this challenge, as applicants face uncertainty regarding to cost recovery, control of litigation and evidentiary thresholds. Without reforms, section 237 risks becoming a symbolic rather than functional tool of corporate governance.

It is therefore recommended that, legislative reforms of the provisions of law governing derivative action should be made so as to define clearly reasonable notice requirement with specificity, including form, content and duration. A formal written demand procedure should be introduced to reduce ambiguity. There should be a codification of pre-action protocols, establishing procedural rules governing the leave application process including timelines, evidentiary requirements and director response obligations.

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