

## WHY IS THE RULE IN FOSS V HARBOTTLE SUCH AN IMPORTANT ONE?

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### 1. Introduction

A company has a separate legal personality, distinct and separate from the members who compose it and so it can 'sue and be sued in its own name'<sup>1</sup>. Decisions of a company are taken by the shareholders and the board members and represent the majority of the company<sup>2</sup>. Each company member is contractually bound by the company's constitution which mandates that every member agrees to be bound by the majority's decisions<sup>3</sup>. Courts have long been reluctant to get involved in the company's internal management<sup>4</sup> as long as directors are operating under the provisions of the Articles<sup>5</sup>. All the above principles coexist in the rule of Foss v Harbottle (1843)<sup>6</sup>. The principle of separate legal personality, the doctrine of majority rule, the statutory contract and the internal management principle are all translated in the Foss v Harbottle rule, the 'rule of procedure governing locus standi'<sup>7</sup>. This rule is the basis of 'common law jurisprudence regarding who may bring an action on behalf of the company'<sup>8</sup> and although its existence dates back beyond 150 years, it still constitutes a significant part of the company law<sup>9</sup>. The rule is considered prudent as it recognises that it is pointless to bring an action to the courts for an issue that a company can resolve on its own, or a wrongdoing that can be settled within its own internal management<sup>10</sup>. Without the rule in Foss v Harbottle, there would occur a huge amount of superficial litigation which would threaten the normal performance of a company<sup>11</sup>. However, there should be a balance between the efficient governance of a company and

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<sup>1</sup> Alan Dignam and John Lowry, *Company Law* (9<sup>th</sup> edn, OUP 2016) 174

<sup>2</sup> 'Majority Rule from Foss v Harbottle' (*Madhurika Ray*, September 2015)  
<<https://raymadhurika.wordpress.com/2017/01/07/majority-rule-from-foss-v-harbottle/>> accessed 10 March 2018

<sup>3</sup> *Ibid* (n 1) 175

<sup>4</sup> K.W. Wedderburn, 'Shareholders Rights and the Rule in Foss v Harbottle' (1957) 15 CLJ 194

<sup>5</sup> *Rajahmundry Electricity Supply Corp Ltd v A. Nageswara Rao*, AIR 1956 SC 213 217

<sup>6</sup> *Ibid* (n 1) 176

<sup>7</sup> *Ibid*

<sup>8</sup> *Ibid* (n 2)

<sup>9</sup> 'Derivative Action' (*NewLawJournal*, October 2007)

<<https://www.newlawjournal.co.uk/content/derivative-action>> accessed 10 March 2018

<sup>10</sup> L.S. Sealy, 'Foss v Harbottle: A Marathon where Nobody Wins' (1981) 40 CLJ 31

<sup>11</sup> *Ibid* (n 2)

the shareholders' interest<sup>12</sup>. For that purpose, there are exceptional circumstances where an individual shareholder may bring an action in the interest of the company to force the company to conform with its constitution and to request a remedy<sup>13</sup>. Apart from the positive critiques regarding the significance of *Foss v Harbottle*, the rule has been also described as 'obscure, complex, rigid, old-fashioned and unwieldy' and so, in an attempt to minimise its problems, the Companies Act 2006 (CA 2006) Part 11 came into force<sup>14</sup>. There are, therefore, contradictive views regarding the performance of the rule in *Foss v Harbottle*.

This essay analyses why the rule in *Foss v Harbottle* is significantly important. It starts by providing the facts of the case, the judgment and the rule of *Foss v Harbottle*. It then discusses the exceptions to the rule and how these led to the introduction of a new statutory derivative claim. Subsequently, it briefly explains how the inefficient intervention of the new statutory derivative claim, as this has been introduced in Part 11 of Companies Act 2006, adds to the importance of the rule.

## **2. *Foss v Harbottle*: the facts, the judgment and the rule**

### **2.1. Facts of the case**

The case of *Foss v Harbottle* is about the Victoria Park Company whose business was to enclose and plant ornamental parks, erect houses, sell, let or otherwise dispose thereof<sup>15</sup>. In 1837, this company was incorporated in an Act of Parliament to evolve decorative parks and gardens<sup>16</sup>. Two minority shareholders of the company, Richard Foss and Edward Starkie Turton, brought a derivative suit against the five directors and promoters of the company alleging that they had misapplied numerous company assets and had unsuitably mortgaged its property<sup>17</sup>. The claimants sought the guilty parties to be found accountable to the company and they requested the appointment of a receiver<sup>18</sup>.

### **2.2. The Decision of *Foss v Harbottle* and the Rule**

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<sup>12</sup> Avtar Singh, *Company Law* (16<sup>th</sup> edn, Eastern Book Company, Lucknow 2015) 479

<sup>13</sup> G.K. Kapoor and Sanjay Dhamija, *Company Law and Practice* (19<sup>th</sup> edn, Taxmann 2013) 704

<sup>14</sup> Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim?' (2012) UCL JLJ 178

<sup>15</sup> *Foss v Harbottle* (1843) 67 ER 189

<sup>16</sup> *Ibid*

<sup>17</sup> *Ibid* (n 15)

<sup>18</sup> *Ibid*

The court dismissed the claim and held that only the company has the right to sue when the company is suffered by its directors<sup>19</sup>. At that point, the court founded a fundamental company law rule which is divided into two limbs<sup>20</sup>. The first is the 'proper plaintiff rule' which indicates that a wrongdoing affected the company can be sued only by the company itself and in its separate legal entity<sup>21</sup>. The second is known as the 'internal management rule' which notifies that when the alleged wrongdoing is approved or established by the members' majority in a general meeting, then the court cannot be involved<sup>22</sup>. This principal rule has received long discussions. The 'proper plaintiff rule' is closely linked to the separate legal personality doctrine which indicates that the company is a legal personality separate and distinct from its members<sup>23</sup>. Lord Halsbury LC affirmed in the pivotal case of *Salomon v Salomon & Co Ltd* [1897] 'that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself [...]'<sup>24</sup>. What is occurred from the above is that the common law designates that the rights and liabilities of a company are retained to the company itself and it is up to the company to settle its liabilities and pursue its rights<sup>25</sup>. Moreover, Jekins LJ in *Edwards v Halliwell* [1950] stated that 'the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or the association of persons itself'<sup>26</sup>. On the other, the 'internal management' rule has strong ties to the 'majority rule' which delivers that the courts will not interfere with the internal management of the company<sup>27</sup>. This rule can be justifiably considered reasonable as the shareholders are supposed to be more appropriate to determine the internal matters of their company<sup>28</sup>. The usually quoted phrase which is relevant here is that '[the] Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom'<sup>29</sup>.

In *Foss v Harbottle*, though, the Act which has incorporated the Victorian Park Company stipulated that the company's governing body is the directors, subject to the supreme control of the members'

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<sup>19</sup> Lynden Griggs, 'A Statutory Derivative Action: Lessons That May Be Learnt From its Past' (2002) 6 UWSLRev 63, 71

<sup>20</sup> Ibid

<sup>21</sup> Ibid

<sup>22</sup> Ibid

<sup>23</sup> Ibid (n 14) 179

<sup>24</sup> *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) at 30

<sup>25</sup> Ibid (n 23)

<sup>26</sup> *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066

<sup>27</sup> Ibid (n 23)

<sup>28</sup> Ibid 180

<sup>29</sup> *Carlen v Drury* (1812) 1 V & B 154, 158; 35 ER 61, 63 (Lord Eldon LC)

general meeting. Consequently, it was only needed to refer to the provisions of the Act in order to justify that it was not fitted for the minority shareholders to bring an action in that manner<sup>30</sup>. Particularly, the Vice Chancellor Sir James Wigram stated that:

[It] is only necessary to refer to the clauses of the Act to shew that, whilst the supreme governing body, the proprietors at a special general meeting assembled, retain the power of exercising the functions conferred upon them by the Act of Incorporation, it cannot be competent to individual corporators to sue in the manner proposed by the Plaintiffs on the present record. [...] The very fact that the governing body of proprietors assembled at the special general meeting may so bind even a reluctant minority is decisive to shew that the frame of this suit cannot be sustained whilst that body retains its functions.<sup>31</sup>

His Honour also discussed *Preston v The Grand Collier Dock Co*<sup>32</sup> and whilst admitting the concurrence between the two cases, he distinguished the Preston case by characterising the wrongdoing in the particular case as one which could be indorsed by a general meeting<sup>33</sup>. Relatively, Prunty argues that even though these characterisations may not be accurate, one point is obvious: ‘in *Foss v Harbottle* the Vice-Chancellor was announcing his refusal to intervene in business affairs which could be effectively resolved by the members of the organisation in question’<sup>34</sup>. Importantly, his honour specified that the established rule would be set aside only for very urgent reasons<sup>35</sup>. Therefore, what significantly occurs from *Foss v Harbottle* is that ‘the judiciary will not interfere where a majority of members may lawfully ratify the conduct in question – a determination which arguably went against the trend of earlier cases’<sup>36</sup>.

The decision in *Foss v Harbottle* is a significant contribution to the company law and specifically to the law regarding minority shareholders; even though it cannot be considered as a great advantage for minority shareholders<sup>37</sup>. The assertions in *Foss v Harbottle* were as comprehensive as those used in

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<sup>30</sup> B.S. Prunty, ‘The Shareholders’ Derivative Suit: Notes on its Derivation’ (1957) 32 NYULR 980, 983

<sup>31</sup> [1843] EngR 478; (1843) 2 Ha 461; 67 E.R. 189 at 202

<sup>32</sup> *Ibid*

<sup>33</sup> *Ibid*

<sup>34</sup> *Ibid* (n 30)

<sup>35</sup> *Ibid* (n 31) at 492

<sup>36</sup> *Ibid* (n 19) 71

<sup>37</sup> *Ibid*

previous case law such as in *Preston v Grant Collier*<sup>38</sup>. Namely, until that time, the minority shareholders were deprived of any right for claiming a remedy on what they saw as a misuse by the directors<sup>39</sup>. Accordingly, the decision in *Foss v Harbottle*, rather than being an expansion of the rights of minority shareholders, it could be better characterised as a limitation of the standing of a minority shareholder to seek judicial interference<sup>40</sup>. Moreover, the judgment in *Foss v Harbottle* represents what Clark names the first stage of capitalism, namely the ‘age of the entrepreneur, the fabled promoter-investor-manager who launched large scale business organizations in corporate form for the first time in history’<sup>41</sup>. Basically, this decision diminished the interests of the minority shareholder to the advantage of the business entity<sup>42</sup>. It is therefore well arguing that the particular case can be realised in the context of businesses expansion in the United Kingdom (UK) during the end of the 19<sup>th</sup> century, a growth which in that period, reflects the ‘expansive phase’ of the economy in the UK<sup>43</sup>.

### 3. Exceptions to the rule

As it has been explained above, the minority shareholder pursuing to correct and compensate a wrongdoing to the company was confronted with the rule that the company is the ‘proper plaintiff’, or alternatively, that the matter was one of internal management that should be resolved in a general meeting by the members<sup>44</sup>. The pure application of the rule in *Foss v Harbottle* permits majority shareholders and directors to absolutely disregard the benefits/rights of minority shareholders<sup>45</sup>. Even though these two rules prevented<sup>46</sup> vexatious litigation<sup>47</sup>, futile actions<sup>48</sup> and multiple suits that would have been occurred by the shareholders,<sup>49</sup> it is well arguing that they rise problems in company law and especially when the wrongs to the company committed by the people in control<sup>50</sup>. To resolve ‘this

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<sup>38</sup> Ibid

<sup>39</sup> Ibid

<sup>40</sup> Ibid

<sup>41</sup> R.C. Clark, ‘The Four Stages of Capitalism: Reflections on Investment Management Treatises’ (1981) 94 HLR 561

<sup>42</sup> Ibid (n 19) 72

<sup>43</sup> SP Ville, ‘The Salomon Judgment and the Development of British Business in the Nineteenth Century’ (Conference at 100 years of Salomon – A Reassessment, Australian, September 1997)

<sup>44</sup> Ibid (n 19) 73

<sup>45</sup> Ibid

<sup>46</sup> K. Wedderburn, ‘Shareholder Rights and the Rule in *Foss v Harbottle*’ (1957) CLJ 194, 195

<sup>47</sup> *La Cie de Mayville v Whitley* [1896] 1 Ch 788

<sup>48</sup> *Bagshaw v E. Union Ry. Co.* [1849] EngR 430; (1849) 7 Hare 114

<sup>49</sup> *MacDougall v Gardiner (No. 2)* (1875) 1 Ch D 13

<sup>50</sup> M.A. Maloney, ‘Whither the Statutory Derivative Action’, [1986] 64 The Canadian Bar Review 308, 310

imbalance in favour of the directors and/or majority shareholders', a number of exceptions were introduced<sup>51</sup>. The directors would not intent to sue themselves for their own wrongdoings and so the exceptions were formulated to ameliorate the worst consequences to the rules by entitling minority shareholders to bring an action in specific defined circumstances<sup>52</sup>.

The circumstances were considered in *Edwards v Halliwell* (1950) where Jenkins LJ specified the four exceptions to the rules in *Foss v Harbottle*<sup>53</sup>. Namely, Jenkins LJ stated that a minority shareholder may bring an action to the court 'where the act complained of was ultra vires the company';<sup>54</sup> 'where the issue is such that it could only be done by a special majority of the members and not a simple majority';<sup>55</sup> 'where the personal rights of the shareholder have been invaded';<sup>56</sup> and finally, 'where what has been done amounts to a fraud on the minority';<sup>57</sup> and 'the wrongdoers are in control of the company'<sup>58</sup>. Interestingly, Wigram VC anticipated the necessity for exceptions to the rule that he introduced and it seems that he had also in mind the criteria for identifying the exceptions<sup>59</sup>. As he stated:

It would be too much to hold that a society of private persons [...] are to be deprived of their civil rights inter se, because in order to make their common objects more attainable, the Crown or the legislature may have conferred upon them the benefit of a corporate character. If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think [...] the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.<sup>60</sup>

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<sup>51</sup> Ibid (n 19) 73

<sup>52</sup> *Edwards v Halliwell* [1950] 2 All ER 1064

<sup>53</sup> Ibid

<sup>54</sup> *Australian Agricultural Co v Oatmont Pty Ltd* (1992) 8 ACSR 255; 106 FLR 314

<sup>55</sup> *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503.

<sup>56</sup> *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* (1988) 6 ACLC 1160

<sup>57</sup> *Ngurli v McCann* [1953] HCA 39; (1953) 90 CLR 425 at 447

<sup>58</sup> Ibid (n 52) at 1067

<sup>59</sup> (1843) 2 Hare 461, 492

<sup>60</sup> Ibid

### 3.1. Where the act complained of was illegal or ultra vires

The first exception supports that a minority shareholder may sue a company when the alleged act is illegal and ultra vires the company's constitution<sup>61</sup>. The Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* (1982) clarified that where the alleged wrongdoing is ultra vires the company, the rule in *Foss v Harbottle* does not apply as the majority of members cannot authorize the transaction<sup>62</sup>. The above point has been exemplified in *Taylor v National Union of Mineworkers* [1986] (a claim for unlawful strike was supported)<sup>63</sup> and in *Smith v Croft (No.2)* [1988] (a claim for a transaction which violated the capital maintenance clauses of the Companies Acts)<sup>64</sup>. This exception illustrates that a minority member may, by seeking his right, bring an action against a threatened illegal action<sup>65</sup>. Notwithstanding, when the shareholder is claiming compensations for the damage suffered by the company due to a transaction actually involved in, the claim will be unsuccessful if he does not fulfil the requisite of wrongdoer control<sup>66</sup>. This is demanded because in such a circumstance, the wrong affects directly the company and therefore, the proper claimant is the company<sup>67</sup>. Good faith is a crucial element in defining maintainability in such cases because the claims here are made in order to bring justice to the company<sup>68</sup>.

### 3.2. Where the matter in issue requires the sanction of a special majority, or there has been non-compliance with a special procedure

The second exception indicates that an individual shareholder may have the right to sue when the alleged wrongdoing demanded the sanction of a special majority of members or when a special procedure has not been attempted<sup>69</sup>. It was held in *Edwards v Halliwell* (1950) that a resolution for enlarging member's subscribers was not valid because the needed two-thirds majority for the particular resolution had not been obtained<sup>70</sup>. Specifically, Jenkins LJ stated that:

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<sup>61</sup>'Majority Rule Shareholders' (Lawteacher.net, March 2018) <<https://www.google.co.uk/?vref=1>> accessed 12 March 2018

<sup>62</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204

<sup>63</sup> *Taylor v National Union of Mineworkers* [1986] IRLR 439, [1986] ICR 736

<sup>64</sup> *Smith v Croft* [1988] Ch 114

<sup>65</sup> *Ibid* (n 61)

<sup>66</sup> *Ibid* (n 63)

<sup>67</sup> *Ibid* (n 1) 184

<sup>68</sup> *Ibid* (n 2)

<sup>69</sup> *Ibid* (n 1) 184

<sup>70</sup> *Ibid* (n 52)

[T]he reason for that exception is clear, because otherwise, if the rule were applied in its full rigour, a company, which, by its directors, had broken its own regulations by doing something without a special resolution which could only be done validly by a special resolution could assert that it alone was the proper plaintiff in any consequent action and the effect would be to allow a company acting in breach of its articles to do de facto by ordinary resolution that which according to its own regulations could only be done by special resolution<sup>71</sup>.

In essence, this is not an actual exception to the rule in *Foss v Harbottle* as ‘it is the company that has done something wrong, rather than being the victim of a wrong’<sup>72</sup>.

### **3.3. Where the act complained of was an invasion/infringement of the members’ personal rights**

The third exception is about the personal rights which vested in each individual shareholder by articles and statute and for which the shareholder can individually apply for infringement in the court<sup>73</sup>. Under the third exception to the rule in *Foss v Harbottle*, an individual shareholder can bring an action in the court only if he overcomes two hurdles<sup>74</sup>. The first hurdle involves the difficulties surrounding the application of well-known ‘outsider’ rights allegedly granted to a company member by the association’s articles<sup>75</sup>. Particularly difficult here is to distinguish insider rights, that are applicable based on the statutory contract, and outsider rights that are usually regarded as not applicable<sup>76</sup>. The second hurdle refers to the difficulty in foreseeing when the court will find that the infringement of an article in the company’s constitution is a simple ‘internal irregularity’ of internal management and so a wrongdoing to the company and not a breach to the company’s constitution for which an individual of a company can bring an action to the court<sup>77</sup>. The aforementioned distinction between these two categories of wrongdoing can rise ambiguity and controversy<sup>78</sup>.

In regard to the second hurdle, it was held by the Court of Appeal in *MacDougall v Gardiner* that if a company member could bring an action to the court for every infringement, ‘then if there happens to

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<sup>71</sup> Ibid (n 52)

<sup>72</sup> Ibid (n 1) 184

<sup>73</sup> S. Chumir, ‘Challenging Directors and the Rule in *Foss v Harbottle*’ (1965) 4 AlbertaLR 98

<sup>74</sup> Ibid (n 1) 185

<sup>75</sup> Ibid

<sup>76</sup> Ibid

<sup>77</sup> Ibid

<sup>78</sup> Ibid

be one cantankerous member, or one member who loves litigation, everything of this kind [as to the facts] will be litigated<sup>79</sup>. In contrary, Jessel MR held in *Pender v Lushington* (1877) that each individual of a company has a personal right to be taken into account with his vote and to bring an action in his own name or in the company's name to implement that right<sup>80</sup>. Dignam and Lawry justifiably supports that any efforts to integrate the case law can result to controversial exercise<sup>81</sup>. It has also been argued that the courts should accept the personal right of a member to sue when the irregularity is connected to a constitutional right that also carries a property element, like the right to be counted and the right to vote; or the right not to have one's association fees augmented without following first the appropriate procedure; or the right to have a stated extra bonus according to the articles of the constitution<sup>82</sup>. Otherwise, it should not be ignored that mere infringements which can be decided by the majority vote in a meeting cannot be claimed by an individual<sup>83</sup>.

The third exception overlaps with the second one 'in so far a shareholder has a personal right to have the articles of association observed'<sup>84</sup>. Therefore, where the alleged conduct constitutes an effort to change the s33 contract without following a procedure involving a particular resolution, the court may allow an individual member to sue in order to prohibit the majority from infringing the article in question. This is explained in *Edwards v Hallwell* (1950) where the two members had a personal right not to get an increase to their subscription before the appropriate procedure taking place<sup>85</sup>.

### **3.4. Where there was a fraud on the minority and the wrongdoers were in control**

The fourth exception has been widely considered as the only real exception to the rule in *Foss v Harbottle* which actually allows a minority member to bring an action to the court for the company's behalf. This exception applies in a scenario where a 'fraud on the minority' has been perpetrated by the majority who control the company and 'will not permit an action to be brought in the name of the company'<sup>86</sup>. Case law and journalists refer to this exception as the 'fraud on the minority'<sup>87</sup>. What

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<sup>79</sup> Ibid (n 49)

<sup>80</sup> *Pender v Lushington* (1877) 6 Ch D 70

<sup>81</sup> Ibid (n 1) 185

<sup>82</sup> Ibid

<sup>83</sup> Ibid

<sup>84</sup> Ibid 184

<sup>85</sup> Ibid

<sup>86</sup> *Burland v Earle* (Consolidated) (1900-3) All E.R. 1452

<sup>87</sup> Ibid (n 1) 186

makes this exception exceptionally important is that it has introduced the concept of derivative claims in common law<sup>88</sup> and interestingly, until the establishment of the Companies Act 2006 and the statutory procedure, this exception functioned as a procedural mechanism by which ‘a shareholder could bring a derivative action to enforce the company’s rights’<sup>89</sup>. Derivative claims are defined as the ‘claims brought against a company by a shareholder on behalf of the company in relation to a breach of duty by a director’<sup>90</sup>. For the application of this exception, there are two elements that should be satisfied: ‘the wrongdoing had to amount to “fraud” and the wrongdoers must have been in control of the company’<sup>91</sup>.

Regarding the element of ‘fraud’, it is noteworthy that the courts have not established precise limits for the interpretation of the word ‘fraud’ even though it has been recognised that it is undoubtedly broader than fraud at common law<sup>92</sup>. Megarry VC in *Estmanco (Kilner House) Ltd v Greater London Council* (1982) declared that ‘an abuse or misuse of power’ can constitute ‘fraud on minority’ under a wider interpretation of the term ‘fraud’<sup>93</sup>. Therefore, the meaning of ‘fraud’ includes conducts that are simply inappropriate but not essentially fraudulent<sup>94</sup>. In *Daniels v Daniels* (1978), a case where the wrongdoer benefited from a negligence occurring in the company, Templeman J stated that under the forth exception, a minority can still bring an action where the powers of directors have been abused ‘intentionally or unintentionally, fraudulently or negligently’ by the directors themselves in a manner which proves advantageous to the directors and unfavourable to the minorities<sup>95</sup>. This extended meaning of fraud which includes cases of self-serving negligence has also been considered in *Burland v Earle* (1902) where Lord Davey expressed that a fraudulent action may be found when ‘the majority are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company, or in which the other shareholders are asked to participate’<sup>96</sup>. Moreover, it was held in *Prudential Assurance v Newman Industries* [1982] that the element of ‘fraud’

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<sup>88</sup> Gareth Baker and Samantha Hacking, ‘UK: Statutory Derivative Claim Regime: Ten Years On’ (2017) Mondaq Business Briefing 1

<sup>89</sup> *Ibid* (n 1) 186

<sup>90</sup> *Ibid* (n 88)

<sup>91</sup> *Ibid* (n 14) 180

<sup>92</sup> *Ibid* (n 1) 186

<sup>93</sup> *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2

<sup>94</sup> *Ibid* (n 1) 186

<sup>95</sup> *Daniels v Daniels* [1978] Ch 406

<sup>96</sup> *Burland v Earle* [1902] AC 83

can be met where the majority shareholders utilise their voting power to impede any procedures being decided against them<sup>97</sup>.

In contrast, the court in *Pavrides v Jensen* (1956) held that the minority shareholder could not bring an action against the directors for their negligent behaviour because there was no personal advantage and so this could not amount to a fraudulent act or dishonesty<sup>98</sup>. These different and contradictory interpretations of fraud 'rest upon the ratio decidendi on which the courts based their judgements in the respective derivative actions'<sup>99</sup>. This is possibly happened because the courts do not provide any exact elements of what constitute 'fraud' in that area but rather, they just recognise, as indicated above, that it is obviously broader than common law fraud<sup>100</sup>.

The second element of the 'wrongdoer control' needs evidence that the supposed wrongdoers had adequate control in order to block legal action from being brought on behalf of the company<sup>101</sup>. At this point, there has been some controversy over the dilemma between de facto control and de jure control and specifically, over the difficulty to identify which of the two can be considered more sufficient for the particular purpose to be implemented<sup>102</sup>. More explicitly, the question here is whether the wrongdoers have to control or retain the majority shares of the company or whether they only have to be capable to exercise adequate control in order to block the procedures<sup>103</sup>. Vinelott J in *Prudential Assurance Co Ltd v Newman Industries Co Ltd (No 2)* (1982) was prepared to consent the suit although the two directors who committed the impugned wrongdoing were not the majority shareholders<sup>104</sup>. The judge stated that the element of 'control' can be satisfied where the matter in question is put before the shareholders in a manner which would not enable them to examine it appropriately<sup>105</sup>. A realistic perspective regarding the notion of 'control' has been also taken by the Court of Appeal which mentions that it should not compulsory be restricted to de jure control, but

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<sup>97</sup> *Prudential Assurance v Newman Industries (No.2)* [1982] 1 All ER 354

<sup>98</sup> *Pavrides v Jensen* [1956] Ch 565

<sup>99</sup> Mike Oluwaseyi Bamigboye, 'The True Exception to the Rule in Foss v. Harbottle: Statutory Derivative Action Revisited' (2016) <<https://ssrn.com/abstract=2863851>> accessed 19 March 2018

<sup>100</sup> K Aina, 'The Derivative Action in Nigeria: A Comparative Review' (2014) 5 U.I.L.S.S. 205

<sup>101</sup> *Ibid* (n 1) 188

<sup>102</sup> *Ibid* (n 1) 188

<sup>103</sup> *Ibid*

<sup>104</sup> *Ibid* (n 97)

<sup>105</sup> *Ibid*

rather, it could include the circumstances where the majority decision is occurred by those votes ‘cast by the delinquent himself plus those voting with him as a result of influence or apathy’<sup>106</sup>.

In *Smith v Croft (No 2)* (1988), it was attempted ‘some tempering of this dilution of the control requirement’<sup>107</sup>. Knox J declared that if ‘the majority inside the minority’ did not agree with the procedures for ‘disinterested reasons’, the single individual pursuing to bring an action to the court would be deprived of locus standi<sup>108</sup>. In designating the shareholders’ independence, Knox J supported that the votes of shareholders:

should be disregarded if, but only if, the court is satisfied either that the either that the vote or its equivalent is actually cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered in such that there is a substantial risk of that happening. The court should not substitute its own opinion but can, and in my view should, access whether the decision making process is vitiated by being or being likely to be directed to an improper purpose<sup>109</sup>.

#### **4. Criticism of the Rule in *Foss v Harbottle* and of its exceptions**

The law relating to the rule in *Foss v Harbottle* and its exceptions has been widely discussed due to the controversy that this creates in the area of company law. Indeed, the rule and its exceptions have proved to have both positive and negative contribution to the company law. This section starts by discussing the significance and the flaws of the rule in *Foss v Harbottle*. It then explains the real implications of the exceptions to the rule in *Foss v Harbottle* and how these led to the introduction of a new statutory derivative claim, Part 11 of the Companies Act. Finally, it ends by examining the effectiveness of the Act and the contemporary position of the rule in *Foss v Harbottle* as it is formed after the statutory procedure.

##### **4.1. The significance and the flaws of the Rule in *Foss v Harbottle* and its exceptions**

On the one hand, the rule is reasonably based on the perspective that it is not necessary to give

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<sup>106</sup> Ibid

<sup>107</sup> Ibid (n 64)

<sup>108</sup> Ibid

<sup>109</sup> Ibid (n 64)

recourse to the courts regarding an issue that a company can resolve or regarding a wrongdoing that can be sanctioned or ignored through an internal procedure<sup>110</sup>. Moreover, it correctly permits judges to deny any intentions of endeavouring to review matters of corporate policy and commercial ruling, namely to decide for things that rightly considered out of their competence and their skills<sup>111</sup>. This is reasonable and fair. It is a fact that the ruling of Wigram VC in *Foss v Harbottle* followed the previous case law regarding unincorporated companies by persisting that the minority should demonstrate that they had wiped out any likelihood of resolution within the internal management<sup>112</sup>. Some indications of the existence of majority rule has been implied in the recent case law but Wigram VC was the very first who declared clearly that the court will not interfere when an irregular conduct has been lawfully authorised by the majority of the shareholders<sup>113</sup>.

Adding to the above, the rule has been justified by judicial policies and this may be considered as a confirmation of its successful validity and application. At the end of the nineteenth century, some judges tried to elucidate the actual principles that were intended to be served by the rule<sup>114</sup>. James LJ in *Gray v Lewis* (1873) rationalised the policy that any ‘body corporate’ is the appropriate claimant in actions for claiming its property by indicating to the clear threat of a variety of shareholders’ suits in the non-appearance of such a doctrine as *Foss v Harbottle*<sup>115</sup>. Another justification, and one which is prima facie much sounder in supporting the rule in *Foss v Harbottle* has promoted in *MacDougall v Gardine*. In that case, Mellish LJ stated that where an action has been done irregularly and the majority shareholders were authorized to do it regularly, ‘or if something is done illegally which the majority of the company are entitled to do legally, there can be no use having litigation about it the ultimate end of which is that a meeting is called and them ultimately the majority gets its wishes’<sup>116</sup>.

On the other hand, the power given to the majority to authorize all but the most important procedures of abuse, can be certainly considered as much more imminent danger than the alleged hazard of ‘multiplicity of actions’<sup>117</sup>. Boyle correctly affirmed that the rule in *Foss v Harbottle* was ‘unfavourable

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<sup>110</sup> Ibid (n 10) 32

<sup>111</sup> Ibid

<sup>112</sup> AJ Boyle, ‘Minority Shareholders’ Remedies’ (2002) 0521791065 Cambridge University Press 1, 4

<sup>113</sup> Ibid (n 112)

<sup>114</sup> Ibid 6

<sup>115</sup> *Gray v Lewis* (1873) 8 Ch App 1035 at 1051.

<sup>116</sup> Ibid (n 49) at 25

<sup>117</sup> Ibid (n 112) 7

to the minority’ as it ‘barred a minority action whenever the alleged misconduct was in law capable of ratification, whether or not an independent majority would ever be given a real opportunity to consider the matter’<sup>118</sup>. The above was the main reason for the existence of the four exceptions to the rule in *Foss v Harbottle*. As it has been indicated above, from the four exception, only the fourth one has been proved as a real exception to the rule. Obvious weaknesses, though, continue to exist even after the establishment of the exceptions<sup>119</sup>. In bringing a derivative claim by relying on the only real exception, namely the ‘fraud of minority’ exception, difficulties are arisen in proving the element of ‘control’, explicitly that the wrongdoers are also the controllers of the company<sup>120</sup>. What else, ambiguity occurs in identifying which wrongdoings are validated and which are not as it has never been administrated by completely consistent principles<sup>121</sup>.

The exceptions to the rule in *Foss v Harbottle* would supposedly allow an aggrieved minority shareholder to sue for a wrongdoing that disadvantaged him and others and that in normal situations would be barred by the wrongdoers in control<sup>122</sup>. The requirements needed for establishing the exceptions may seem to be easily fulfilled<sup>123</sup>. In reality, however, the law concerning the rule in *Foss v Harbottle* and its exceptions was essentially only reachable by professional practitioners who could examine cases covering 150 years<sup>124</sup>. Moreover, deterring judicial attitudes constituted it doubtful ‘as to whether the courts were capable of developing a coherent set of legal principles that would strike the proper balance between the competing goals of enhancing “shareholder confidence” and not imposing “significant burdens on management”’<sup>125</sup>. Adding to the above practical difficulties, it is noteworthy that one of the intentions of the rule in *Foss v Harbottle* was to distinguish ‘cheaply and expeditiously’ the cases where a shareholder has the right to sue due to internal irregularities or infringement of directors’ duties, from the cases where he has not such a right<sup>126</sup>. Quite frequently, though, the rule succeeds the contrary outcome<sup>127</sup>. The ultimate example here is the case of *Smith v Croft (No. 2)* [1987] ‘which lasted approximately 17 days and in which over one hundred authorities

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<sup>118</sup> Ibid 4

<sup>119</sup> Ibid (n 112) 7

<sup>120</sup> Ibid

<sup>121</sup> Ibid

<sup>122</sup> *Russell v Wakefield Waterworks Co* (1875) L.R. 20 Eq. 474

<sup>123</sup> Ibid (n 14) 180

<sup>124</sup> Ibid

<sup>125</sup> Ibid

<sup>126</sup> D.D. Prentice, ‘Shareholder actions: the rule in *Foss v Harbottle*’ (1988) LQR 341

<sup>127</sup> Ibid

were cited to the court<sup>128</sup>.

In general, the rule in *Foss v Harbottle* along with its exceptions seem to suffer from a range of defects<sup>129</sup>. In summary, these shortcomings involve the unclear statement as to what comprises 'control' by the supposed wrongdoers; the difficulty to define 'fraud'; the unclear significance and extent of ratification; and finally, the so obvious reluctance of the courts to interfere with the companies' internal management<sup>130</sup>. Due to the above negative implications, the rule in *Foss v Harbottle* has been described as 'obscure, complex, rigid, old-fashioned and unwieldy'<sup>131</sup>. Law Commission of the United Kingdom commended against the rule by stating 'that there should be a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the action'<sup>132</sup>. Consequently, all the above criticisms gave impetus to the requests for a comprehensible statutory derivative claim which has been finally introduced in Part 11 of Companies Act 2006<sup>133</sup>.

#### 4.2. The statutory procedure: Companies Act 2006, Part 11

The statutory derivative action is considered one of the most controversial and debated reforms established by the Companies Act 2006<sup>134</sup>. This innovation is found in Part 11 of the Companies Act 2006 and it is mainly based on the recommendations of the Law Commission, namely its purpose is to simplify and modernise the law regarding the derivative claims so as to advance its accessibility<sup>135</sup>. In attaining the above purpose, the statutory derivative action put aside the 'arcane rule' of *Foss v Harbottle* and the relevant elements of 'fraud on the minority' and 'wrongdoer control' and replaced them with a judicial discretion to grant authorization by following the statutory factors specified in ss.261-263<sup>136</sup>. These amendments have raised ambiguity and controversy, with practitioners expressing their worries that they will possibly result to augmented litigation by activist

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<sup>128</sup> *Smith v. Croft (No. 2)* [1987] 3 W.L.R. 405

<sup>129</sup> K. Vere-Stevens, 'Should We Toss Foss: Toward an Australian Statutory Derivative Action' (1997) 25 ABLR 127

<sup>130</sup> A. Arora, 'A Review of Minority Shareholder Protection' (2000) 21 *The Company Lawyer* 37

<sup>131</sup> *Ibid* (n 14) 178

<sup>132</sup> Law Commission, *Shareholder Remedies: Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965* (Law Com No 246, 1997) para 6.15.

<sup>133</sup> *Ibid* (n 1) 188

<sup>134</sup> Andrew Keay and Joan Loughrey, 'Something old, something new, something borrowed: an analysis of the new derivative action under the Companies Act 2006' (2008) LQR 469

<sup>135</sup> *Ibid*

<sup>136</sup> *Ibid*

shareholders<sup>137</sup>. These fears occurred due to an alteration of the current law which indicates that shareholders are now able to ‘bring a derivative action against directors for negligence from which they do not benefit, as well as for other breaches of duty’<sup>138</sup>. Extra concerns are imposed to the lawyers who fear that the combination of the above provision with the directors’ new duty enforced under s.172 of the Act and demands the promotion of the company’s success, ‘will result in shareholders bringing derivative actions alleging that directors have negligently failed to have regard to one of the factors in s.172, or placed undue weight on others’<sup>139</sup>.

Nevertheless, the actual consequences of the statutory derivative action are uncertain<sup>140</sup>. Although shareholders can now seek to bring a derivative action against directors for negligence from which directors have not be benefited, the permission for a derivative action is greatly depended on the courts’ approach which have the discretion to permit a claim to continue with the procedure<sup>141</sup>. If the courts follow a restraining approach, a few actions may be permitted to continue after the application<sup>142</sup>. This application for permission to continue a derivative claim is a two-stage procedure<sup>143</sup>. At the first stage, a shareholder is required to establish a prima facie case in order to grant a permission to proceed<sup>144</sup>. If the applicant fails to provide a prima facie case, the claim will be dismissed by the courts<sup>145</sup>. If the applicant succeeds, the claim continues to the second stage, which has been considered contentious<sup>146</sup>. At that stage, the courts ask the company to provide evidences for the case and then, they exercise their discretion to decide whether to grant permission for the claim to continue<sup>147</sup>. The sections of the Act provide a list of factors that the courts should take into consideration in order to decide whether to give permission or not<sup>148</sup>. In essence, the courts must consider the following factors:

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<sup>137</sup> Milner Moore and Lewis Herbert Smith, ‘In the Line of Fire - Directors Duties under the Companies Act 2006’ <<http://www.herbertsmith.com/NR/rdonlyres/B65D78B4-23E8-463E-8D51-9E893A0705E7/3831/IntheLineofFire.pdf>> accessed 20 March 2018

<sup>138</sup> Ibid (n 134)

<sup>139</sup> Ibid

<sup>140</sup> Ibid

<sup>141</sup> Ibid 470

<sup>142</sup> Ibid

<sup>143</sup> Ibid

<sup>144</sup> Companies Act 2006 s.261(2)

<sup>145</sup> Ibid

<sup>146</sup> Ibid (n 134) 470

<sup>147</sup> Companies Act 2006 s.261(3)

<sup>148</sup> Companies Act 2006 s.263(3) and (4)

whether the shareholder is acting in good faith; the importance which a person under a duty to promote the success of the company would attach to continuing the action; whether the wrong could be ratified or authorised; whether the company has decided not to bring a claim; the availability of an alternative remedy; and the views of the independent members of the company.<sup>149</sup>

Indeed, the operation of the second stage of the procedure succeeded so as not to be confirmed ‘the fear that the new statutory procedure would open the floodgates of litigation against directors’<sup>150</sup>. This can be illustrated in *Stimpson v Southern Landlords Association* (2010) where the court refused the permission<sup>151</sup>.

#### 4.3. The rule in *Foss v Harbottle* after the statutory procedure

For journalists who had lengthy criticised the defects of the rule in *Foss v Harbottle*, Part 11 of the Act was a fresh start that most significantly delivered for the fall of the ‘fraud on minority’ and the ‘wrongdoer control’ which were pre-requisites for bringing a derivative action<sup>152</sup>. Interestingly, it has been argued that Part 11 of the Companies Act 2006 ‘do not formulate a substantive rule to replace the rule in *Foss v Harbottle*’<sup>153</sup> and therefore, the rule in *Foss v Harbottle* along with the wrongdoer consideration continue to be taken into account even after the implementation of the Act. Case law illustrates that the statute can be read in two ways<sup>154</sup>. The one option is to be interpreted as providing the court with a number of rules for identifying when the derivative claim must be allowed and with a number of factors to be taken into consideration when effecting its permission discretion<sup>155</sup>. From this viewpoint, the rule in *Foss v Harbottle* and the ‘fraud on minority’ exception are irrelevant because they are not mentioned at all. On the other perspective, Part 11 is seen as delivering a procedure for the implementation of all previous rules of common law, including of course the proper plaintiff rule<sup>156</sup>. According to the second reading, the court at Stage 1 ‘determines whether there is a "prima facie case" for giving permission' which—relying on the common law’s understanding of this term—

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<sup>149</sup> Ibid

<sup>150</sup> Ibid (n 1) 200

<sup>151</sup> *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387

<sup>152</sup> David Kershaw, ‘The rule in *Foss v Harbottle* is dead: long live the rule in *Foss v Harbottle*’ (2015) 3 JBL 274, 301

<sup>153</sup> Explanatory Notes to the Companies Act 2006, para 491

<sup>154</sup> Ibid (n 152) 302

<sup>155</sup> Ibid (n 152) 302

<sup>156</sup> Ibid

involves a threshold determination of whether the wrongdoers control the general meeting’ and ‘at Stage 2 [...] the court must determine following receipt of evidence from all parties whether the litigation should be permitted to proceed by applying the s.263 criteria’<sup>157</sup>. Both of the above readings are validly used by the courts<sup>158</sup>. Thus, it can be correctly stated that Part 11 of the Companies Act 2006 has clearly failed to replace the fundamental rule of *Foss v Harbottle*<sup>159</sup> and so it can be regarded as a lost chance to address some of the shortcomings of the rule<sup>160</sup>.

## 5. Conclusion

By taking everything into consideration, the obvious conclusion to be drawn is that the rule in *Foss v Harbottle* is indeed remarkably significant in company law. Its importance can be realised by considering that it involves four of the most fundamental doctrines of company law: the rule of separate legal personality, the internal management rule, the statutory contract, and the doctrine of majority rule. However, the rule in *Foss v Harbottle* gives great power to the majority shareholders and the controllers of the board. Thus, unfair results occur when the wrongdoers are at the same time members of the board capable to bar an action from being claimed by the company in order to gain redress for their wrongdoings. For that reason, there have been established four exceptions to the rule in order to allow minority shareholders to bring an action to the court against an infringement occurred by the majority. Although there are four exceptions to the rule, the only real one is the fourth exception which requires two elements to be satisfied: the ‘fraud on the minority’ and the ‘wrongdoers control’. The particular exception introduced the very crucial derivative action in common law and so the rule along with its exception can be seen as the initial attempt for providing minority remedies. This illustrates that although the courts tried to mitigate the restrictive approach of *Foss v Harbottle*, they are yet reluctant to interfere with the internal management of the company and so they are careful not to largely differentiated from the rule in *Foss v Harbottle*. At that point, it is reasonably argued that a rule for which the courts introduced many exceptions in order to fill its gaps, is inevitably inappropriate with many shortcomings. In the case of *Foss v Harbottle*, the fact that there is only one actual exception underlines the significance of the rule. Last but not least, the statutory derivative claim did not manage to replace the rule in *Foss v Harbottle* as the courts do not

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<sup>157</sup> Ibid

<sup>158</sup> Ibid

<sup>159</sup> Ibid

<sup>160</sup> Ibid (n 1) 200

strictly follow the statutory procedure and the sections in the Companies Act 2006. Therefore, it is observed that despite the shortcomings of the rule, there is a silent acceptance of continuing to use the common law procedure. This is an evidence that the rule of *Foss v Harbottle* still useful for the courts today and justifies why this rule is still alive 160 years after its existence.

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