EXCEPTIONS TO 'THE RULE IN FOSS V. HARBOTTLE': INDIAN CONTEXT

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Introduction

'In a democracy you indeed have to win by a majority'. Likewise, a company which is an association of individuals acts in accordance with the decisions taken by the majority of its members. The dissenting members i.e. minority (if there is one) is bound by the decisions unless and until they are able to show that the power, which vests with the majority, has been abused or prejudices the interest of the company. The members of a company can express their wishes at general meetings by voting for or against the resolutions proposed. However, the resolution binds all the members, even those who vote against it.

The protection of the minority shareholders within the domain of corporate activity constitutes one of the most difficult problems facing modern company law. The aim must be to strike a balance between the effective control of the company and the interest of the small and individual shareholders. Similarly, in the words of Palmer: "A proper balance of the rights of majority and minority shareholders is essential for the smooth functioning of the company."

The Companies Act, 2013 therefore, contains a large number of provisions for the protection of the interests of investors in companies. The aim of these provisions is to require those who control the affairs of a company to exercise their powers according to certain principles of natural justice and fair play.

Rule in Foss v. Harbottle

The basic principle relating to the administration of the affairs of the company is that the Courts will not, in general intervene at the instance of the shareholder in the matters of internal administration; and will not interfere with the management of a company by its directors so long as they are acting within the powers conferred on them under the Articles of the company. Nothing connected with the internal disputes between the shareholders is to be made subject of

an action by a shareholder. This rule was laid down as early as 1843 in the celebrated case of Foss v. Harbottle:

In this case the action was by two shareholders in a company against the directors charging them with concerting and effecting various fraudulent and illegal transaction whereby the property of the company was misapplied and wasted, and praying that the defendant might be decreed to make good to the company the losses. The action was rejected in respect of those transaction which a majority of shareholder had the power to confirm.

The Court held that the action could not be brought by the minority shareholders. The wrong done to the company was one which could be ratified by the majority of members. The company was the proper plaintiff for the wrong done to the company, and the company can act only through its shareholders. The majority of the members should be left to decide whether to commence proceedings against the director.

The pre-eminently procedural character of ‘the rule in Foss v. Harbottle was clearly Expressed in the following restatement of the rule by Jenkins, L.J in Edwards v. Halliwell:

First, the proper plaintiff is an action 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. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or associations is in favour of what has been done, then cadet quaestio(cannot be questioned).”

Applicability in India:

The rule is not completely applicable to Indian scenario and the right of minority members are protected by the law. The legislature and the Court have clearly demarcated the boundaries as to when can a minority shareholder bring an action against the company when the act of the company prejudices its interests.The Supreme Court in Rajamundhry Electric Supply Corpn. v. A. Nageshwar Rao observed that the conduct with which the defendant are charged is an

injury not to the plaintiffs exclusively, it is an injury to whole corporation. In such cases the rule is that the corporation should sue in its own name and its corporate character. It is not a matter of course for any individual members of a corporation thus to assume themselves the right of suing in the name of the corporation. In law the corporation and the aggregate of members of the corporation are not the same thing. The Delhi High Court in ICICI v. Parasrampuria Synthetic Ltd has held that a mechanical and automatic application of Foss v. Harbottle rule to the Indian situations, Indian conditions and Indian corporate realities would be improper and is misleading. The principle, in the countries of its origin, owes its genesis to the established factual foundation of shareholder power and majority shareholder power centred around private individual enterprise and involving a large number of small shareholders, is vastly different from the ground realities.

Here the modern Indian corporate entity is not the multiple contribution of small individual shareholders but a predominantly and indeed overwhelmingly state supported funding structure at all stage by receiving substantial funding up to 80% or more from financial institutions which are entirely State controlled or represent substantial State interest and, thus, their shareholding may be small but it is these financial institutions which provide entire funds for the continuous existence and corporate activities.

Exceptions:

The majority supremacy, however, does not prevail in all situations. The operative field of the rule in Foss v. Harbottle extends to cases in which the corporations are competent to ratify managerial sins. But there are certain acts which no majority of shareholders can approve or affirm. In such cases each and every shareholder may sue to enforce obligation owed to the company. He brings the action as a representative of the corporate interest. In the American literature a representative action of this kind is called the ‘derivative actions’. The relief goes to the company. Similarly, a shareholder may sue to recover ultra vires spend money from the company’s officers responsible for the transaction.

Acts ultra vires

A shareholder is entitled to bring an action against the company and its officers in respect of matters which are ultra vires and which no majority of shareholders can sanction. The rule in Foss v. Harbottle applies only as long as the company is acting within its powers. The suitable

illustration to this context is Bharat Insurance Company Ltd v. Kanhaiya Lal: The plaintiff was a shareholder of the respondent company. One of the objects of the company was: To advance money at interest on security of lands, houses, machinery and other property situated in India. The plaintiff complained that the several investment have been made the company without adequate security and contrary to the provisions of memorandum and therefore prayed for a perpetual injunction to restrain it from making such investment. The Court observed as follows:

The broad rule in such cases is no doubt that in all matter of internal management of a company, the company itself is the best judge of its affairs and the Court should not interfere. But application of the assets of the company is not a matter of mere internal management. It is alleged that directors are acting *ultra vires* in their application of the funds of the company. Under these circumstances a single member can maintain a suit for declaration as to the true construction of the article in question.

The plaintiff’s own conduct in the circumstances must be proper. Since the minority shareholders action in which the plaintiff shareholder sues on behalf of the company is a procedural device for the purpose of doing justice for the benefit of the company. Where it is controlled by the miscreant directors or shareholders, the Court is entitled to look at the conduct of the plaintiff to satisfy itself that the plaintiff is a proper person to bring the action.

Thus, if the plaintiff’s were so tainted as to bar equitable relief of their was and unacceptable delay in bringing the action, the plaintiff might well be held not to be a proper person to bring the action.

In ***Narcombe v. Narcombe***, the action was by the wife, a minority shareholder, against the wrong doings of her husband as a director. In the matrimonial proceeding between them she came to know of the improper profits made by the husband and such profits were even taken into consideration in preparing the award, it was held that she was not a proper plaintiff for a derivative action.

Fraud on minority

Where the majority of a company’s members use their power to defraud or oppress the minority, their conduct is liable to be impeached even by a single shareholder. The fraud or oppression need not amount to a tort at common law, but it must involve an unconscionable

use of the majority's power resulting, or likely to result, either in financial loss or in unfair or discriminatory treatment of the minority, and it must certainly be more serious than the failure of the majority to act in the interest of the company as a whole, which will include the Court to annul a resolution altering the company's memorandum or articles. The concept of fraud on the minority can be best understood in the landmark case ***Menier v. Hooper's Telegraph Works Ltd.*** In this case a company was formed to lay down a transatlantic telegraph cable which was to be made by Hooper's Telegraph works Ltd. The majority shareholder 'Hooper' found that it could make a greater profit by selling the cable to another company which wished to lay it down on the same route, but which would not buy unless it had the necessary Government concessions for the undertaking. The first company had obtained such concessions, and so Hooper induced the trustee in whom they were vested to transfer them to the second company. To prevent the first company from suing to recover the concessions, Hooper procured the passing of a resolution that the first company should be wound up voluntarily, and that a liquidator should be appointed whom Hopper could trust not to pursue the company's claim against Hooper and the trustee. Menier, a minority shareholder of the first company, brought a derivative action against Hooper to compel it to account to the company for the profits it derived from the improper arrangements it had made. It was held that Hooper's machinations amounted to an oppressive expropriation of the minority shareholders, and that a derivative action would therefore lie against it.

The present trend is that any breach of duty which causes loss to the company should be regarded as a fraud on the minority. In view of the inactivity of the legislature in the area of minority protection, it is welcome that the Courts have taken it upon themselves to extend that area and to enable minorities more frequently than before to have their grievances ventilated in Court.

Acts requiring special majority

There are certain acts which can only be done by passing a special resolution at a general meeting of shareholders. Accordingly, if the majority purport to do any such act by passing only an ordinary resolution or without passing special resolution in the manner required by law, any member or members can bring an action to restrain the majority. Such actions were

allowed in ***Dhakeswari Cotton Mills v. Nil Kamal Chakravarty*** and ***Nagappa Chettiar v. Madras Race Club***.

Wrongdoers in control

Sometimes an obvious wrong may have been done to the company, but the controlling shareholders would not permit an action to be brought against the wrongdoer. In such cases, to safeguard the interest of the company, any member or members may bring an action in the name of the company. This was recognised in Foss v. Harbottle itself: 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 these rights to which in their corporate character they were entitled, one cannot but think that the principle so forcefully laid down by ***Lord Cottenham in Wallworth v. Holt*** and 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."

In the case of ***Glass v. Atkin***, it was held that the control exists if it would be futile to call a general meeting because the wrongdoers would directly or indirectly exercise a decisive influence over the result. This exception to Foss v. Harbottle applies whenever the defendants are shown to be able by means of any manipulation of their position in the company to ensure that the action is not brought by the company. It has been suggested that the principle should extend to this extent that when a director is in breach of fiduciary duty, every shareholder may be regarded an authorized organ to bring the action.

Individual membership rights

Every shareholder has vested in him certain personal rights against the company and his shareholders. A large number of such rights have been conferred upon shareholders by the acts itself, but they may also arise out of articles of association. Such rights are commonly known as individual membership rights and respecting them the rule of majority simply does not operate. In the words of Palmer, "if such a right is in question, a single shareholder can, on principle, defy a majority consisting of all the other shareholders".

In ***Nagappa Chettiar v. Madras Race Club***, the Court observed that a shareholder is entitled to enforce his individual rights against the company, such as his right to vote, the right to have his vote recorded, or his right to stand as a director of a company at an election. This principle was applied by the Kerala High Court in deciding ***Joseph v. Jos***. In this case the plaintiff was a candidate and he contested the election, but was defeated. He was proposed as a candidate again to fill up the second vacancy. But the chairman, on account of his previous defeat, disqualified him. In his action against the ruling, the Court held that he was entitled to a declaration that the proceeding of the meeting as regards the election of directors were null and void. An individual membership right implies that the individual shareholders can insist on strict observance of the legal rules, statutory provisions and the provisions in the memorandum and articles which cannot be waived by a bare majority of shareholder. Every shareholder can assert such a right in his own name.

Oppression and mismanagement

Lastly, it has been stated by Sinha J of the Calcutta High Court in ***Kanika Mukherjee v. Rameshwar Dayal Dubey*** that the principle embodied in Section 397 and 398 of the Indian Companies Act which provide for prevention of oppression and mismanagement, is an exception to the rule in Foss v. Harbottle which lays down the Sanctity of the majority rule.

Conclusion

Like a democratic country, company law provides for adequate safeguards for the minority shareholders when their rights are walked over by the majority. But in the arena corporate matters, the value of shareholding of an individual matters and if a single individual holding majority of the shareholding votes in favour of scheme of arrangement, the same shall be binding on several individuals. The majority leadership, does not prevail in all decision making processes. The operative field of the rule in Foss v. Harbottle extends to cases in which the acts of the corporations prejudices the minority and the majority can get away with by the fact that they are 'in majority'. Therefore, the principles laid down in this case does not have mechanical application in India.