

LLM COMMERCIAL LAW (2006-2007):

COMPANY LAW & INSOLVENCY

Question:

“... the rule [in *Foss v Harbottle*] is not an inflexible rule and it will be relaxed where necessary in the interests of justice”

per Jenkins LJ in *Edwards v Halliwell* [1950] 2 All ER 1064, 1067

Analyse the above comment with reference to relevant English and Commonwealth case law and academic commentary. Is it correct to say that the rule will be “relaxed where necessary in the interests of justice”? If not, ought it to be?

Answer (Mark = 84%): (see overleaf)

Introduction

*"In company law, the student soon learns that most roads seem to lead to the Foss v Harbottle doctrine, but later he discovers that much of this field is a maze, leading him back through many of the subject's other doctrines."*¹

The Rule in Foss v Harbottle

The rule in *Foss v Harbottle* [1843]² ("the Rule") "describes the policy of the courts of not hearing a claim concerning the affairs of a company brought by a member or members of the company."³ It "provides the starting point that A cannot bring an action against B to recover damages for an injury done by B to C."⁴

Like a natural person, a registered company can sue and be sued. It is a legal person separate and distinct from its members⁵. However, companies are creatures of statute, and statute provides for a legal relationship between the company and its members⁶. All members are *prima facie* bound to abide by the decisions of the majority taken at a general meeting.

For Lowry and Dignam (2006, p.185) the Rule translates the doctrine of separate legal personality, the statutory contract and the principle of majority rule into a rule of procedure governing *locus standi*. When a plaintiff has established that he has standing and entitlement to sue⁷, he may bring an action in the name of the company (a 'derivative action').

The three pillars of the Rule⁸ were described in Lord Davey's 1902 *locus classicus*:

"[T]he court will not interfere with the internal management of companies acting within their powers ...

[I]t is clear law that in order to redress a wrong done to the company ... the action should prima facie be brought by the company itself ...

*[N]o mere irregularity which can be remedied by the majority will entitle the minority to sue ..."*⁹

The Rule "avoids a multiplicity of suits" and "recognises that litigation ... is futile if the majority do not want it"¹⁰ (Charlesworth, 2005, p.342). A further policy objective - the

¹ Baxter (1987, p.6)

² 2 Hare 461

³ Mayson et al (2005, p.593)

⁴ *Johnson v Gore Wood & Co. (A Firm)* [1999] PNLR 426 (at p.456), per Ward LJ delivering the judgment of the Court of Appeal (Nourse, Ward and Mantell L.JJ).

⁵ *Salomon v Salomon & Co. Ltd.* [1897] AC 22

⁶ s.14 Companies Act 1985 ("the statutory contract"); See also the dicta of Stirling J in *Wood v Odessa Waterworks* [1889] 42 Ch D 636, e.g. at p.642: "The articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other."

⁷ Which is determined as a preliminary issue.

⁸ The 'proper plaintiff' principle; the 'internal management' principle; and the 'majority rule' principle.

⁹ *Burland v Earle* [1902] AC 83, at pp.93-94

¹⁰ "Those who take interests in companies limited by shares have to accept majority rule" per Lord Wilberforce in *Re Kong Thai Sawmill Sdn Bhd* [1978] 2 MLJ 227 (at p.229)

court's unwillingness to interfere in business affairs - was encapsulated in a famous dictum of Lord Eldon LC:

*"This court is not required on every occasion to take the management of every playhouse and brewhouse in the kingdom".*¹¹

Limits to the Rule

Baxter¹² enquires: "What is to happen ... if a company is unable to complain because those holding the reins of power ... are the persons injuring it and it suits them to watch it suffer?" The general meeting "has historically failed to protect shareholders from the abuse by directors of their powers"¹³; and so the necessity for exceptions to the Rule is obvious.

In *Edwards v Halliwell* [1950]¹⁴ Jenkins LJ described four such 'exceptions', and commented that the Rule was "not inflexible" and would "be relaxed where necessary in the interests of justice."¹⁵

This paper questions whether the Rule will be "relaxed where necessary in the interests of justice"; and, if not, will review whether it ought to be so relaxed.

The Personal 'Exceptions'

*"The 'exceptions' to the Rule ... are essentially not exceptions at all. They appear to be situations in which ... the Rule cannot apply."*¹⁶

Three of the Jenkins LJ's four 'exceptions' give rise to *personal* and not *derivative* actions, and so strictly there is no room for applying the Rule. These are: infringement by the majority of the minority's personal rights¹⁷; failure to obtain a special majority¹⁸; and *ultra vires* or illegal acts carried out by the majority¹⁹. They are therefore not considered further.

¹¹ *Carlen v Drury* [1812] 1 Ves & B 154, (at p.158)

¹² Baxter (1987, p.7)

¹³ Hargovan (1996, p.633)

¹⁴ 2 All ER 1064

¹⁵ *Ibid.* (at p.1067)

¹⁶ Wedderburn (1957, p.203)

¹⁷ Discussing the s.20 Companies Act 1948 "statutory contract" (now s.14 of the 1985 Act), Gregory (1981, p.526) notes that the "... true scope of the provision ... need[s] to be determined, not least because the extent to which a shareholder can enforce it, determines one extent to which [the Rule] will not defeat a minority action." However, as Wedderburn (1957, p.210) notes, in most of the cases "there is not a breath of discussion concerning the Rule ...".

¹⁸ *Edwards v Halliwell* itself was a case where members of a trade union successfully sued the union after a vote to increase membership dues failed to obtain a two-thirds majority. However, Jenkins LJ stated that the case was "*not even within the general ambit of the rule [in Foss v Harbottle]*" and that the Rule had "... *no application at all, for the [members] who are suing sue, not in the right of the union, but in their own right ...*" (at pp.1067-8)

¹⁹ Following the enactment of ss.35(2) and 35(A)(4) of the Companies Act 1985, the *ultra vires* doctrine has been severely curtailed. Further, as Charlesworth (2005, p.346) notes these cases now are better regarded as falling within the 'special majority' category (note 18 *supra*).

Fraud on a Minority with the Wrongdoers in Control

The fourth exception, fraud on the minority, “has been described as ‘the only true exception’ to [the Rule], a fair description when it is considered that the others are ... strictly speaking, not even within [its] ambit”.²⁰

In *Edwards v Halliwell*²¹, Jenkins LJ provided an oft-quoted definition of this exception:

*“... where what has been done amounts to ... a fraud on the minority and the wrongdoers are themselves in control of the company, the rule is relaxed in favour of the aggrieved minority who are allowed to bring what is known as a minority shareholders’ action ... The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.”*²²

The parameters of this exception depend upon definitions of ‘wrongdoer control’ and ‘fraud’. It appears clear that fraud will encompass expropriation of company property²³, and is “plainly wider than fraud at common law”²⁴. However, “locating the indicia of fraud ... can be a matter of intractable difficulty”.²⁵ The debate over wrongdoer control hinges upon whether *de jure* control²⁶ is necessary, or whether *de facto* control²⁷ suffices. Rider (1978, p.274) insists that, if *de jure* control is required, it would lead to “cases of obvious injustice” and so “must be wrong.” The bounds of this exception provide limits as to when the Rule may be ‘relaxed in the interests of justice’.

Relaxation in the ‘Interests of Justice’: A Fifth Exception?

*“[Prudential v Newman (No.2)] ... contains a number of welcome rulings ... the disputed fifth exception to the Rule (based on the ‘interests of justice’) is not an ill-established and superfluous gloss on the other four, but the very foundation of the court’s willingness to lend its aid to a minority member who seeks redress for a corporate wrong.”*²⁸

Do minority shareholders have redress if the majority have not been fraudulent, but merely negligent? Does it matter if the majority have benefited from their own mistakes? Put shortly: is the Rule relaxed when justice demands?

History

The idea that the Rule may be relaxed in the interests of justice is as old as *Foss v Harbottle* itself, for, in that case, the court held that “the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which

²⁰ Berkahn (1998, p.81)

²¹ [1950] 2 All ER 1064

²² *Ibid.*, at p.1067

²³ *Cook v Deeks* [1916] 1 AC 554, PC

²⁴ *Estmanco v GLC* [1982] 1 WLR 2, per Megarry VC (at p.12)

²⁵ Sullivan (1985, p.240); “The defining characteristics of an unratifiable breach of duty ... so elusive ... [that] ... progress may lie in abandoning the search for the unratifiable wrong and concentrating instead on the prerequisites of valid ratification.” (ibid, pp.243-244)

²⁶ i.e. a shareholding of over 50%

²⁷ That is, the ability to block ratifications, usually by reliance on the fact that many shareholders do not attend company meetings and/or do not exercise their right to vote.

²⁸ Sealy (1981, pp.31-32)

corporations are required to sue.”²⁹ Thirty years later, Jessell MR remarked that the Rule is “subject to exceptions [which] depend very much on the necessity of the case; that is the necessity of the court doing justice.”³⁰ In 1915 Swinfen-Eady LJ, agreeing with the remarks of Wigram V-C in *Foss*, stated that “in certain cases members may sue on behalf of the corporation if the interests of justice require it.”³¹ Following Jenkins LJ’s confirmatory dicta in *Edwards v Halliwell* [1950]³², Russell LJ in *Heyting v Dupont* [1964]³³ was prepared to accept³⁴ that the interests of justice required departure from the Rule on occasions.³⁵

The leading modern case is *Prudential Assurance v Newman Industries (No.2)* [1982].³⁶ The first instance decision of Vinelott J has been termed “admirable”³⁷, and “the most creative analysis of [the Rule] in its long history.”³⁸ Sullivan (1985, pp.238-239) considers that it could “form the basis for a more liberal restatement of the law”, thus increasing the scope of the derivative action, and making it a more potent deterrent to misconduct.

The case tested the boundaries of ‘wrongdoer control’, since the ‘majority’ directors of Newman owned less than 50% of the shares. It was also arguable whether the majority were ‘fraudulent’. Nevertheless, Vinelott J allowed Prudential to sue in Newman’s name.

Vinelott J’s definition of ‘fraud’ was controversial. After reviewing the authorities³⁹, he concluded that fraud could encompass situations where: “directors, though acting “in the belief that they were doing nothing wrong”⁴⁰ are guilty of a breach of duty ... to exercise proper care, and [so] obtain some benefit.”⁴¹ This squarely contradicted the view of Wedderburn (1958, p.96) that “fraud lies in the nature of the transaction, rather than in the motives of the majority”; and so, unsurprisingly, this ‘ingenious but astonishing escape route’⁴² incurred the ire of the learned commentator, who accused Vinelott J of ‘sweeping away’⁴³ nine decades of authority⁴⁴, and that applying his new principles would demand “intellectual gymnastics of Olympic quality.”⁴⁵

As to the level of control required of the wrongdoers, Vinelott J favoured *de facto* over *de jure* control; accepting that control included “any means of manipulation of [the wrongdoers] position in the company”⁴⁶ and, relying heavily on *Atwool v. Merryweather*

²⁹ [1843] 2 Hare 461, per Wigram V-C at p.464

³⁰ *Russell v Wakefield Waterworks Co.* [1875] LR 20 Eq 474, at p.480

³¹ *Baillie v Oriental Telephone and Electric Co. Ltd.* [1915] 1 Ch. 503, at p.518

³² [1950] 2 All ER 1064, 1067; i.e. the quotation which is under discussion in this paper.

³³ 1 WLR 843, at p.851

³⁴ Without accepting it as a proposition of law (*ibid.*)

³⁵ Although, on the facts (company deadlocked), the wrong complained of (withholding by defendant of patent application), could not have caused further damage to the company.

³⁶ Ch 257; hereafter “Prudential”

³⁷ Barnes (1987, p.92)

³⁸ Sealy (1982, p.247)

³⁹ *Burland v Earle* [1902] AC 83; *Regal (Hastings) v Gulliver* [1967] 2 AC 134; *Cook v Deeks* [1916] 1 AC 554; *North-West Transportation v Beatty* [1887] 12 App Cas 589; *Alexander v. Automatic Telephone Co.* [1900] 2 Ch. 56; *Pavrides v Jensen* [1956] Ch. 565; *Heyting v Dupont* [1963] 1 WLR 1192; *Daniels v Daniels* [1978] Ch. 406.

⁴⁰ (*Alexander v. Automatic Telephone Co.* [1900] 2 Ch. 56, per Lindley M.R. at p65)

⁴¹ Ch 257, at p.316

⁴² Wedderburn (1981, p.210)

⁴³ *Ibid.* p.211

⁴⁴ Particularly *North-West Transportation v Beatty* [1887] 12 App Cas 589, in which a director’s vote was allowed to ratify his act of selling property to a company at an undervalue.

⁴⁵ Wedderburn (1981, p.211)

⁴⁶ Ch. 257, at p.325

[1868]⁴⁷, stated “that the court has jurisdiction to entertain a claim by a minority shareholder ... even where the other defendants ... do not have a majority of votes in general meeting ...”⁴⁸

Importantly, Vinelott J then linked the *Atwool* case to a ‘strand of authority’⁴⁹ which describes the Rule as being flexible in the interests of justice, and concluded:

“In [the] circumstances ... *Prudential* have shown that the interests of justice do require that a minority action should be permitted.”⁵⁰

Objections in England to Relaxing the Rule in ‘the Interests of Justice’

Vinelott J’s judgment remains the high watermark for an ‘interests of justice’ relaxation of the Rule in England. On appeal⁵¹, the Court of Appeal, in a prosaic *obiter dictum*⁵², was “not convinced” that the interests of justice was “a practical test”⁵³ since it could involve “a full-dress trial before [being] applied.”⁵⁴ This led Sealy (1982, p.248) to ruefully declare the fifth exception “a dead letter.”

Relaxation of the Rule in the interests of justice has met with three principal objections. The first is as expounded by the Court of Appeal in *Prudential*.⁵⁵ In order to hear whether the action is justified, it may be necessary to ‘dress-rehearse’ the facts, leading to significant cost implications. This is a forceful point, recognised even by adherents of an ‘interests of justice’ relaxation. *Prudential* ran for 69 days at first instance, prompting Sealy to observe that the “indefensible, disgraceful feature [of the case] was that the time was [spent] deciding a preliminary issue, whose sole justification can only be the saving of forensic time”.⁵⁶

The second objection concerns the lack of clarity or certainty which would obtain upon a “justice” relaxation. For example, Megarry V-C has stated that although justice was an underlying reason for the Rule, “the reasons for an exception must not be confused with the exception itself. If the test were simply justice or injustice, this would mean different things to different men.”⁵⁷

Thirdly, there are the supporters of the ‘internal management’ principle of the Rule. In *Pavlidis v Jensen* [1956]⁵⁸, where directors had been merely negligent, counsel for the minority prayed in aid of the ‘interests of justice’ relaxation. Danckwerts J rejected the claim, citing Lord Davey in *Burland v Earle* [1092]⁵⁹ and holding that mere negligence on the part of “an amiable set of lunatics”⁶⁰ did not defeat the Rule. His judgment was

⁴⁷ LR 5 Eq 464. At p.319, Vinelott J stated: “[Atwool] has been frequently cited without any questions as to its correctness ...”

⁴⁸ Ch 257, at p.320

⁴⁹ Ch. 257 at p.321. The ‘strand’ includes *Foss v Harbottle* itself; *Russell v Wakefield Waterworks Co.* [1875] LR 20 Eq 474; and *Edwards v Halliwell* [1950] 2 All ER 1064 (where he repeated the dicta of Jenkins J, at p.1067, which are under discussion)

⁵⁰ *Ibid.* at p.327.

⁵¹ [1982] Ch 204

⁵² Newman ‘accepted’ the first instance ruling, and so effectively had changed sides on appeal. The Rule was therefore not in issue on appeal.

⁵³ *Ibid.*, at p.221

⁵⁴ *Ibid.*

⁵⁵ See quotations at notes 53, 54 above.

⁵⁶ Sealy (1981, p.29)

⁵⁷ *Estmanco (Kilner House) Ltd. v Greater London Council* [1982] 1 All ER 437

⁵⁸ Ch. 565, at pp.575-576

⁵⁹ See note 9 above

⁶⁰ This colourful phrase was coined by counsel for the minority in its (unsuccessful) submissions (Ch.565 at p.570)

resoundingly endorsed by Hahlo (1957) as upholding the 'internal management' aspect of the Rule.⁶¹

However, Danckwerts J's decision was not universally welcomed. Baxter (1987, p.20) called his reasoning 'wooden', arguing "if the quality of the act is everything, and negligence is always the wrong quality, appalling hardship can be created ...". Gower (1956, p.541) deplored the alleged acts of the directors (selling company property at a massive undervalue), and argued for the Rule "to be decently interred" as it nullified even the modest duties of skill and care owed by the directors. Phelan (1982, p.456) argued that the decision "... is tantamount to giving directors carte blanche as to the degree of responsibility they use in discharging their functions" and that "negligent management is capable of causing tremendous economic harm."⁶² There are clear undertones of a desire for an 'interests of justice' relaxation in these protests.

Thus, whilst the Court of Appeal's *obiter dicta* in the *Prudential* case have acted as a dead hand on an 'interests of justice' relaxation, there are those who would contend that "[p]lace the Court of Appeal, Vinelott J was not using the "interests of justice" as a "practical test" for use in determining the right to bring a derivative action, but as indicative of the need for such an action should fraud and control, as he defined them, be present."⁶³

The Rule Relaxed?

In *Daniels v Daniels* [1978]⁶⁴ a husband and wife were directors of a small company, and they bought company land for £4,250; the land later was resold for £120,000, the profit accruing to the directors. Templeman J held that a derivative action would lie: "To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £115,000 odd at the expense of the company is something entirely different"⁶⁵. He distinguished *Pavlides v Jensen* on the basis that in that earlier case, there had been no benefit for the directors. Phelan (1982, p.455) argues that "the type of negligence involved in *Daniels* constitutes a misfeasance [warranting] an application of the 'justice exception'." Vinelott J in *Prudential* took this reasoning a stage further, stating that he "could not see what principle underlies the distinction"⁶⁶, so doubting even the requirement for the majority to personally benefit.

s.459 Companies Act 1985: An Existing Alternative?

By s.459 Companies Act 1985⁶⁷, a minority shareholder may sue when the company's affairs are being, or have been, conducted in a manner which is "unfairly prejudicial"⁶⁸ to the his interests. Such conduct has been held to include: failure to pay dividends without

⁶¹ See quotation at note 100, below

⁶² Phelan (1982) at. p.460

⁶³ Sullivan (1985, p.245, note 78)

⁶⁴ Ch. 406

⁶⁵ *Ibid.*, at p.414

⁶⁶ [1981] Ch 257, at 316; see also note 41 above.

⁶⁷ The section has its roots historically in the work of the Cohen Commission ('Report of the Committee on Company Law Amendment' [1945] Cmnd 6649), which was tasked with looking into alternatives to the *Foss v Harbottle* doctrine.

⁶⁸ As to which, see the judgment of Lord Hoffmann in the leading case of *O'Neill v Phillips* [1999] 1 WLR 1092, HL

explanation⁶⁹; mismanagement of the companies affairs⁷⁰; and diverting business away from the company.⁷¹

However, despite a comprehensive range of remedies⁷², in practice the procedure has been used almost exclusively as an “exit door” for aggrieved minorities, leaving the Law Commission (1997, para. 6.11) to advocate a separate derivative action procedure for those who “wish to stay in the company”.⁷³ Thus, despite this flexible and arguably suitable alternative, the Rule lives on.

“Interests of Justice” Relaxation: The Position in the Commonwealth

A perusal of judicial decisions and academic commentary readily validates the observation by Mayson et al (2005, p.618) that: “In the Commonwealth, courts have been favourable to the idea of making an exception to the proper claimant principle whenever the justice of the case requires it.”

In South Africa, Booysen J, noted that the Rule was “not absolute”⁷⁴, continuing: “where ... a shareholder is left with a diminished patrimony, the continued application of the Rule would amount to an unwarranted and technical obstruction to the course of justice.”⁷⁵

The Canadian case of *Teck Corporation v Millar* [1973]⁷⁶ is oft-cited as an instance of relaxation of the Rule in the interests of justice.⁷⁷ Axworthy (1996, pp.410-411⁷⁸) considers that a justice exception could conceivably be used by shareholders in order to assist *employees* who wish to enforce their rights under s.46(1) Companies Act 1980.⁷⁹

The Nigerian commentator, Osunbor (1987), in a wide-ranging criticism of the “interests of justice” relaxation, concludes: “... certainly the “interests of justice” by themselves are not an exception to the Rule as they are too nebulous, vague and infinitely elastic.”⁸⁰ Nevertheless, he reports the acceptance⁸¹ there of the ‘interests of justice’ relaxation in *Edokpolor v Sem-Edo Wire Industries Ltd.* [1984]⁸². The Nigerian Supreme Court observed: “this is a clear case in which a minority shareholder should, in the interests of

⁶⁹ *Re. Sam Weller & Sons Ltd* [1989] 3 WLR 923

⁷⁰ *Re. Macro (Ipswich)* [1994] 2 BCLC 354

⁷¹ *Re. London School of Electronics* [1986] Ch. 211

⁷² By s.461 Companies Act 1985, the court can make order regulating or directing a company’s conduct; allowing a derivative action; or providing for purchase of shares (the latter has proved by far the most popular).

⁷³ See also Muckwiri (2004) who argues that, partly due to ease of use, s.459 has become an instrument of oppression by a *minority* shareholder.

⁷⁴ *Mclelland v Hulett & Ors.* [1992] (1) SA 456(D)

⁷⁵ *Ibid.*

⁷⁶ 2 WWR 385

⁷⁷ Minority were allowed to institute a derivative action because a shareholders meeting had previously voted in favour of such an action. See, further, Iacobucci (1973, p.355 et seq); but note Osunbor (1987, p.5) who contends that the passing of a resolution (rather than the ratification of a wrong) in *Teck v Millar* puts the case into the ‘personal’ rights, not the ‘derivative action’ category.

⁷⁸ At note 95

⁷⁹ Now s.309 Companies Act 1985; viz. directors should have regard to the interests of employees as well as the interests of members. As Dine (2005, p.196) points out, “this provision has no teeth and can be seen as mere ‘window dressing’.”

⁸⁰ At p.13

⁸¹ At p.11, Osunbor observes that: “It is curious that while the courts in England are trying to expunge the “interests of justice” from the list of exceptions, recent writing and decisions in Nigeria seem to be doing the opposite.”

⁸² 7 SC 119. Osunbor, however, considers that this case is more properly classified as an infringement of a personal right (at p.11),

justice, be allowed to sue as [an exception] to [the Rule]." Barnes (1987, p.94) notes of the case that: "... so Nigerian an approach of the Supreme Court ... striking a fair solution of conflicting claims ... to assist an otherwise helpless minority shareholder, cannot fail to be agreeable to many in this jurisdiction."

After a thorough review of the Australian jurisprudence, Sealy (1989, p.52) notes the robust approach of the judiciary: "The picture that consistently comes through is one of a willingness to get at the substantial issue undistracted by any consideration of locus standi or procedure." Berkahn (1998, p.88) offers further Antipodean perspective, noting that New Zealand courts employ the same uncompromising approach as their Australian counterparts.

The development of the 'fifth exception' in Australia has been well-mapped by Hargovan (1996), who notes that in *Biala v Mallina Holdings Ltd.* [1993]⁸³, Ipps J stoutly championed the 'justice of case' as a valid criterion for bringing a derivative action. Noting that modern corporations were far larger and more complex than in the time of *Foss v Harbottle*, Ipps J held: "to the extent that policy may be relevant in determining whether a fifth ... exception to the rule be recognised, I consider it desirable to allow a minority shareholder to bring a derivative claim where the justice of the case clearly demands ..."⁸⁴ To emphasise the viewpoint of the Australian judiciary, Hargovan also cites Street J's view that a fifth exception provides desirable flexibility: "*It is, perhaps, a useful door to be left open lest in some extremely unusual circumstances injustice would result from applying the rule*".⁸⁵

Statutory Derivative Actions in the Commonwealth

*"A statutory derivative action ... can play an instrumental role in the emancipation of the minority shareholder. It will give the courts the opportunity to forge a new judicial philosophy, with emphasis on easier and cheaper access, on the protection of minority shareholders, and on managerial accountability."*⁸⁶

Railing against the procedural obstacles of the Rule, several Commonwealth jurisdictions have enacted statutory provisions to enable minority shareholders to more easily institute a derivative action. Hargovan (1996, p.644) notes that the Canadian⁸⁷ and New Zealand⁸⁸ provisions require the action to be in the "interests of the company." The phrase "for the benefit of the company" is equated by Reisburg (2003, p.253) as "... parallel to the wide test of the "interests of justice" ...", suggesting that the statutory provisions can encompass an "interests of justice" relaxation.

Such a suggestion has received judicial confirmation in Australia, where, in *Karam v ANZ Banking Group* [2000]⁸⁹, Santow J held: "... while the matter cannot be said to be free from doubt, I consider the better view to be that the statutory derivative action⁹⁰ has

⁸³ 11 ACLC 1082, see also Hargovan (1996, pp. 634-635)

⁸⁴ Ibid. at p.1102

⁸⁵ *Hawkesbury Development Co. Ltd. v Landmark Finance Pty Ltd.* [1969] 2 NSW 782, at p. 789. Noted by Hargovan (1996, p.636)

⁸⁶ Hargovan (1996, p.639)

⁸⁷ Section 245(2)(c) of the Ontario Business Corporations Act 1982

⁸⁸ Section 209X(2)(d) Companies Act 1955, and Section 165(2) Companies Act 1993

⁸⁹ NSWSC 596

⁹⁰ ss.236, 237 of the Corporations Law, Pt. 2F.1A (Now repealed; replaced by the Corporations Act 2001)

displaced any potential recourse to the fifth (or other) exception in [the Rule] for the Plaintiffs, notwithstanding that the right to invoke it may have accrued.”⁹¹

Thus, it appears that not only is the Commonwealth judicially more “willing to become embroiled in the substantive issue and see it resolved, and [to brush] aside a Foss v Harbottle objection in a couple of sentences without citation of authority”⁹², but also that aggrieved minorities there can now rely on statute to see that justice is done.

Proposed Reform in England

*“... the introduction of a clear set of rules for the derivative action in this country would follow the lead given in other leading jurisdictions. In an age of increasing globalisation of investment and growing international interest in corporate governance, greater transparency in the requirements for a derivative action is in our view highly desirable.”*⁹³

The Company Law Reform Bill currently being debated in Parliament, will, if enacted, bring the law in England closer into line with Commonwealth jurisdictions. A statutory derivative action⁹⁴ will provide a procedure which will: “... set down criteria for the court distilled from the *Foss v Harbottle* jurisprudence.”⁹⁵ Importantly, a derivative claim “may be brought ... in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company”.⁹⁶ This reverses *Pavlides v Jensen*.

Furthermore, the procedure cross-refers to proposed statutory duties of directors, including a duty to “act in the way [the director] considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.”⁹⁷ The new Bill also provides that where ratification of a director’s act is required, a resolution is passed by “disregarding votes against the resolution by members with a personal interest, direct or indirect, in the ratification”⁹⁸, and that the duty of care required of directors is now to be measured to an objective standard.⁹⁹

Conclusion

*“Companies are, rightly, controlled by the majority shareholders, and anyone who takes shares ... is well aware of [this]. From the point of view of social policy it would be unfortunate if the courts could intervene in the internal affairs of a company, acting within its powers, save in the case of fraud. To say that the courts should be able to interfere whenever it is necessary ‘to do justice’ is to beg the question, for, in the absence of fraud or ultra vires, an act of which the majority approves is neither unjust nor a wrong to the company.”*¹⁰⁰

⁹¹ At para. 31

⁹² (Sealy, 1989, p.53)

⁹³ Law Commission (1997, para. 6.9)

⁹⁴ ss.239-242 of the current Bill

⁹⁵ Company Law Reform Bill, Explanatory notes, para. 480

⁹⁶ Company Law Reform Bill, Clause 239(3)

⁹⁷ *Ibid.* Clause 156(1)

⁹⁸ *Ibid.* Clause 216(4)

⁹⁹ *Ibid.* Clause 158. However, the common law may have been moving in this direction in any event, see *Re. D’Jan of London* [1993] BCC 646, in which Hoffman LJ stated that the common law duty of care owed by directors was as per s.214 Insolvency Act 1986 (also an objective standard).

¹⁰⁰ Hahlo (1957, p.88)

“Equity is concerned with substance not form, and it seems to me to be contrary to principle to require wronged minority shareholders to bring themselves within the boundaries of the well-recognised exceptions ... where an unjust or unconscionable result may otherwise ensue.”¹⁰¹

In both the case law and in academic commentary, there is a manifest tension between those on one hand who favour certainty, respecting the ‘majority rule’ and ‘internal management’ principles of the Rule; and those who, on the other hand, desire flexible, equitable, justice-driven exceptions or relaxations.

Whilst certainty is a laudable objective, should gross negligence be so easily excused? There is surely “room in company law for recognition of the fact that behind [a limited company], or amongst it, there are individuals, with rights, expectations and obligations *inter se* which are not necessarily submerged in the company structure.”¹⁰²

As to the arguments propounded by devotees of the ‘internal management’ principle, surely Sealy’s balanced views provide an effective counter:

“[The Rule] ... allows judges to disclaim any pretensions of corporate policy and questions of commercial judgment. Rightly – for that is not their function, and not their skill. But they are expert in knowing what is honest and what is fair; and it is their business not to allow injustices to go unremedied.”¹⁰³

It is submitted that, at minimum, English lawyers should follow the lead of their Commonwealth brethren, and endorse relaxation of the Rule whenever justice so demands. Furthermore, the proposed statutory derivative action, currently being debated in Parliament, should allow derivative actions in circumstances where justice requires them. This mechanism, if passed into law, will bring England into line with many other Commonwealth jurisdictions, hopefully rendering the need for an ‘interests of justice’ relaxation of the Rule otiose.

Preventing Injustice

But surely prevention is far better – and massively cheaper – than any cure. Rider (1978, pp.286-287) was certainly correct when he observed:

“Where a company is negligently operated the potential for economic harm is tremendous. Bad and incompetent management places shareholders, creditors, employees, suppliers and consumers at risk. There is of course no panacea and the law, and in particular the sledgehammer of a derivative action, can only have a limited role to play. Of far greater practical significance in the future will be the continuing improvement of managerial education ... and the creation of internal mechanisms within the enterprise to improve ... communication and supervision ... The appointment in recent years of outside directors on a non-executive basis ... is another step in the right direction.”

The recent (albeit, sadly, reactive) schemes to improve UK corporate governance via the Cadbury¹⁰⁴, Greenbury¹⁰⁵, Hampel¹⁰⁶ and Higgs¹⁰⁷ initiatives resulted in the July 2003

¹⁰¹ *Biala v Mallina Holdings Ltd.* [1993] 11 ACLC 1082, per Ipps J at p.1102

¹⁰² *Ebrahimi v Westbourne Galleries* [1973] AC 360, HL per Lord Wilberforce (at p.379)

¹⁰³ Sealy (1981, p.32), emphasis as original.

¹⁰⁴ Report of the Committee on the Financial Aspects of Corporate Governance [1992]

publication by the Financial Reporting Council of the 'Combined Code of Corporate Governance' ("the Combined Code"). The Combined Code lists several principles of good corporate practice, including, *inter alia*: a requirement for independent non-executive directors to constructively scrutinise the executive¹⁰⁸; a clear division of responsibility between heading the board and running the business¹⁰⁹; and transparency and openness in directors' remuneration¹¹⁰, and in dialogue between directors and shareholders¹¹¹.

It is, perhaps, too early to judge the success of the Combined Code; however, by combining it with the Section 459 remedy; the proposed statutory statement of directors' duties¹¹²; and a new statutory objective standard of skill and care¹¹³, it is to be fervently hoped that litigation concerning the Rule - regardless of any "interests of justice" relaxation - will diminish to vanishing point.

[3996 words]

¹⁰⁵ Directors' Remuneration, Report of a Study Group [1995]

¹⁰⁶ Committee on Corporate Governance: Final Report [Jan 1998]; Combined Code [Jun 1998]

¹⁰⁷ Review of the Role of Non-Executive Directors [2003]

¹⁰⁸ Combined Code (2003), Principle A.3

¹⁰⁹ *Ibid.*, Principle A.2

¹¹⁰ *Ibid.*, Principle B.2

¹¹¹ *Ibid.*, Principle D.1

¹¹² As to which see note 97, above.

¹¹³ As to which, see note 99, above.

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