

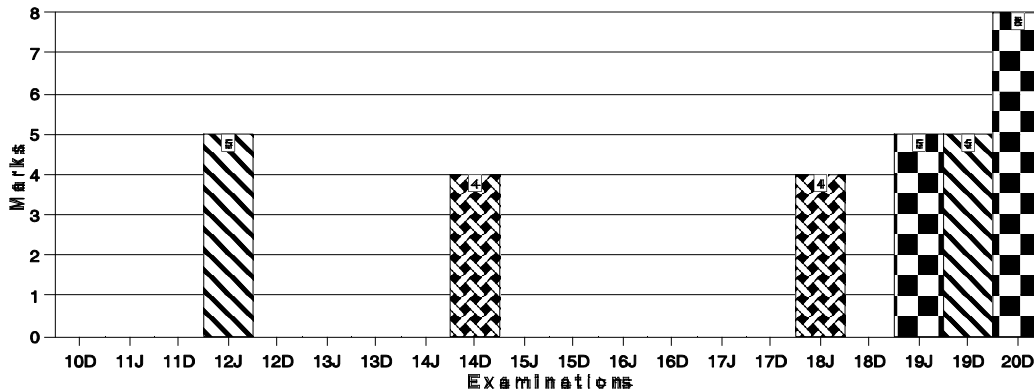
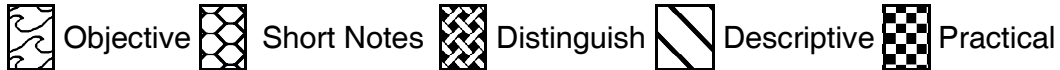
1 SHAREHOLDERS' DEMOCRACY

THIS CHAPTER INCLUDES

- Shareholders' Democracy
- Majority Powers and Minority Rights
- Justification and Advantages of the Rule in *Foss v. Harbottle*
- Exceptions to the Rule in *Foss v. Harbottle*

Marks of Objective, Short Notes, Distinguish Between, Descriptive & Practical Questions

Legend



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CHAPTER AT A GLANCE

Shareholders' Democracy

- The concept of shareholders' democracy in the present day corporate world denotes the shareholders' supremacy in the governance of the business and affairs of corporate sector either directly or through their elected representatives.
- The Government of India, has been endeavouring to disperse the shareholdership as widely as possible to avoid concentration of ownership in few hands.
- Thus the shareholder' democracy can play an important role in stimulating the Board of directors, raising company performance, and ensuring that the community at large takes a greater interest in industrial progress.
- Democracy means the rule of people, by people and for people. In that context the shareholders democracy means the rule of shareholders, by the shareholders', and for the shareholders' in the corporate enterprise, to which the shareholders belong.
- Precisely it is a right to speak, congregate, communicate with co-shareholders and to learn about what is going on in the company.

Majority Powers and Minority Rights

- A company being an artificial person with no physical existence, functions through the instrumentality of the Board of directors who is guided by the wishes of the majority, subject, of course, to the welfare of the company as a whole.
- It is, therefore, a cardinal rule of company law that prima facie a majority of members of a company are entitled to exercise the powers of the company and generally to control its affairs. Member's right to vote is recognised as right of property and the shareholder may exercise it as he thinks fit according to his choice and interest.

- A special resolution, for instance, requires a majority of 3/4^{ths} of those voting at the meeting and therefore, where the Act or the articles require a special resolution for any purpose, a three-fourth majority is necessary and a simple majority is not enough.
- The resolution of a majority of shareholders, passed at a duly convened and held general meeting, upon any question with which the company is legally competent to deal, is binding upon the minority and consequently upon the company.

The Principle of Non-interference (Rule in *Foss v. Harbottle*)

- The general principle of company law is that every member holds equal rights with other members of the company in the same class.
- The scale of rights of members of the same class must be held evenly for smooth functioning of the company. In case of difference(s) amongst the members the issue is decided by a vote of the majority.
- Since the majority of the members are in an advantageous position to run the company according to their command, the minorities of shareholders are often oppressed.
- The company law provides for adequate protection for the minority shareholders when their rights are trampled by the majority.
- The basic principle of non-interference with the internal management of company by the Court is laid down in a celebrated case of *Foss v. Harbottle* 67 E.R. 189; (1843) 2 Hare 461 that no action can be brought by a member against the directors in respect of a wrong alleged to be committed to a company. The company itself is the proper party of such an action.

Exceptions to the rule in *Foss v. Harbottle*

The rule in *Foss v. Harbottle* is not absolute but is subject to certain exceptions. In other words, the rule of supremacy of the majority is subject to certain exceptions and thus, minority shareholders are not left helpless, but they are protected by:

- (a) the common law; and
- (b) the provisions of the Companies Act.

The cases in which the majority rule does not prevail are commonly known as exceptions to the rule in *Foss v. Harbottle* and are available to the minority. In all these cases an individual member may sue for declaration that the resolution complained of is void, or for an injunction to restrain the company from passing it. The said rule will not apply in the following cases:

1. Ultra Vires Acts
2. Fraud on Minority
3. Wrongdoers in Control
4. Resolution requiring Special Majority but is passed by a simple majority
5. Personal Actions
6. Breach of Duty
7. Prevention of Oppression and Mismanagement

DISTINGUISH BETWEEN

2014 - Dec [2] Distinguish between the following:

(b) 'Oppression' and 'mismanagement'.

(4 marks)

Answer:

Points	Oppression	Mismanagement
Meaning	The term 'Oppression' is not defined in the Companies Act, 2013. Oppression, according to the dictionary meaning of the word, is any act exercised in a manner burdensome, harsh and wrongful. Oppression means violation of condition of fair play. The complaining member must be	The term "Mismanagement" is also not defined in the Companies Act, 2013. Normally mismanagement means gross misconduct of affairs of the company or misuse of powers given to directors or members under the Companies Act, 2013.

	<p>under a burden which is unjust, harsh or tyrannical. It involves lack of probity or fair dealing to a member in the matter of rights as a shareholders.</p>	
<p>Examples</p>	<p>Some of the acts held as oppressive are as follows:</p> <ul style="list-style-type: none"> • Continuous refusal to register shares to retain control over affairs of the company. • Illegal removal of director one group and appointing other director without notice to one group of directors. • Calling board meeting with 2 days notice so that NRI directors cannot attend and allotting shares to one group so that it comes into majority. • Issuing shares to wife of directors for wholly illusive consideration. • Attempt to deprive members of his ordinary membership rights e.g. denial of voting right or denial to contest election as director. 	<p>Some of the acts held as mismanagement are as follows:</p> <ul style="list-style-type: none"> • Not allowing director to function as director • Reckless sanction and disbursement of loans. • Serious violation of legal provisions • Acting beyond authority of memorandum and articles. • Directors do not take serious actions in case of corruption, embezzlement etc. • Diversion of funds • Operation of bank accounts by unauthorized persons.

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2018 - June [2] Distinguish between the following:

(a) Oppression and mismanagement application and Class action suits.

(4 marks)

Answer:

Oppression and Mismanagement Application:

Section 244 of the Companies Act, 2013 provides that the following members of a company have the right to apply in case of oppression and management referred to under **Section 241** to the tribunal:

- (a) in the case of a company having a share capital, not less than one hundred members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one-tenth of the issued share capital of the company, subject to the condition that the applicant or applicants has or have paid all calls and other sums due on his or their shares;
- (b) in the case of a company not having a share capital, not less than one-fifth of the total number of its members:

The Tribunal has the power that on an application made to it in this behalf, waive all or any of the above mentioned requirements so as to enable the members to apply under **Section 241**.

Class Action Suits:

Section 245 of the Companies Act, 2013, deal with Class action suits. It is provided that members, depositors or any class of them, may, if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors, file an application before the Tribunal on behalf of the members or depositors.

The requisite number of members is as under:

- (a) in the case of a company having a share capital, not less than one hundred members of the company or not less than such percentage of the total number of its members as may be prescribed, whichever is less, or any member or members holding not less than such percentage of the issued share capital of the company as may be prescribed, subject to the condition that the applicant or applicants has or have paid all calls and other sums due on his or their shares;
- (b) in the case of a company not having a share capital, not less than one-fifth of the total number of its members.

Further, the requisite number of depositors shall not be less than one hundred depositors or not less than such percentage of the total number of depositors as may be prescribed, whichever is less, or any depositor or depositors to whom the company owes such percentage of total deposits of the company as may be prescribed.

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DESCRIPTIVE QUESTIONS

2008 - Dec [7] (b) What reliefs are available to the minority shareholders against wrongful conduct of the majority? **(7 marks)**

Answer:

Protection is accorded to minority Shareholders under the Companies Act in the following circumstances:

1	The variation of class rights	The rights attached to the shares of any class can be varied as per Section 48(1) with the consent in writing of the holder of not less than 3/4 th of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of the issued shares of that class. But the holders of not less than 10% of the shares of that class who had not assented to the variation may apply to the Tribunal for the cancellation of the variation as per Section 48(2) .
2	Schemes of reconstruction and amalgamation	The minority is accorded protection in cases where they dissent to the scheme of reconstruction or amalgamation.
3	Oppression and mis-management	The principle of majority rule does not apply to cases where Sections 241 to 246 are applicable for prevention of oppression and mis-management. A member, who complains that the affairs of the

6.18

Scanner CS Prof. Prog. M-II Paper 6 (2017 Syllabus)

		company are being conducted, in a manner oppressive to some of the members including himself, or against public interest, he may apply to the Tribunal.
4	Alternative remedy to winding up	Any member or members, who complain that the affairs of the company are being conducted in a manner oppressive to some of the members including themselves, may apply for winding up of company.
5	Investigation by the Government	As per Section 210 the Central Government may appoint one or more competent persons as inspectors to investigate the affairs of any company and to report thereon in such manner as the Central Government may direct.

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2012 - June [1] {C} Comment on the following:

- (iii) The NCLT or law will not interfere with the internal management of companies acting within their powers. **(5 marks)**

Answer:

1	The Principle of Majority Rule	<ul style="list-style-type: none"> • Majority must prevail is the principle of company management like any democratic set up, the majority has its way in a company though due provision must also be made for the protection of minority interest. • This principle that the will of the majority should prevail and bind the minority is known as the principle of majority rule. • The principle of majority rule was first given recognition in the case of <i>Foss. Vs. Harbottle</i>.
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2	Fact of the Case	<ul style="list-style-type: none"> • Two members of an incorporated company took legal proceeding against the directors of the company, charging them guilty of fraudulent acts resulting in loss to the company. • The minority shareholders, therefore, decided to take an action for damages against the directors. • The shareholders in general meeting by majority resolved not to take any action against the directors alleging that they were not responsible for the loss which has been incurred. • The NCLT held that the actions were capable of confirmation by the majority.
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A. General Law:

1	Act illegal or ultra vires	<ul style="list-style-type: none"> • The Rule in <i>Foss Vs. Harbottle</i> applies only where the act complained of is within the powers of the company. If act is ultra vires the company, the rule does not apply, no majority can sanctioned or confirm such an act and every shareholder is entitled to bring on action against the company and its officers in respect of it. • Thus, every shareholder is entitled to sue for an injunction to restrain the <i>ultra vires</i> acts of the directors or the officers of the company.
2.	Fraud on the minority	Where the majority of a company members use their power to defraud or oppress the minority, their conduct is liable to be impeached even by a single shareholders.

3.	Wrongdoers in control of the company	<ul style="list-style-type: none"> • When the persons against whom the relief is sought themselves hold and control the majority of shares in the company and will not permit an action to be brought in the name of the company and shareholders may sue in their own names. • Its reason is that if the majority of shareholders will not be given such right their grievance can never reach the NCLT because the wrongdoers themselves, being in control of company would not allow the company to sue.
4	Acts requiring a special resolution	Sometimes the act or the articles of the company require acts to be done only by passing a special resolution at a general meeting of the company and therefore if the majority shareholders purport to do any act without passing a special resolution (i.e. by passing an ordinary resolution), anyone can bring an action to prevent the majority to do so.
5.	Individual membership rights	In case of infringement of the individual membership rights, every shareholder is entitled to bring an action in his own name. "If such a right is in question a single shareholder can, on principal, defy a majority consisting of all the other shareholders."

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2019 - Dec [1] (a) "Shareholders democracy means the rule of shareholders, by the shareholders and for the shareholders in the corporate enterprise, to which the shareholders belong". Comment on the above and enumerate any *five* provisions of the Companies Act, 2013 which demonstrate the same.

(5 marks)

Answer:

Democracy means the rule of people, by people and for people. In that context the shareholders democracy means the rule of shareholders, by the shareholders', and for the shareholders' in the corporate enterprise, to which the shareholders belong. Precisely it is rights to speak, congregates, and communicates with co-shareholders and to learn about what is going on in the company.

Recognizing the supreme authority of the shareholders', the Companies Act, 2013 has given authority to them to appoint directors at the Annual General Meetings to direct, control, conduct and manage the business and affairs of the company.

Under the Companies Act, 2013 the powers have been divided between two segments:

one is the Board of Directors and the other is of shareholders. The Directors exercise their powers through meetings of Board of directors and shareholders exercise their powers through Annual General Meetings/ General Meetings. Although constitutionally all the acts relating to the company can be performed in General Meetings but most of the powers are delegated to the Board by virtue of the constitutional documents of the company viz. the Memorandum and Articles of Association.

The Companies Act, 2013 demarcates between the power of the directors as well as that of shareholders. The shareholders exercise their powers at the general meetings by way of ordinary/special resolutions. Some of the businesses which can be transacted at meetings of shareholders are as under:

- Alteration of Memorandum of Association and Articles of Association.
- Further issue of share capital.
- To transfer some portions of uncalled capital to reserve capital to be called up only in the event of winding up of the company.
- To reduce the share capital of the company.
- To shift the registered office of the company outside the state in which the registered office is situated at present.
- To decide a place other than the registered office of the company where the statutory books, required to be maintained may be kept.
- To appoint auditors.

- To approach Central Government for investigation into the affairs of the company.
- To allow Related Party Transaction.
- To allow a director, partner or his relative to hold office or place of profit.
- Payment of commission of more than 1% of the net profits of the company to a managing or a whole time director or a manager.
- To make loans, to extend guarantee or provide security to other companies or make investment beyond the limit specified.
- To borrow money and to charge out the assets of the company to secure the borrowed money.
- To appoint directors.
- To remove directors.
- To increase or reduce the number of directors within the limits laid down in Articles of Association.
- To cancel, redeem debentures etc.

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PRACTICAL QUESTIONS

2019 - June [1] (a) A is a minority shareholder who brought an action for damages against the Company and its directors on the ground that they have been negligent in selling a plant owned by the Company for ₹ 25 Lakh. A alleged that the real value of plant was about ₹ 70 Lakh. Evaluate based on decided case law(s), whether action taken by A will be maintainable in the Court. **(5 marks)**

Answer:

No, the action taken by "A" will not be maintainable in court on the mentioned ground. The management of company is based on the majority rule. Almost every question relating to the affairs of the company is required to be decided upon either by an ordinary Resolution or by a Special Resolution of shareholders.

In *Pavrides v. Jensen* (1956) Ch. 565, a minority shareholder brought an action for damages against three directors and against the company itself on the ground that they have been negligent in selling a mine owned by the company for £ 82,000, whereas its real value was about £ 10,00,000. It was held that the action was not maintainable. The judge observed, " It was open to the company, on the resolution of a majority of the shareholders to sell the mine at a price decided by the company in that manner, and it was open to the company by a vote of majority to decide that if the directors by their negligence or error of judgement has sold the company's mine at an undervalue, proceedings should not be taken against the directors".

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2020 - Dec [2] (b) A Shareholder of a Company brought an action for damages against the Company and its two Directors on the ground that they have been negligent in selling a property owned by the Company for ₹ 75 crore whereas its real value was ₹ 100 crore.

Is this suit maintainable?

(4 marks)

(c) The Company Secretary of a Company was allotted quarters during the tenure of his employment. He has retired on 31st March, 2019. As per the terms of his employment, he is required to vacate his quarters within one month of his ceasing to be in employment. i.e. by 30th April, 2019. He seeks one year to vacate the premises on the ground of his children's education. The Company wants him to vacate as it has to allot it to the new Company Secretary. What would be your advice to the Company under the given circumstances?

(4 marks)

TOPIC NOT YET ASKED BUT EQUALLY IMPORTANT FOR EXAMINATION**DESCRIPTIVE QUESTIONS**

Q1. Discuss the Justification and advantages of the Rule in *Foss v. Harbottle*.

Answer:

Justification and Advantages of the Rule in *Foss v. Harbottle*

The justification for the rule laid down in *Foss v. Harbottle* is that the will of the majority prevails. On becoming a member of a company, a shareholder agrees to submit to the will of the majority. The rule really preserves the right of the majority to decide how the company's affairs shall be conducted. If any wrong is done to the company, it is only the company itself, acting, as it must always act, through its majority, that can seek to redress and not an individual shareholder.

Moreover, a company is a person at law, the action is vested in it and cannot be brought by a single shareholder. Where there is a corporate body capable of filing a suit for itself to recover property either from its directors or officers or from any other person then that corporate body is the proper plaintiff and the only proper plaintiff [*Gray v. Lewis, (1873) 8 Ch. Appl. 1035*].

The main advantages that flow from the Rule in *Foss v. Harbottle* are of a purely practical nature and are as follows:

- 1. Recognition of the separate legal personality of company:** If a company has suffered some injury, and not the individual members, it is the company itself that should seek to redress.
- 2. Need to preserve right of majority to decide:** The principle in *Foss v. Harbottle* preserves the right of majority to decide how the affairs of the company shall be conducted. It is fair that the wishes of the majority should prevail.

3. **Multiplicity of futile suits avoided:** Clearly, if every individual member were permitted to sue anyone who had injured the company through a breach of duty, there could be as many suits as there are shareholders. Legal proceedings would never cease, and there would be enormous wastage of time and money.
4. **Litigation at suit of a minority futile if majority does not wish it:** If the irregularity complained of is one which can be subsequently ratified by the majority it is futile to have litigation about it except with the consent of the majority in a general meeting. In *Mac Dougall v. Gardiner, (1875) 1 Ch. 13 (C.A.)*, the articles empowered the chairman, with the consent of the meeting, to adjourn a meeting and also provided for taking a poll if demanded by the shareholders. The adjournment was moved, and declared by the chairman to be carried; a poll was then demanded and refused by the chairman. A shareholder brought an action for a declaration that the chairman's conduct was illegal. Held, the action could not be brought by the shareholder; if the chairman was wrong, the company alone could sue.

Application of *Foss v. Harbottle* Rule in Indian context – The Delhi High Court in *ICICI v. Parasrampuriah Synthetic Ltd. SSL, July 5, 1998* has held that an automatic application of *Foss v. Harbottle* Rule to the Indian corporate realities would be improper. Here the Indian corporate sector does not involve a large number of small individual investors but predominantly financial institutions funding atleast 80% of the finance. It is these financial institutions which provide entire funds for the continuous existence and corporate activities. Though they hold only a small percentage of shares, it is these financial institutions which have really provided the finance for the company's existence and, therefore, to exclude them or to render them voiceless on an application of the principles of *Foss v. Harbottle* Rule would be unjust and unfair.

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Q2. Explain the exception to the rule in *Foss v. Harbottle*.

Answer:

Exceptions to the Rule in *Foss v. Harbottle*

The rule in *Foss v. Harbottle* is not absolute but is subject to certain exceptions. In other words, the rule of supremacy of the majority is subject to certain exceptions and thus, minority shareholders are not left helpless, but they are protected by:

- (a) the common law; and
- (b) the provisions of the Companies Act.

The cases in which the majority rule does not prevail are commonly known as exceptions to the rule in *Foss v. Harbottle* and are available to the minority. In all these cases an individual member may sue for declaration that the resolution complained of is void, or for an injunction to restrain the company from passing it. The said rule will not apply in the following cases:

1. Ultra Vires Acts

Where the directors representing the majority of shareholders perform an illegal or ultra vires act for the company, an individual shareholder has right to bring an action. The majority of shareholders have no right to confirm an illegal or ultra vires transaction of the company. In such case a shareholder has the right to restrain the company by an order or injunction of the court from carrying out an ultra vires act.

In *Bharat Insurance Ltd. v. Kanhya Lal*, A.I.R. 1935 Lah. 792, the plaintiff was a shareholder of the Bharat Insurance Company. One of the objects of the company was : "To advance money at interest on the security of land, houses, machinery and other property situated in India..." The plaintiff complained that "several investments had been made by the company without adequate security and contrary to the provisions of the memorandum and therefore, prayed for perpetual injunction to restrain it from making such investments".

2. Fraud on Minority

Where an act done by the majority amounts to a fraud on the minority; an action can be brought by an individual shareholder. This principle was laid down as an exception to the rule in *Foss v. Harbottle* in a number of cases. In *Menier v. Hooper's Telegraph Works*, (1874) L.R. 9 Ch. App. 350, it was observed that it would be a shocking thing if the majority of

shareholders are allowed to put something into their pockets at the expenses of the minority. In this case, the majority of members of company 'A' were also members of company 'B', and at a meeting of company 'A' they passed a resolution to compromise an action against company 'B', in a manner alleged to be favourable to company 'B', but unfavourable to company 'A'. Held, the minority shareholders of company 'A' could bring an action to have the compromise set aside.

3. Wrongdoers in Control

If the wrongdoers are in control of the company, the minority shareholders' representative action for fraud on the minority will be entertained by the court [Cf. **Birch v. Sullivan, (1957) 1 W.L.R. 1274**]. The reason for it is that if the minority shareholders are denied the right of action, their grievances in such case would never reach the court, for the wrongdoers themselves, being in control, will never allow the company to sue [*Par Jenkins L.J. in Edwards v. Halliwell, (1950) 2 All E.R. 1064, 1067*].

In *Glass v. Atkin (1967) 65 D.L.R. (2d) 501*, a company was controlled equally by the two defendants and the two plaintiff. The plaintiff brought an action against defendants alleging that they had fraudulently converted the assets of the company for their own private use. The Court allowed the action and observed: "While the general principle was for the company itself to bring an action, where it had an interest, since the two defendants controlled the company in the sense that they would prevent the company from taking action."

4. Resolution requiring Special Majority but is passed by a simple majority

A shareholder can sue if an act requires a special majority but is passed by a simple majority. Simple or rigid, formalities are to be observed if the majority wants to give validity to an act which purports to impede the interest of minority. An individual shareholder has the right of action to restrain the company from acting on a special resolution to which the insufficient notice is served [*Baillie v. Oriental Telephone and Electric Co. Ltd., (1915) 1 Ch. 503 (C.A.)*; refer also *Nagappa Chettiar v. Madras Race Club, 1 M.L.J. 662*].

5. Personal Actions

Individual membership rights cannot be invaded by the majority of shareholders. He is entitled to all the rights and privileges appertaining to his status as a member. An individual shareholder can insist on the strict compliance with the legal rules, statutory provisions. Provisions in the memorandum and the articles are mandatory in nature and cannot be waived by a bare majority of shareholders [*Salmon v. Quin and Axtens*, (1909) A.C. 442]. In *Nagappa Chettiar v. Madras Race Club*, (1949) 1 M.L.J. 662 at 667, it was observed by the Court that “An individual 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.

6. Breach of Duty

The minority shareholder may bring an action against the company, where although there is no fraud, there is a breach of duty by directors and majority shareholders to the detriment of the company. In *Daniels v. Daniels*, (1978) 2 W.L.R. 73, the plaintiff, who were minority shareholders of a company, brought an action against the two directors of the company and the company itself. In their statement of the claim they alleged that the company, on the instruction of the two directors who were majority shareholders, sold the company’s land to one of the directors (who was the wife of the other) for £ 4,250 and the directors knew or ought to have known that the sale was at an under value. Four years after the sale, she sold the same land for £ 1,20,000. The directors applied for the statement of claim to be disclosed on reasonable cause of action or otherwise as an abuse of the process of the Court.

7. Prevention of Oppression and Mismanagement

The minority shareholders are empowered to bring action with a view to preventing the majority from oppression and mismanagement. These are the statutory rights of the minority shareholders.

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