

**THE LAW COMMISSION**

**SHAREHOLDER REMEDIES**

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# PART 1

## OVERVIEW

- 1.1 Many people invest in companies. They buy shares in the hope that the value of their investment will increase. People also buy shares in private companies in order to secure a say in how the company is run, or to ensure that they are directors. There are other reasons for acquiring shares. A vital question for every shareholder is “when can shareholders bring proceedings to enforce their or the company’s rights?”. That is the principal question to which this project is directed.

### Terms of reference

- 1.2 In February 1995, the Lord Chancellor and the President of the Board of Trade requested us, in consultation with the Scottish Law Commission:

**... to carry out a review of shareholder remedies with particular reference to:— the rule in *Foss v Harbottle* (1843) 2 Hare 461 and its exceptions; sections 459 to 461 of the Companies Act 1985; and the enforcement of the rights of shareholders under the articles of association; and to make recommendations.**<sup>1</sup>

- 1.3 The DTI has, since 1992, been carrying out a review of a number of areas of company law and this consultation paper is our second contribution to this review.<sup>2</sup>

### Scope of the project

- 1.4 This paper concentrates on two main problems. The first is the obscurity and complexity of the law relating to the ability of a shareholder to bring proceedings on behalf of his company. He may wish to bring proceedings on behalf of his company to enforce liability for a breach by one of the directors of his duties to the company. These duties include fiduciary duties of loyalty and good faith which mean that directors are obliged to act honestly and in good faith in the interests of the company, to exercise their powers for a proper purpose and not to place themselves in a position where their interests conflict with their duties to the company. Directors also have duties of skill and care in relation to the management of the company’s business.

<sup>1</sup> The original terms of reference continued: “**The review is to be conducted under the present law and under proposals to be made by the Department of Trade and Industry as to the reform of the law relating to duties of the directors of companies and as to Part X of the Companies Act**”. The Department of Trade and Industry’s (“DTI”) work on directors’ duties has, however, been delayed and, accordingly, our own review is conducted only under the present law.

<sup>2</sup> The first was annexed to DTI, *Company Law Review: The Law Applicable To Private Companies* (November 1994). We are also carrying out a review of the law on the execution of deeds and documents by or on behalf of all bodies corporate under a reference from the Lord Chancellor and the President of the Board of Trade.



1.5 There has been much interest recently in improving the accountability of directors to shareholders in listed companies. For example, the report of the Committee on the Financial Aspects of Corporate Governance (“the Cadbury Committee”), published in 1992, emphasised the importance of non-executive directors in listed companies.<sup>3</sup> The report of the study group chaired by Sir Richard Greenbury on directors’ remuneration (“the Greenbury Committee”), published in 1995, recommended that directors’ remuneration should be determined by a committee of non-executive directors, and that the remuneration committee should make a report to shareholders which should be included in the annual accounts.<sup>4</sup> Both these reports have been endorsed by the Stock Exchange.<sup>5</sup> The Hampel Committee, set up to succeed the Cadbury Committee, will review the role of executive directors, non-executive directors and shareholders in listed companies.<sup>6</sup> However, since the content of directors’ duties is outside this project, issues as to the accountability of directors in listed or other companies are also outside the project. So far as such duties and issues are concerned, this project is concerned only with the machinery by which the duties owed in law can be enforced.

1.6 There are two related principles, known as the rule in *Foss v Harbottle*,<sup>7</sup> which are the bases of the law relating to the ability of a shareholder to bring proceedings on behalf of his company.<sup>8</sup> One of the two principles is that where a wrong has been done to a company only the company, not individual members, can take action and is referred to as the “proper plaintiff”<sup>9</sup> principle. A breach of duty is a wrong to the company and therefore as a general rule, the remedy for it lies with the company not with the individual shareholders. The second principle is that the will of the majority of the members of the company should in general prevail in the running of its business. This is known as the “majority rule” principle. If a majority does not want to take action, for example, because the wrongdoing director(s) control the majority of votes, a minority of shareholders must show that the facts fall within an exception to the rule

<sup>3</sup> *Report of the Committee on the Financial Aspects of Corporate Governance* (December 1992) (“the Cadbury Report”).

<sup>4</sup> See *Directors’ Remuneration: the Report of a Study Group chaired by Sir Richard Greenbury* (July 1995) (“the Greenbury Report”).

<sup>5</sup> London Stock Exchange, *The Listing Rules* (“the Listing Rules”), paras 12.43(j), 12.43(w) and 12.43(x).

<sup>6</sup> See *Financial Times* 23 November 1995.

<sup>7</sup> (1843) 2 Hare 461; 67 ER 189. Under the restatement of the rule by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 the so called “exceptions” are sometimes referred to as “limbs” of the rule itself; see para 4.5 below.

<sup>8</sup> The rule in *Foss v Harbottle* and the exceptions to it are part of Scots law; see the decision of the House of Lords in *Orr v Glasgow etc Railway Co* (1860) 3 Macq 799. The Scottish procedure relating to the rule and its exceptions is, however, different from English law; see para 6.5, n 8 below.

<sup>9</sup> Or, in an action before the Scottish courts, the proper pursuer. All future references to “plaintiff” should be read for a Scottish action as including “pursuer”.

in *Foss v Harbottle*. The exceptions are rigid. The law in this field is complex and obscure, and this may well deter minority shareholders from bringing such proceedings. The attempt to provide an alternative procedure for minority shareholders' actions by statute has not been successful.<sup>10</sup> Other common law jurisdictions have recently introduced or considered the introduction of a statutory derivative action.<sup>11</sup> Accordingly, the first problem on which this paper concentrates is the law relating to actions by minority shareholders on behalf of their company.

- 1.7 The second main problem on which we focus in this paper is the efficiency of the remedy which is most widely used by minority shareholders to obtain some personal remedy in the event of breaches of directors' duties, or of other unsatisfactory conduct of company business. This is the remedy for unfairly prejudicial conduct, to be found in sections 459-461 of the Companies Act 1985.<sup>12</sup> These sections provide remedies for types of conduct which sometimes cannot be remedied in any other way. Such conduct occurs most frequently in smaller companies in which most of the members are involved in management.<sup>13</sup> An example of such conduct is the exclusion from management of one of the owner-managers by the others.<sup>14</sup> These sections provide personal remedies, such as an order that a party's shares should be bought by other shareholders or by the company. This remedy is particularly needed by shareholders in companies in which there is no market for the shares.<sup>15</sup> However, proceedings for relief from unfair prejudice often entail complex factual investigation and result in costly and cumbersome litigation, which is particularly detrimental to smaller companies, in which most of the members are involved in management.<sup>16</sup> In a small company the management time used in litigation rather than running the business is more likely to damage the business than in larger companies.

<sup>10</sup> By Companies Act 1985, s 461(2)(c) (first enacted in Companies Act 1980, s 75(4)(c)); see generally paras 7.11 and 10.8-10.9 below and Appendix D.

<sup>11</sup> See Appendix F.

<sup>12</sup> Arts 452-454 of the Companies (Northern Ireland) Order 1986 (SI 1986 No 1032).

<sup>13</sup> Of 156 s 459 petitions issued in 1994-1995, 84.6% related to companies in which there were 5 or fewer shareholders. 96.2% of all petitions concerned private companies. Just under 79% of the petitions concerned companies in which all or most of the shareholders were concerned in management. See further, Appendix E, Table 1.

<sup>14</sup> Of 156 petitions brought under s 459 in 1994-1995, 67.3% included an allegation of exclusion from management. See Appendix E, Table 1.

<sup>15</sup> Just under 70% of the petitions sought the purchase of the petitioners' shares. See Appendix E, Table 1.

<sup>16</sup> In *Re Elgindata Ltd* [1991] BCLC 959 the hearing lasted 43 days, costs totalled £320,000 and the shares, originally purchased for £40,000, were finally valued at only £24,600. In *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354 the hearing of s 459 proceedings and a related action lasted 27 days at first instance alone. The parties subsequently claimed that they were entitled to recover total costs of £725,000 under orders of the court; see *Re Macro (Ipswich) Ltd* [1996] 1 WLR 145, 148. This did not include the costs of the subsequent appeal hearing: *Re Macro (Ipswich) Ltd* 22 May 1996 (unreported, CA).

- 1.8 A third problem which this paper examines is the enforcement of shareholders' contractual rights under the articles of association. This includes the question of the extent to which a member can insist upon the affairs of the company being conducted in accordance with the articles of association.
- 1.9 In examining the rights of members under the articles of association, we have not examined rights which they may have in some other capacity, such as directors, employees or creditors. Examination of these "outsider" rights is beyond the scope of this project. Likewise, we have not considered whether the division of power between members on the one hand and directors on the other hand should be changed. This again would be outside the scope of our project as it would involve consideration of the content of shareholders' rights rather than the means by which they may be enforced.
- 1.10 Likewise we have not addressed the problems which arise through shares being held by nominees.<sup>17</sup> This is becoming increasingly common in public companies, because of the ability to deal with shares more easily if they are in the name of a nominee of the shareholder's financial adviser, and because of the introduction of CREST.<sup>18</sup> The use of nominees also occurs in private companies, as, for example, where a husband becomes a director but places the shares in the names of his wife and children as nominees for him.
- 1.11 There is a wide variety of different shareholder profiles. In the smaller companies there may be only a handful of shareholders who, but for the desire to have limited liability, may well have combined together in partnership. At the other end of the scale there are very large public listed companies. Many of their shareholders these days will be institutional shareholders<sup>19</sup> who can exercise influence on the company because of their financial muscle, without exercising any legal remedy.<sup>20</sup> Moreover, some institutional shareholders only manage the funds of others and therefore are not provided by their clients with funds for litigation purposes.

<sup>17</sup> In this connection, see generally ProShare, *Code for Nominee Operators of Listed Companies* (1995).

<sup>18</sup> CREST is the electronic share settlement system, under which transfers on the share register may be effected electronically. It became operational on 15 July 1996. Trading electronically through CREST requires membership of the system. Private investors now have a choice of three ways of holding shares: in certificated form, in a nominee company, or, a new option, as a sponsored member in CREST. A sponsored member is the direct legal owner of the shares, but the shares are held in electronic form and transactions are carried out through CREST by the sponsor, usually a bank or stockbroker.

<sup>19</sup> According to a survey conducted by the Office for National Statistics (formerly the Central Statistical Office), *Share Ownership: A Report on the Ownership of Shares at 31st of December 1994* (1995), pension funds and insurance companies owned approximately 49.7% of the equity of listed companies as at 31 December 1994.

<sup>20</sup> See, for example, *The Responsibilities of Institutional Shareholders in the UK* (December 1991) published by the Institutional Shareholders' Committee.

- 1.12 Companies come in all sorts of shapes and sizes.<sup>21</sup> A provision which is appropriate for certain companies may be inappropriate for others operating in a different environment. Furthermore, it is very common these days for companies to organise in groups or to carry on business through associated and related companies.<sup>22</sup>
- 1.13 In reviewing the law of shareholder remedies, there are competing goals. On the one hand, a benefit of improving shareholder remedies would be to enhance shareholder confidence. It would also highlight private enforcement of shareholder rights and reduce reliance upon criminal sanctions, which are in any event inadequate to deal with many of the problems that arise within companies. At the same time it is as important not to impose significant new burdens on management. A proper balance must be struck between these competing goals.
- 1.14 We have used the term “derivative action” to denote proceedings which a shareholder brings to enforce a cause of action vested in the company.<sup>23</sup> We have used the term “personal action” to denote an action which a shareholder may bring in his own right, for example because he has a statutory right to do so or because he has some contractual right under the articles of association or under a shareholder agreement.<sup>24</sup> We have used the term “petitioner” to describe an applicant under section 459 of the Companies Act 1985 and/or section 122(1)(g) of the Insolvency Act 1986,<sup>25</sup> although if the recommendations made by Lord Woolf in his report<sup>26</sup> are implemented, petitions may no longer be used.<sup>27</sup> We have used the words “member” and “shareholder” interchangeably, though in most situations it is not necessary that the member holds shares, so that members of companies limited by guarantee which do not have a share capital are included.<sup>28</sup> We have used the expression “minority shareholder” for

<sup>21</sup> See Appendix E, Tables 2-4.

<sup>22</sup> See *Gore-Browne on Companies* (44th ed 1986) para 1.4 and S Turley, “The Impact of the Seventh EEC Directive on UK Group Accounts” (1986) 7 Co Law 10.

<sup>23</sup> In Scottish law, the paucity of case law in this area means that whilst the substantive law is the same as that in English law, however, no special procedural rules have developed; see para 6.5, n 8 below.

<sup>24</sup> A personal action may be brought by a shareholder in a representative capacity if there are numerous persons who have the same interest in the proceedings: Rules of the Supreme Court (“RSC”), O 15, r 12.

<sup>25</sup> When considering more generally the remedies available to shareholders, and setting out our provisional proposals for reform, we have used the term “applicant” to denote the person who is seeking to pursue the remedy.

<sup>26</sup> *Access to Justice, Final Report to the Lord Chancellor on the Civil Justice System in England and Wales* (July 1996) (“the Woolf Report”).

<sup>27</sup> *Ibid*, Recommendation 114.

<sup>28</sup> However, trade unions are not included. Trade unions are not in general treated as bodies corporate; see Trade Union and Labour Relations Act 1992, s 10(2).

simplicity, to connote one or more members not holding the majority of voting rights capable of being cast at general meetings.<sup>29</sup>

### **Structure of the paper**

- 1.15 Section A, Part 2 deals with the situation where a member brings proceedings to enforce a provision of the company's memorandum and articles of association. Part 3 examines two further situations in which a member can bring proceedings on his own behalf. These are for the purpose of enforcing statutory rights under the Companies Acts<sup>30</sup> and enforcement of rights under shareholder agreements. Section B considers the law and procedure governing proceedings brought by shareholders on behalf of the company. It starts in Part 4 with an analysis of the rule in *Foss v Harbottle* which permits such proceedings in limited situations. We then go on in Part 5 to consider other restrictions on shareholders bringing proceedings on behalf of the company. The first is ratification,<sup>31</sup> and the others are inequitable conduct by the member, where other adequate remedies are available, and where the company is in liquidation. In Part 6 we look at the procedure and costs involved in such actions.
- 1.16 Section C examines the personal remedy which is most widely used by shareholders, namely sections 459-461 of the Companies Act 1985.<sup>32</sup> Part 7 sets out the history of the remedy. Part 8 examines its relationship with winding up under section 122(1)(g) of the Insolvency Act 1986, because the two remedies are commonly pleaded in the alternative<sup>33</sup> and because circumstances were identified in the leading case on the availability of the Insolvency Act remedy, *Ebrahimi v Westbourne Galleries Ltd*,<sup>34</sup> ("*Ebrahimi*") which will in many situations also govern the availability of a remedy under section 459.<sup>35</sup> Part 9 sets out the substantive requirements which have to be satisfied in order for shareholders to obtain a remedy under section 459 and Part 10 examines the remedies available under section 461. Part 11 looks at procedural aspects of proceedings under section 459.

<sup>29</sup> The situation could occur in which shareholders holding a majority of the votes capable of being cast at general meetings claim that they have been unfairly prejudiced, but the circumstances would be very unusual. See the comments of Knox J in *Re Baltic Real Estate Ltd (No 1)* [1993] BCLC 498, 501, and in *Re Baltic Real Estate Ltd (No 2)* [1993] BCLC 503, 506-507.

<sup>30</sup> Some of which are summarised in Part 12.

<sup>31</sup> Under this head we examine the circumstances in which such proceedings can be prevented or halted by a resolution passed by a majority of shareholders confirming or adopting the acts or transactions of which the minority complains.

<sup>32</sup> Arts 452-454 of the Companies (Northern Ireland) Order 1986 (SI 1986 No 1032).

<sup>33</sup> Just under 40% of 156 petitions issued under s 459 in 1994 and 1995 also sought this remedy. See Appendix E, Table 1.

<sup>34</sup> [1973] AC 360.

<sup>35</sup> See Hoffmann LJ in *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14, 19 ("*Saul D Harrison*") at para 9.24 below.

- 1.17 Section D contains a brief summary of other statutory remedies to be found in the Companies Act 1985 (Part 12) and the Insolvency Act 1986 (Part 13). A number of these remedies are personal to shareholders.<sup>36</sup> We are not making any proposals regarding these matters.
- 1.18 Section E, Part 14 contains a summary of the major defects in the current law and sets out what we are trying to achieve in this project. In Part 15 we summarise the reforms which we provisionally recommend and in Parts 16-20 we deal with them in more detail, as well as canvassing other options for reform. We also invite suggestions as to any other reform possibilities to which we have not adverted in this paper. Part 21 contains a summary of our provisional recommendations and consultation issues.

### **Scottish Law Commission**

- 1.19 We have acted in consultation with the Scottish Law Commission which agrees with the content of this paper.<sup>37</sup>

### **Acknowledgments**

- 1.20 We gratefully acknowledge assistance from the persons and bodies listed in Appendix J. We would like to express our particular thanks to those persons who attended our working party meetings, and to our consultants, Professor D D Prentice of the University of Oxford, and Ms Brenda Hannigan of the University of Southampton, who have assisted us throughout the project. We are also grateful to the officials of the Companies Court who assisted us in the statistical survey referred to in Appendix E. However, the views expressed in this Consultation Paper are those of the Law Commission.

<sup>36</sup> The sources of the law which governs the running of companies and which therefore affects shareholder remedies are many and various. They include primary and secondary legislation, accounting standards (set by the Accounting Standards Board and the Auditing Practice Board), market regulation (such as the Listing Rules and the City Code on Takeovers and Mergers (“the Takeover Code”)). This paper does not contain a review of all the sources. Nor does it cover court orders in any detail, apart from those which can be granted under s 461 of the Companies Act 1985. Examples of issues omitted are: the detail of the remedies of account, declarations of trust and tracing, and the equivalent Scottish remedies. The remedies available for the recovery of trust property are the subject of a separate item in the Law Commission’s Sixth Programme of Law Reform (1995) (Law Com No 234, Item 7). Furthermore, we do not cover common law remedies in contract and tort (or, in Scots law, delict), nor the law of restitution. Nor does this project deal with the rights which a shareholder may have as a result of misstatements made at the time he acquired his shares. Likewise, the areas covered by the DTI consultative document, *Shareholder Communications at the Annual General Meeting* (April 1996) (see para 12.10, n 28 below) are outside this project.

<sup>37</sup> The footnotes concerning Scotland are the responsibility of the Scottish Law Commission.

# **SECTION A THE PERSONAL ACTION**

## **PART 2 A SHAREHOLDER'S PERSONAL RIGHTS ARISING FROM THE COMPANY'S CONSTITUTION**

### **Introduction**

- 2.1 In this part of the consultation paper we look at shareholders' remedies arising from the constitution of the company. We consider the contractual nature of such rights under section 14 of the Companies Act 1985<sup>1</sup> and consider how they differ from common law contractual rights.<sup>2</sup> We consider the nature of membership rights<sup>3</sup> and restrictions on the enforcement of such rights where breaches are held to be merely internal irregularities, in respect of which the shareholder cannot bring a personal action.<sup>4</sup> We next consider whether, and in what circumstances, a shareholder can bring a personal action in respect of transactions outside a company's powers,<sup>5</sup> and the basis on which resolutions altering the articles can be challenged.<sup>6</sup> Finally, we consider if it is possible to identify personal rights in the articles which will be enforceable by a member bringing a personal action.<sup>7</sup>

### **The company constitution**

- 2.2 The constitutions of companies registered under the Companies Acts comprise two separate documents — the memorandum of association and the articles of association.<sup>8</sup> In broad terms, the memorandum governs the relationship between the company and the outside world, whereas the articles represent the domestic regulations of the company and govern its internal administration.
- 2.3 The Companies Act 1985 provides that a company's memorandum and articles shall be in the form specified in regulations made by the Secretary of State "... or as near to

<sup>1</sup> Article 25 of the Companies (Northern Ireland) Order 1986.

<sup>2</sup> See paras 2.6-2.14 below.

<sup>3</sup> See paras 2.15-2.20 below.

<sup>4</sup> See paras 2.21-2.28 below.

<sup>5</sup> See paras 2.29-2.30 below.

<sup>6</sup> See paras 2.31-2.38 below.

<sup>7</sup> See para 2.39 below.

<sup>8</sup> Agreements between members and matters agreed by resolution may also be seen as part of the company's constitution. See Companies Act 1985, s 35A(3).

that form as circumstances admit”.<sup>9</sup> The current regulations<sup>10</sup> contain six tables, one of which is Table A.

- 2.4 Table A prescribes model articles which will bind public or private companies limited by shares which do not register articles and which will apply insofar as registered articles do not exclude or modify them. A company may adopt articles by reference to Table A. Many companies specifically exclude Table A, however, adopting regulations tailored to their own needs, or adopt only those parts of Table A which suit them.
- 2.5 Many companies will, for example, need to modify the provisions of Table A relating to the transfer of shares, and attach voting and other special rights to classes of shares. Various model forms of articles suitable for different types of company are available commercially.

#### **The section 14 contract and how it differs from other contracts**

- 2.6 Section 14(1) of the Companies Act 1985 prescribes the legal effect of the memorandum and articles of association. It provides that:

Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.

- 2.7 The source of the present wording of the section is the Joint Stock Companies Act 1844<sup>11</sup> which continued to rely on the “deed of settlement”, the then existing common law method of forming companies. Subscribers agreed in the deed to be associated in an enterprise with a prescribed joint stock divided into a specified number of shares. Under the 1844 Act, the deed was to be registered and was to contain “... a Covenant on the Part of every Shareholder, with a Trustee on the Part of the Company to pay up the Amount of the Instalments on the share taken by such Shareholder and to perform the several Engagements in the Deed contained on the Part of the Shareholders”.<sup>12</sup>

<sup>9</sup> Section 3(1) of the Companies Act 1985.

<sup>10</sup> The Companies (Tables A to F) Regulations 1985 (SI 1985 No 805). Section 8A of the Companies Act 1985 empowers the Secretary of State to prescribe a new Table G which would be a model set of articles of association for a “partnership company”. The DTI published a *Consultative Document on Table G* in March 1995 (URN 95/609).

<sup>11</sup> Section 7 and Sched A. Neither the 1844 Act, nor the subsequent Limited Liability Act 1855 applied to Scotland. The Joint Stock Companies Act 1856 and later legislation applied equally to Scotland.

<sup>12</sup> *Ibid*, s 7.



- 2.8 The Joint Stock Companies Act 1856 subsequently substituted the modern form constitution — the memorandum and articles of association — for the deed of settlement and adopted wording similar to that now in force. It did not take fully into account, however, the new development of the incorporated company as a separate legal entity; the memorandum and articles were to bind “... as if ... signed and sealed by each member ...”, there being no reference to the company also being deemed to have signed and sealed. This omission survived subsequent Acts<sup>13</sup> and is maintained in the Companies Act 1985 where, again, no provision is made for any deemed sealing on the part of the company.<sup>14</sup>
- 2.9 Section 14 creates a contract which forms the basis of legal relations between the company and its members and between the members inter se.<sup>15</sup> It is well recognised,<sup>16</sup> however, that this so called “statutory contract” differs in a number of significant respects from a standard contract.<sup>17</sup>
- 2.10 Section 14 is deemed to be “... subject to the provisions of the Act”.<sup>18</sup> The memorandum and articles are the statutory documents of the company and, as such, are also governed by the statute which controls them.<sup>19</sup> Statutory provisions to which the contract is subject include provisions authorising alteration of the memorandum

<sup>13</sup> See, for example, Companies Act 1948, s 20(1).

<sup>14</sup> See *Re Compania de Electricidad de la Provincia de Buenos Aires Ltd* [1980] Ch 146, 187, per Slade J. The company has long been assumed, however, to be a party to the statutory contract. See *Hickman v Kent or Romney Marsh Sheep Breeders' Association* [1915] 1 Ch 881 (“*Hickman's case*”).

<sup>15</sup> Over the years, many academics have attempted to resolve the debate as to the precise nature of this statutory contract, but without any real consensus emerging. See, for example: K W Wedderburn, “Shareholders’ Rights and the Rule in *Foss v Harbottle*” [1957] CLJ 194; G D Goldberg, “The Enforcement of Outsider Rights under Section 20 of the Companies Act 1948” (1972) 35 MLR 362; G N Prentice, “The Enforcement of ‘Outsider’ Rights” (1980) 1 Co Law 179; R Gregory, “The Section 20 Contract” (1981) 44 MLR 526; G D Goldberg, “The Controversy on the Section 20 Contract Revisited” (1985) 48 MLR 158; R R Drury, “The Relative Nature of a Shareholder’s Right to Enforce the Company Contract” [1986] CLJ 219. See also n 16 below.

<sup>16</sup> See C Shepherd, “Distinctive Features of the Section 14 Contract” (1993) 27 Law Teach 80; S Griffin, “The Limited Contractual Nature of Section 14 of the Companies Act 1985” (1993) 14 Co Law 217; T E Crowther, “The Nature of the Contract in Section 14(1) of the Companies Act 1985” (1992) 24 Bracton LJ 81.

<sup>17</sup> One example of the differences between such contracts is illustrated by Sched 1 of the Unfair Contract Terms Act 1977 which provides that: “Sections 2 to 4 of this Act do not extend to — ...  
(d) any contract so far as it relates —  
(i) to the formation or dissolution of a company ..., or  
(ii) to its constitution or the rights or obligations of its corporators or members.”

<sup>18</sup> See, for example, Companies Act 1985, s 303 which provides that, subject to certain conditions, a director can be removed by ordinary resolution notwithstanding anything in the articles or in any agreement between the company and the director.

<sup>19</sup> *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693, 696, per Dillon LJ.

and articles by special majority only.<sup>20</sup> Unlike a normal contract, which would require the consent of all parties to the agreement to alteration of its terms, the statutory contract is, therefore, entered into on terms which are alterable by a 75 per cent majority.<sup>21</sup>

- 2.11 The statutory contract also differs from other contracts in that it constitutes what has been called “... the framework of a long-term relationship between the contracting parties”.<sup>22</sup>
- 2.12 The courts regard articles as commercial documents which “... should be construed so as to give them reasonable business efficacy”.<sup>23</sup> The Court of Appeal has recently held, however, that terms cannot be implied into the articles to give them business efficacy.<sup>24</sup> Nor can rectification of the articles be ordered by the court, even if the terms of the contract do not accurately reflect the intention of the parties.<sup>25</sup>
- 2.13 Furthermore, although it is now accepted that the company can enforce the section 14 contract against the members<sup>26</sup> and that the members can enforce it against each other,<sup>27</sup> there are limitations on the rights which members can enforce.
- 2.14 In *Hickman’s* case,<sup>28</sup> Astbury J commented that it was “... clear from many authorities that shareholders as against their company can enforce and restrain breaches of its regulations”.<sup>29</sup> As we shall now see, this is not always the case where a member seeks

<sup>20</sup> Sections 4 and 9 of the Companies Act 1985. Shareholders wishing to challenge special resolutions passed under these sections may be able to do so if the resolutions were not passed bona fide for the benefit of the company as a whole. See paras 2.31-2.38 below.

<sup>21</sup> Shareholders may have additional contractual obligations towards each other, however, if they enter into shareholder agreements, discussed at paras 3.3-3.17 below.

<sup>22</sup> See R R Drury, “The Relative Nature of a Shareholder’s Right to Enforce the Company Contract” [1986] CLJ 219, 246; and C A Riley, “Contracting out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts” (1992) 55 MLR 782.

<sup>23</sup> *Holmes v Keyes* [1959] Ch 199, 215, *per* Jenkins LJ.

<sup>24</sup> See *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693, but see also *Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985] BCLC 11 and *Re Thundercrest Ltd* [1995] 1 BCLC 117.

<sup>25</sup> *Scott v Frank F Scott (London) Ltd* [1940] Ch 794. But the court may order an alteration of the articles under the Companies Act 1985, s 461; see paras 10.4-10.5 below. Furthermore, until recently, it had been the case that, as a result of the rule in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317, a member was prevented from suing for damages for breach of the s 14 contract. This rule was abolished by Companies Act 1985, s 111A (as inserted by Companies Act 1989, s 131(1)).

<sup>26</sup> *Hickman’s* case [1915] 1 Ch 881.

<sup>27</sup> *Rayfield v Hands* [1960] Ch 1.

<sup>28</sup> [1915] 1 Ch 881.

<sup>29</sup> *Ibid*, at p 898.

to enforce rights other than his pure membership rights or where he is unable to bring a personal action because the court holds that the particular breach is an “internal irregularity”.

### **Membership rights**

- 2.15 The decision in *Hickman’s* case is generally accepted as authority for the rule that the statutory contract only confers rights on a member in his capacity as member (sometimes referred to as “insider rights”), not in any “outsider” capacity such as his position as a solicitor or director of the company.<sup>30</sup>
- 2.16 In *Hickman’s* case, Astbury J analysed previous case law on membership rights and concluded that “[a]n outsider to whom rights purport to be given by the articles in his capacity as such outsider, whether he is or subsequently becomes a member, cannot sue on those articles treating them as contracts between himself and the company to enforce those rights. Those rights are not part of the general regulations of the company applicable alike to all shareholders and can only exist by virtue of some contract between such person and the company ...”.<sup>31</sup>
- 2.17 Astbury J’s conclusions have been criticized by several commentators and have not been uniformly applied by the courts, particularly in cases involving shareholder directors.<sup>32</sup>
- 2.18 Shareholder directors have been held not to be able to rely on an arbitration provision in the articles<sup>33</sup> and, in some cases, have been prevented from relying on articles relating to their rights to hold office, to take part in management<sup>34</sup> and to receive

<sup>30</sup> The approach of the courts to whether members have to be affected as members to bring proceedings under s 459 is considered at paras 9.18-9.20 below.

<sup>31</sup> [1915] 1 Ch 881, 897. The issue in *Hickman’s* case was not whether the plaintiff could enforce rights under the articles, but whether he was bound by an arbitration clause, either under an article of the defendant association’s constitution (which applied to members in their capacity as members), or in that his application for membership of the association, once accepted, constituted a submission to arbitration, as defined by s 4 of the Arbitration Act 1889. On the facts, Astbury J held that *Hickman’s* accepted application was such a submission and directed that the dispute be referred to arbitration. His comments on the nature of membership rights are, strictly, obiter dicta.

<sup>32</sup> See K W Wedderburn, “Shareholders’ Rights and the Rule in *Foss v Harbottle*” [1957] CLJ 194, 210; R Gregory, “The Section 20 Contract” (1981) 44 MLR 526; and L S Sealy, *Cases and Materials in Company Law* (5th ed 1992) p 96.

<sup>33</sup> *Beattie v E & F Beattie Ltd* [1938] Ch 708, where the Court of Appeal applied what it took to be the decision in *Hickman’s* case, holding that, as proceedings had been brought against the plaintiff in his capacity as a director and not that of a shareholder, he could not rely on the arbitration clause contained in the articles.

<sup>34</sup> *Browne v La Trinidad* (1888) 37 Ch D 1, where the Court of Appeal refused to allow the plaintiff to rely on a provision in the articles stating that he should be a director and should not be removed from office until a specified date.

remuneration. In other cases, directors have been able to rely on such provisions and so to enforce their rights under them.<sup>35</sup>

2.19 The court has refused, however, to allow a plaintiff to rely on a provision in the articles that he should be the company's solicitor.<sup>36</sup> It has also been held that a company promoter could not rely on provisions in the articles providing for his costs<sup>37</sup> and that the vendor of property to a company could not rely on articles which provided for the payment of consideration for that property.<sup>38</sup>

2.20 The court's application of the "outsider rights" restriction suggested by Astbury J in *Hickman's* case has been inconsistent.<sup>39</sup> It is difficult to reconcile *Hickman's* case with some of the earlier cases. However, the general view continues to be that "... the section confers contractual effect on a provision in the memorandum and articles only in so far as it affords rights or imposes obligations on a member qua member".<sup>40</sup>

<sup>35</sup> See *Pulbrook v Richmond Consolidated Mining Co* (1878) 9 Ch D 610 (right to take part in management); *Imperial Hydropathic Hotel Co, Blackpool v Hampson* (1882) 23 Ch D 1 (right to hold office). See also *Quin & Axtens Ltd v Salmon* [1909] AC 442 (right to veto certain board resolutions).

<sup>36</sup> *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 Ex D 88; the Court of Appeal holding that the plaintiff was unable to rely on this provision as he was not a party to the articles. It appears that the plaintiff was not a member of the company when the articles were adopted but had become one several months after its incorporation. It is not clear whether this was seen as significant by the court. See also dicta in *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd* [1987] Ch 1 (a case involving class rights) where, at p 16, Scott J referred to *Eley* and held that, although the timing of the plaintiff's membership may have been relevant, in such a case, "... if, in all the circumstances, the right conclusion was still that the rights or benefits conferred by the article were not conferred on the beneficiary in the capacity of member or shareholder of the company, then the rights could not, in my view, be regarded as class rights".

<sup>37</sup> *Melhado v Porto Alegre, New Hamburg, and Brazilian Railway Co* (1874) LR 9 CP 503. Again, it is unclear whether the plaintiff was also a shareholder and whether this factor was relevant in the court's decision. On this point see n 39 and n 40 below.

<sup>38</sup> *Pritchard's* case (1873) 8 Ch App 956. The articles provided that, on incorporation, the company should enter into an agreement with the vendor of the mine, under which the purchase of the mine from him would be funded partly in cash and partly in fully paid shares. The articles were signed by the vendor who received the stated number of shares. When the company went into liquidation, the vendor brought an action on the question of whether the articles constituted a contract in writing with him so that the shares could be considered as fully paid. Mellish LJ held that the articles could not be considered as a contract between the company and the vendor as, "... in themselves the articles of association are simply a contract as between the shareholders inter se in respect of their rights as shareholders". *Ibid*, at p 960.

<sup>39</sup> See L S Sealy, *Cases and Materials in Company Law* (5th ed 1992) pp 95-97; R Gregory, "The Section 20 Contract" (1981) 44 MLR 526; G D Goldberg, "The Controversy on the Section 20 Contract Revisited" (1985) 48 MLR 158. See also K W Wedderburn, "Shareholder Rights and the Rule in *Foss v Harbottle*" [1957] CLJ 194, 213 whose view is that a member can enforce outsider rights "... so long as he *sues* qua member and not qua outsider ..." (emphasis added).

<sup>40</sup> See *Gower's Principles of Modern Company Law* (5th ed 1992) pp 284 and 646. Other commentators have accepted that outsider rights are not usually enforceable but have suggested situations in which they should be so. The view is expressed by K W Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" [1957] CLJ 194, 212 that it may be possible for a member in that capacity to enforce a right given to him in some other capacity

Clearly, this restriction may have practical implications for those seeking to rely on certain provisions in the articles.<sup>41</sup>

### **Internal irregularities<sup>42</sup>**

- 2.21 Even if the articles which have been breached create insider rather than outsider rights, members may not be able to bring personal actions in respect of those breaches. This is because of the court's classification of breaches of certain constitutional provisions as "internal irregularities" for which no personal action will lie.
- 2.22 The internal irregularities restriction stems from the majority rule and proper plaintiff principles explained in Part 1 above and forming part of the so-called rule in *Foss v Harbottle*.<sup>43</sup> These principles were said by the court in *Mozley v Alston*<sup>44</sup> to apply to

by the articles. This view is based on *Quin & Axtens Ltd v Salmon* [1909] 1 Ch 311, affirmed [1909] AC 442, but it would not appear to be consistent with the approach adopted in other cases such as *Beattie v E & F Beattie Ltd* [1938] Ch 708. Compare also *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd* [1987] Ch 1. See also G D Goldberg, "The Enforcement of Outsider Rights under Section 20(1) of the Companies Act 1948" (1972) 35 MLR 362, 363, who suggests that a member has "... a contractual right to have any of the affairs of the company conducted by the particular organ of the company specified in the Act or the company's memorandum or articles ..." and that "outsider rights" should only be enforced if they are "incidental to this right". G N Prentice, "The Enforcement of 'Outsider Rights'" (1980) 1 Co Law 179 suggests that a member only has rights under the articles insofar as they relate to the company's power to function (in which case outsider rights would be enforceable). For other comment on the scope of outsider rights see R R Drury, "The Relative Nature of a Shareholder's Right to Enforce the Company Contract" [1988] CLJ 219; N A Bastin, "The Enforcement of a Member's Rights" [1977] JBL 17; R J Smith, "Minority Shareholders and Corporate Irregularities" (1978) 41 MLR 147; R Gregory, "The Section 14 Contract" (1981) 44 MLR 526 and M Blackman, "Members' Rights Against the Company and Matters of Internal Management" (1993) 110 SALJ 473.

<sup>41</sup> The practical effect of the rule that the statutory contract does not create outsider rights is that rights given by the company to directors, solicitors and others should be contained in separate agreements. Directors should (and usually do) have service contracts. Promoters may need first to enter into a contract with the company's proposed members or directors and then into a post-incorporation contract with the company. See *Kelner v Baxter* (1866) LR 2 CP 174 and s 36C of the Companies Act 1985. The courts have been prepared, however, in certain cases, to infer an extrinsic contract from provisions in the articles. See *Swabey v Port Darwin Gold Mining Co* (1889) 1 Meg 385.

<sup>42</sup> Internal irregularities might arise from a breach of the company's articles, or from provisions of the Companies Act 1985 (see, for example, breaches of notice provisions discussed at paras 2.25-2.27 below).

<sup>43</sup> (1843) 2 Hare 461; 67 ER 189. This case involved an action by two shareholders against five directors (three of whom had become bankrupt) and others claiming, among other things, that there had ceased to be a sufficient number of qualified directors to constitute a board and that a receiver should be appointed over the company's assets. Wigram V-C held that any injury was to the company which was, therefore, the proper plaintiff.

<sup>44</sup> (1847) 1 Ph 790; 41 ER 833. Two shareholders sought to restrain four directors of the company from acting as directors when they should have retired in rotation under the articles. Cottenham LC refused to permit the shareholders to bring their action; he relied on the decision in *Foss v Harbottle* and held that the company was the proper plaintiff. In the words of Gower (*Gower's Principles of Modern Company Law* (5th ed 1992) p 644), *Mozley v Alston* extended the rule in *Foss v Harbottle* to "... cases where there has been an irregularity in the operation of the company". Gower adds that "... the test of whether the irregularity was such that a member could bring an action in respect of it was said to be whether the irregularity

cases involving internal irregularities and are used as justification for the court's refusal to uphold personal actions by shareholders. The statement of the rule in *Foss v Harbottle* in the case of *Edwards v Halliwell*<sup>45</sup> as restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>46</sup> is set out here for ease of reference:

- (1) The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is prima facie the corporation.
- (2) Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, no individual member of the corporation is allowed to maintain an action in respect of that matter because, if the majority confirms the transaction, *cadit quaestio* [the question is at an end]; or, if the majority challenges the transaction, there is no valid reason why the company should not sue.
- (3) There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction.
- (4) There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority.
- (5) There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.<sup>47</sup>

2.23 *MacDougall v Gardiner*<sup>48</sup> was one of the earliest cases in which these principles were applied. Mellish LJ referred to *Foss v Harbottle*<sup>49</sup> and *Mozley v Alston*<sup>50</sup> and rejected the plaintiff's application to set aside a resolution for an adjournment passed on a show of hands when his right to call for a poll had been refused by the chairman. He held that, if the internal affairs of the company were not being properly managed, "... the company are the proper persons to complain".<sup>51</sup> There was no use in having litigation "... the ultimate end of which is only that a meeting has to be called and then ultimately the majority gets its wishes".<sup>52</sup>

was one that could not be rectified by an ordinary resolution".

<sup>45</sup> [1950] 2 All ER 1064, 1066-1069.

<sup>46</sup> [1982] Ch 204.

<sup>47</sup> *Ibid*, at pp 210-211.

<sup>48</sup> (1875) 1 Ch D 13.

<sup>49</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>50</sup> (1847) 1 Ph 790; 41 ER 833.

<sup>51</sup> *MacDougall v Gardiner* (1875) 1 Ch D 13, 23. For discussion of this decision see N A Bastin, "The Enforcement of a Member's Rights" [1977] JBL 17 and R J Smith, "Minority Shareholders and Corporate Irregularities" (1978) 41 MLR 147.

<sup>52</sup> (1875) 1 Ch D 13, 25.

- 2.24 Nevertheless, shareholders have been entitled to bring claims based on irregularities in voting procedures, such as the wrongful exclusion of proxy votes which would otherwise have resulted in the defeat of a resolution.<sup>53</sup>
- 2.25 Similarly, in several cases involving defective notices of meetings, the courts have allowed personal actions to proceed,<sup>54</sup> for example, where the notice of the meeting did not on its face give the date of the meeting,<sup>55</sup> was not sufficiently informative,<sup>56</sup> or did not disclose an interest of the directors (and so failed adequately to describe the matter to be discussed).<sup>57</sup> The courts have also upheld a member's personal right to challenge a special resolution where the member did not receive adequate notice of the resolution, for example, in connection with the reconstruction of a company,<sup>58</sup> or an increase in the company's capital.<sup>59</sup>

<sup>53</sup> The court having ruled that the votes were valid declared that the resolutions were valid: *Oliver v Dalgleish* [1963] 1 WLR 1274. See also *Henderson v Bank of Australasia* (1890) 45 Ch D 330 where a shareholder was wrongly prevented from proposing an amendment to a special resolution revising the deed of settlement of a bank and the resolution was declared invalid. Members have also been able to enforce personal rights relating to information in the company register (*Re British Sugar Refining Co* (1857) 3 K&J 408; 69 ER 1168); to receive dividends declared or due under the articles (*Wood v Odessa Waterworks Co* (1889) 42 Ch D 636); to exercise pre-emption rights under the articles (*Rayfield v Hands* [1960] Ch 1) and to transfer shares in accordance with the articles (*Moffatt v Farquhar* (1878) 7 Ch D 591).

<sup>54</sup> See also s 376 of the Companies Act 1985 and the DTI consultative document, *Shareholder Communications at the Annual General Meeting* (April 1996), discussed at para 12.10 below.

<sup>55</sup> *Alexander v Simpson* (1890) 43 Ch D 139. See also *Muskelwhite v C H Muskelwhite & Son* [1962] Ch 964, where the plaintiffs successfully complained about the holding of a meeting to which they had received no invitation at all.

<sup>56</sup> *Johnson v Lyttle's Iron Agency* (1877) 5 Ch D 687.

<sup>57</sup> *Kaye v Croydon Tramways Co* [1898] 1 Ch 358.

<sup>58</sup> *Tiessen v Henderson* [1899] 1 Ch 861.

<sup>59</sup> *MacConnell v E Prill & Co* [1916] 2 Ch 57. See also *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503 and the decision in *Normandy v Ind, Coope & Co Ltd* [1908] 1 Ch 84, where the court refused to allow a claim by a shareholder to challenge special resolutions altering the articles where the notice had been defective, as it considered that the only consequence of the invalidity was that the directors were acting without authority and that the other shareholders might have ratified the conduct. The decision has been criticised as allowing a bare majority to correct an irregularity in the passing of a special resolution; see C R Baxter, "Irregular Company Meetings" [1976] JBL 323, 330 and *Pennington's Company Law* (6th ed 1990) p 658. A defect in a special resolution can only be put right by a subsequent special resolution; see, for example, *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503, 515-516, *per* Cozens-Hardy MR. However, the court did not hold that a special resolution could be remedied in this way, but only that an ordinary resolution could confirm what was done in breach of a limitation on the directors' powers under the articles as they previously stood. Although these cases involved special resolutions, the decision of the court in each case appears to have been based on the inadequacy of the notice received by the member, rather than on the nature of the resolution passed. The same arguments were used by the court in *Kaye v Croydon Tramways Co* (see n 57 above), which involved an ordinary resolution.

- 2.26 On the other hand, in *Cotter v National Union of Seamen*,<sup>60</sup> a case involving improperly convened meetings, the court refused to allow a plaintiff's claim to restrain the carrying out of certain resolutions passed at the meetings.<sup>61</sup>
- 2.27 It has been suggested that the above case might be distinguished on the basis that the irregularities complained of had not prejudiced the plaintiff, were merely "technical" and could easily be corrected by the company going through the proper procedure.<sup>62</sup>
- 2.28 We next consider in what circumstances a shareholder can bring a personal action in respect of transactions outside a company's powers, and the basis on which resolutions altering the articles may be challenged.

### **Transactions outside the company's powers**

#### *Restraining future transactions*

- 2.29 It has long been the case that a shareholder can bring a personal action to restrain a threatened ultra vires act.<sup>63</sup> The common law position in this respect was not altered by section 35 of the Companies Act 1985.<sup>64</sup>

#### *Past transactions*

- 2.30 In *Smith v Croft (No 2)*,<sup>65</sup> it was held that a shareholder's action to recover money or property which the company was entitled to claim as a result of a past ultra vires transaction was a derivative action.

### **Challenging resolutions to amend the articles of association**

- 2.31 Under section 9 of the Companies Act 1985,<sup>66</sup> a company may alter its articles of association by special resolution. We next examine the circumstances in which a member may challenge such a resolution. We then consider the basis on which other resolutions may be challenged.

<sup>60</sup> [1929] 2 Ch 58.

<sup>61</sup> The Court of Appeal cited with approval a passage from *MacDougall v Gardiner* (1875) 1 Ch D 13, 25: "... if some irregularity has been committed, it would be quite possible for the legal entity, by means of further meetings, further notices, and the like, to make regular what apparently, or what it is argued, is irregular". *Ibid*, at pp 100-101, *per* Lord Hanworth MR.

<sup>62</sup> See C R Baxter, "Irregular Company Meetings" [1976] JBL 323, 327 who stated that: "... the court's decision actually rested on the form of action".

<sup>63</sup> See *Smith v Croft (No 2)* [1988] Ch 114.

<sup>64</sup> As substituted by Companies Act 1989, s 108(1). This section made changes to the law on ratification and the effect of s 35 is discussed at paras 4.23-4.24 and 5.3-5.5 below. The equivalent section in Northern Ireland is art 45 of the Companies (Northern Ireland) Order 1986.

<sup>65</sup> [1988] Ch 114.

<sup>66</sup> Article 20 of the Companies (Northern Ireland) Order 1986.



2.32 The power of the company to alter its articles under the section is subject to the provisions of the Companies Acts and to the memorandum of association. However,

... it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.<sup>67</sup>

2.33 In the later case of *Greenhalgh v Arderne Cinemas Ltd*,<sup>68</sup> Evershed MR said:

Certain principles, I think, can be safely stated as emerging from [the] authorities. In the first place, I think it is now plain that “bona fide for the benefit of the company as a whole” means not two things but one thing. It means that the shareholder must proceed upon what, in his honest opinion, is for the benefit of the company as a whole. The second thing is that the phrase “the company as a whole” does not ... mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person’s benefit.

I think that the matter can, in practice, be more accurately and precisely stated by looking at the converse and by saying that a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate<sup>69</sup> between the majority shareholders and the minority shareholders, so as to give to the former an advantage of which the latter were deprived. When the cases are examined in which the resolution has been successfully attacked, it is on that ground. It is therefore not necessary to require that persons voting for a special resolution should ... dissociate themselves altogether from their own prospects and consider whether what is thought to be for the benefit of the company as a going concern.<sup>70</sup>

<sup>67</sup> *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, 671, per Lindley MR.

<sup>68</sup> [1951] Ch 286.

<sup>69</sup> See also Lord Wilberforce in *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821 (PC), at p 835 where he said of the phrases “bona fide in the interest of the company as a whole” and “for some corporate purpose”, “[s]uch phrases if they do anything more than restate the general principle applicable to fiduciary powers, at best serve, negatively, to exclude from the area of validity cases where the directors are acting sectionally, or partially: ie improperly favouring one section of the shareholders against another”.

<sup>70</sup> [1951] Ch 286, 291 (footnote added).

- 2.34 These tests are not always easy to apply and have been criticised,<sup>71</sup> but it is outside the scope of this project on remedies to consider whether some other test should be substituted as a matter of substantive law. However, examples can be given of alterations to the articles which have been set aside or upheld to illustrate how the principles operate.
- 2.35 In *Allen v Gold Reefs of West Africa Ltd*,<sup>72</sup> the Court of Appeal held that the company could validly amend its articles so as to give itself a lien over fully-paid shares for other debts of the holder. This was so even though in practice this only adversely affected the position of those who sought to challenge the alteration, who were the executors of an insolvent member. This member had, at the date of his death (and before the alteration), become liable to the company in respect of calls on other partly-paid shares. However, the altered article was capable of applying to all fully-paid shares and was fair in principle, and the Court of Appeal (by a majority) therefore held that the alteration could not be said to have been passed in bad faith or other than for the benefit of the company as a whole.
- 2.36 In *Sidebottom v Kershaw Leese & Co Ltd*,<sup>73</sup> the Court of Appeal upheld an alteration of the articles of the company which enabled the directors to require the transfer at full value of the shares of a shareholder competing with the company's business. Lord Sterndale MR held that it was for the benefit of the company that it should not be obliged to have members who were competing with it in business, and who might be able to get knowledge from their membership which would enable them to compete better.<sup>74</sup> The alteration would have been valid even if it was aimed at a particular shareholder.<sup>75</sup>
- 2.37 *Sidebottom v Kershaw Leese & Co Ltd* may be compared with the subsequent case of *Dafen Timplat Co Ltd v Llanelly Steel Co (1907) Ltd*,<sup>76</sup> in which an amendment to the articles to enable the majority shareholders to require any member (other than a named

<sup>71</sup> See *Gower's Principles of Modern Company Law* (5th ed 1992) pp 599-604. See also the decision of the High Court of Australia in *Gambotto v WCP Ltd* [1994] 16 ACSR 1, where the court departed from the *Allen* test on the particular facts of the case. See further D D Prentice, "Alteration of Articles of Association — Expropriation of Shares" (1996) 112 LQR 194.

<sup>72</sup> [1900] 1 Ch 656.

<sup>73</sup> [1920] 1 Ch 154.

<sup>74</sup> Lord Sterndale MR stressed in this case, that this question was "... a point which ought to be decided by the voices of the business men who understand the business and understand the nature of competition, and whether such a position is or is not for the benefit of the company". *Ibid*, at pp 165-166. See also the comments of Atkin LJ in the Court of Appeal in *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9, 20.

<sup>75</sup> [1920] 1 Ch 154, 166-167, *per* Lord Sterndale MR, 171-172, *per* Warrington LJ, 173-174, *per* Eve J.

<sup>76</sup> [1920] 2 Ch 124.

member) to transfer his shares was held to be invalid. This article would have applied whether or not the member was acting to the detriment of the company. Peterson J held that "... the power of compulsory acquisition by the majority of shares which the owner does not desire to sell is not lightly to be assumed whenever it pleases the majority to do so".<sup>77</sup>

- 2.38 In general, the right of a shareholder to vote is regarded as a right of property which he is entitled to cast in his own interests.<sup>78</sup> He is not bound to cast his vote in the company's interests. However, the court will intervene if, for instance, the resolution deprives the minority shareholders of their share of the company's assets.<sup>79</sup> It is not clear whether the courts will apply the test used to assess the validity of resolutions amending the company's articles to other types of resolution.<sup>80</sup> In *Clemens v Clemens Bros*,<sup>81</sup> however, Foster J assumed that the test could be applied to an ordinary resolution authorising the issue of shares.

### **Identifying enforceable personal rights in the articles**

- 2.39 It is clear that a member does not have a personal right to enforce all the provisions of the articles; where there are breaches of the articles which are ratifiable, he has no such right. Several writers have suggested criteria to identify such rights. It has been suggested, for example, that a member should be able to enforce rights of a proprietary nature.<sup>82</sup> Ultimately, what constitutes a personal right must depend upon the terms of

<sup>77</sup> *Ibid*, at p 142. Moreover, the exclusion of the named shareholder was not shown to be for the benefit of the company as a whole. See also *Brown v British Abrasive Wheel Co* [1919] 1 Ch 290, which was explained in the case of *Sidebottom v Kershaw Leese & Co Ltd*.

<sup>78</sup> See *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC), at p 593.

<sup>79</sup> See generally *Buckley on the Companies Acts* (14th ed 1981) Vol 1 p 971.

<sup>80</sup> See the comments of Knox J in *Smith v Croft (No 2)* [1988] Ch 114, 186, discussed at para 4.28 below and of Lord Greene MR in *Greenhalgh v Arderne Cinemas* [1946] 1 All ER 512, 513 discussed at paras 20.20-20.21 below. See also the comments of Lord Wilberforce and Lord Cross in *Ebrahimi* [1973] AC 360 at pp 381 and 386 on the applicability of this test to proceedings under s 122(1)(g) of the Insolvency Act 1986.

<sup>81</sup> [1976] 2 All ER 268. Foster J said at p 281 that the question was did the majority shareholder "... when voting for the resolutions, honestly believe that those resolutions, when passed would be for the benefit of the plaintiff." Note the criticism of this approach in *Gower's Principles of Modern Company Law* (5th ed 1992) p 603, which calls the decision "rather startling". See also V Joffe, "Majority Rule Undermined?" (1977) 40 MLR 71.

<sup>82</sup> See, for example, N A Bastin, "The Enforcement of a Member's Rights" [1977] JBL 17, 21-22, who suggests that a property right will be "... connected to the value and marketability of a share ..." or could be "... any right conferred by the articles which can be exercised and enjoyed by a shareholder without the concurrence of others". He suggests that *MacDougall v Gardiner* can be explained in this way, as the right to demand a poll in that case "... was not a personal right or a right of property because the articles of the company provided for the taking of a poll only if demanded by five members". He suggests that "... if the articles had provided for the taking of a poll if demanded by one member then the decision would have been different as the right would have become a right of property and therefore personal". See also R R Drury, "The Relative Nature of a Shareholder's Right to Enforce the Company Contract" [1986] CLJ 219, 238, who suggests that "... the existence of some proprietary interest weighed heavily with Jessel MR in *Pender v Lushington*".

the articles and the event giving rise to the alleged breach.<sup>83</sup> For the right to be personal, the court must be satisfied that, properly construed, the right has accrued to the member individually and not simply to him in common with other shareholders. Thus, a shareholder has a personal right to vote on a resolution before the company in general meeting.<sup>84</sup> However, where the capital is not divided into classes of shares,<sup>85</sup> he would have no personal right to prevent the company from altering its articles to make some uniform amendment to all the voting rights of members (for example, by providing that in future each share should confer only one vote for every 10 shares held, rather than one vote per share).<sup>86</sup> Depending on the facts, he may be able to allege that the resolution was not passed bona fide in the interests of the company,<sup>87</sup> or that the alteration is unfairly prejudicial<sup>88</sup> to his interests for the purposes of section 459 of the Companies Act 1985.<sup>89</sup>

<sup>83</sup> See C R Baxter, "Irregular Company Meetings" [1976] JBL 323, whose view is that the principles which should have been applied in some of these decisions which relied on *Foss v Harbottle* and *MacDougall v Gardiner* were that "... the court will not interfere in the affairs of a company unless it is necessary to do so and that interference is always unnecessary when it has no practical consequence". *Ibid*, at p 322. See also C R Baxter, "The Role of the Judge in Enforcing Shareholder Agreements" [1983] CLJ 96. Other attempts to rationalise the court's approach include R R Drury who, in "The Relative Nature of a Shareholder's Right to Enforce the Company Contract" [1986] CLJ 219, stresses the importance of the relative rights of shareholders.

<sup>84</sup> *Pender v Lushington* (1877) 6 Ch D 70, 81, *per* Lord Jessel MR.

<sup>85</sup> So that class rights arise; see paras 12.16-12.17 below.

<sup>86</sup> See, for example, *Gowder's Principles of Modern Company Law* (5th ed 1992) p 534.

<sup>87</sup> See paras 2.31-2.38 above.

<sup>88</sup> See para 9.39 below.

<sup>89</sup> The question we consider later is whether it is appropriate to give examples of personal rights in the legislation. For the reasons given below, we provisionally take the view that it is not appropriate to amend the Companies Act 1985 in this way. See paras 20.2-20.4 below.

## **PART 3 OTHER CIRCUMSTANCES IN WHICH A SHAREHOLDER CAN BRING A PERSONAL ACTION**

### **Introduction**

- 3.1 Part 2 dealt with the situation where a member brings proceedings to enforce a provision of the company's memorandum or articles of association. As we have seen, he can bring those proceedings on his own behalf. A member may also bring proceedings on his own behalf if he wishes to enforce a statutory right, that is a right which the Companies Act 1985 confers on a member. In addition, he may bring proceedings if he has entered into an agreement with other shareholders with respect to the exercise of rights attached to their shares (a "shareholder agreement") and he seeks to enforce that agreement. In this part we discuss statutory rights and shareholder agreements.

### **Statutory rights**

- 3.2 Certain provisions in the Companies Acts give an individual shareholder rights and remedies in specified matters.<sup>1</sup> The principal rights and remedies conferred are summarised in Part 12 below.

### **Shareholder agreements**

#### *Introduction*

- 3.3 Members frequently make agreements with other members to give them rights in addition to those conferred by the memorandum and articles of association. These agreements are governed by the ordinary principles of contract law. Thus, unlike the statutory contract,<sup>2</sup> they will not automatically bind subsequent members.<sup>3</sup> They are principally made by the shareholders of private companies,<sup>4</sup> but they may also be made by small groups of shareholders in public companies.<sup>5</sup> Although we have called them shareholder agreements, there is no reason why members of a company which has no share capital should not enter into an agreement with respect to their rights as members.

<sup>1</sup> Eg shareholders have the right to call meetings and table resolutions (see paras 12.9-12.10 below) and the right to challenge resolutions (see paras 12.11-12.18 below), plus a number of miscellaneous remedies (see paras 12.19-12.23 below).

<sup>2</sup> Ie s 14 of the Companies Act 1985; see paras 2.6-2.14 above.

<sup>3</sup> If a subsequent member is to be bound by the agreement there will need to be a fresh agreement.

<sup>4</sup> G Stedman & J Jones, *Shareholders' Agreements* (2nd ed 1990) p 1.

<sup>5</sup> These agreements may amount to agreements to which s 204 of the Companies Act 1985 (art 212 of the Companies (Northern Ireland) Order 1986) may apply.

### *Advantages*

- 3.4 A member can be given protection by a shareholder agreement in addition to that provided by the articles. For example, he may be given the right to require other members to acquire his shares in certain events.<sup>6</sup> Unlike the statutory contract they are not subject to unilateral alteration by special resolution.<sup>7</sup> The terms of such agreements can only be altered with the consent of all the parties thereto. Moreover, the ordinary remedies for breach of contract will be available for breach of a shareholder agreement.
- 3.5 If a shareholder agreement incorporates the provisions of an article, a member will be entitled to enforce that right in contract even though the article confers “outsider rights”<sup>8</sup> which he could not enforce under the statutory contract created by section 14 of the Companies Act 1985.<sup>9</sup> For example, a right of a director to receive remuneration on the basis set out in the articles will be enforceable in accordance with ordinary contract principles as a term of the contract for his appointment.<sup>10</sup>

### *Contents*

- 3.6 A shareholder agreement may require shareholders to consult together before certain decisions are taken or to vote on resolutions of the company in general meeting in a particular way. If the company is a party it may agree to take or not to take certain action, or to consult the parties to the agreement before entering into certain transactions, for example, a secured loan or a contract for the sale of its business. A shareholder agreement may also give a member a right to receive certain information from the company.
- 3.7 A shareholder agreement may provide for arbitration and it may regulate events during the pre-incorporation period, whereas the company’s constitution only has contractual effect on incorporation.

<sup>6</sup> Note, however, that it is also possible to make rights given by the articles less vulnerable to alteration by creating a separate class of shares and attaching the rights to those. Such “class rights” may only be altered by three-quarters of the members of the class (s 125 of the Companies Act 1985) and there is provision for members to object (s 127). See paras 12.16-12.17 below.

<sup>7</sup> Sections 4 and 9 of the Companies Act 1985.

<sup>8</sup> See paras 1.9 and 2.15 above.

<sup>9</sup> See para 2.9 above. Such a shareholder agreement might provide: “Each of the parties hereto ... undertakes with each of the others fully and promptly to observe and comply with the provisions of the Articles to the intent and effect that *each and every provision* thereof shall be enforceable by the parties hereto inter se and *in whatever capacity*” (emphasis added). See G Stedman & J Jones, *Shareholders’ Agreements* (2nd ed 1990) p 6. Note, however, the effect of *Russell v Northern Bank Development Corp’n Ltd* [1992] 1 WLR 588, (on appeal to the House of Lords from the Court of Appeal in Northern Ireland) on parties to shareholder agreements. See paras 3.11-3.16 below.

<sup>10</sup> *Re New British Iron Co, ex parte Beckwith* [1898] 1 Ch 324, and see *Bailey v Medical Defence Union* (1995) 18 ACSR 521, which concerned the right of a member of a mutual insurance company to an indemnity on the terms contained in the company’s articles.

*Disclosure of agreements*

- 3.8 One of the recognised advantages of shareholder agreements is that, unlike the memorandum and articles, they are generally not open for public inspection. They are, therefore, useful tools where confidentiality is desired.<sup>11</sup> However, such agreements need to be filed with the Registrar of Companies, pursuant to section 380(4)(c) of the Companies Act 1985, if they amount to an informal agreement between all the members to amend the articles.<sup>12</sup>

*Enforceability*

- 3.9 Shareholder agreements are commonly concluded between all the members inter se or between some of the members only. It is well established that agreements concluded between shareholders without the company as a party are valid and enforceable.<sup>13</sup>
- 3.10 A shareholder agreement may be enforced by injunction in the same way as any other contract. Moreover, the court will not exercise its power under section 371 of the Companies Act 1985 to give directions for a meeting of the company if those directions would conflict with an agreement entered into by all the members. Thus, in *Harman v BML Group Ltd*,<sup>14</sup> where a shareholder agreement required the presence of a minority shareholder for meetings to be quorate, the Court of Appeal held that a direction could not be given for a meeting to be held with some other quorum requirement. Dillon LJ said:

... it is not right, in my view, to invoke section 371 to override class rights attached to a class of shares which have been deliberately — in this case by the shareholders' agreement — imposed for the protection of the holders of those shares ...<sup>15</sup>

He also observed that it was not for the court "... to make a new shareholders' agreement between the parties and impose it on them".<sup>16</sup>

<sup>11</sup> See G Stedman & J Jones, *Shareholders' Agreements* (2nd ed 1990) p 54. See also A Marsden, "Does a Shareholders' Agreement Require Filing with the Registrar of Companies?" (1994) 15 Co Law 19.

<sup>12</sup> This is the result of a pre-consolidation amendment recommended by the Law Commissions: see Amendment of the Companies Acts 1948-1983 (1983) Law Com No 126; Scot Law Com No 83; Cmnd 9114. See also the comments of Michael Wheeler QC (sitting as a Deputy Judge of the High Court) in *Cane v Jones* [1980] 1 WLR 1451, 1460.

<sup>13</sup> See, for example, *Russell v Northern Bank Development Corpn Ltd* [1992] 1 WLR 588, at paras 3.11-3.16 below.

<sup>14</sup> [1994] 1 WLR 893.

<sup>15</sup> *Ibid*, at p 898. It is interesting to contrast this case with that of *Re British Union for the Abolition of Vivisection* [1995] 2 BCLC 1, where Rimer J, in the special circumstances of that case, held that directions could be given for a postal ballot on an application for an order to hold a meeting (under s 371 of the Companies Act 1985), even though, under the company's articles, members had to vote in person.

<sup>16</sup> [1994] 1 WLR 893, 898.

- 3.11 Prior to *Russell v Northern Bank Development Corp'n Ltd*,<sup>17</sup> the company was also frequently joined as a party. In this case, the shareholder agreement, to which the company was a party, purported to restrict the company's statutory power to increase its share capital by ordinary resolution.<sup>18</sup> Unanimous consent of the parties was required. The company gave notice of an extraordinary general meeting ("EGM") to consider an ordinary resolution to increase its capital. A party to the shareholder agreement, who did not consent to this increase, sought an injunction restraining the other parties to the agreement from voting on the resolution.
- 3.12 The defendants argued that the agreement was void in its entirety, both as regards the company and as between the shareholders inter se, because it amounted to an unlawful and invalid fetter on the company's statutory powers. Lord Jauncey (with whom the rest of the House of Lords agreed), held that the undertaking between the shareholders was enforceable insofar as it amounted merely to a private agreement as to the exercise by the shareholders of their respective voting rights.<sup>19</sup> In so doing he found that "... shareholders may lawfully agree inter se to exercise their voting rights in a manner which, if it were dictated by the articles, and were thereby binding on the company would be unlawful".<sup>20</sup>
- 3.13 This approach is consistent with *Bushell v Faith*,<sup>21</sup> in which the House of Lords held that an article which gave a director weighted voting rights on any resolution to remove him was valid.
- 3.14 The significance of *Russell v Northern Bank Development Corp'n Ltd* is that "... it puts beyond question that the shareholder's freedom to contract in respect of voting rights is not constrained even in circumstances where the effect of a contract may be to prevent or fetter the exercise of a statutory power".<sup>22</sup>
- 3.15 However, the undertaking by the company in a formal agreement, independent of its articles, not to exercise its statutory powers to alter its memorandum was "... as

<sup>17</sup> [1992] 1 WLR 588.

<sup>18</sup> Section 121 of the Companies Act 1985.

<sup>19</sup> In so doing the House of Lords held that the agreement between the company and the shareholders which was void as being contrary to statute could be severed from the agreement between the shareholders inter se which was valid and enforceable.

<sup>20</sup> [1992] 1 WLR 588, 593.

<sup>21</sup> [1970] AC 1099. Their Lordships recognised that the clause was "... obviously designed to evade section 184(1) of the Companies Act 1948 ..." (now s 303 of the Companies Act 1985), which provided that a director is to be removable by an ordinary resolution notwithstanding anything to the contrary in the company's articles. *Ibid*, at p 1105.

<sup>22</sup> E Ferran, "The Decision of the House of Lords in *Russell v Northern Bank Development Corporation Ltd*" [1994] CLJ 343, 345.



obnoxious as if it had been contained in the articles of association ...”<sup>23</sup> and, therefore, contrary to statute as an unlawful fetter on the company’s statutory powers to alter its share capital. The agreement was void in so much as it purported to bind the company.

- 3.16 The precise effect of the decision in *Russell v Northern Bank Development Corp’n Ltd* has been the subject of academic controversy.<sup>24</sup> Ferran<sup>25</sup> has noted the practical repercussions of the restriction imposed on the company’s freedom to contract. She observes that parties to a joint venture often enter into a shareholder agreement and that (prior to the decision in this case) the joint venture company was frequently made a party to the agreement. We are not aware that the decision creates any difficulties in practice.<sup>26</sup>

#### *Conclusion*

- 3.17 A member may secure greater protection for himself by entering into a shareholder agreement with other members. Such an agreement cannot, however, restrict any of the statutory powers of the company. However, the same effect can be achieved, as between the parties to a shareholder agreement, by the terms of such an agreement.

<sup>23</sup> *Russell v Northern Bank Development Corp’n Ltd* [1992] 1 WLR 588, 594.

<sup>24</sup> See B J Davenport, “What did *Russell v Northern Bank Development Corporation Ltd* Decide?” (1994) 109 LQR 553 and E Ferran, “The Decision of the House of Lords in *Russell v Northern Bank Development Corporation Ltd*” [1994] CLJ 343.

<sup>25</sup> E Ferran, “The Decision of the House of Lords in *Russell v Northern Bank Development Corporation Ltd*” [1994] CLJ 343.

<sup>26</sup> See on this Ferran, *ibid*, who argues that practitioners have found ways of circumventing *Russell* so that its practical effect is, in fact, limited.

# SECTION B THE DERIVATIVE ACTION

## PART 4 A SHAREHOLDER'S RIGHT TO BRING AN ACTION ON BEHALF OF THE COMPANY

### Introduction<sup>1</sup>

- 4.1 In this part, we consider the circumstances in which a minority shareholder can bring a derivative action. First, we review the majority rule and proper plaintiff principles.<sup>2</sup> We then consider the circumstances in which members have traditionally been able to bring derivative actions in spite of these principles;<sup>3</sup> in cases involving fraud on the minority,<sup>4</sup> ultra vires transactions<sup>5</sup> and breaches of special resolution procedures.<sup>6</sup>

### The majority rule and proper plaintiff principles

- 4.2 The majority rule principle developed as a result of the courts' historical reluctance to become involved in disputes over the internal management of business ventures.<sup>7</sup>
- 4.3 The majority rule principle is closely linked to the proper plaintiff principle<sup>8</sup> which has been described by the Court of Appeal as "... the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C".<sup>9</sup> To allow a third party to bring an action

<sup>1</sup> The references in this and the following parts to detailed procedure and to the term "derivative action" in particular, do not apply to Scottish procedure; see para 1.6, n 8 above and para 6.5, n 8 below.

<sup>2</sup> See paras 4.2-4.3 below.

<sup>3</sup> See paras 4.4-4.6 below.

<sup>4</sup> See paras 4.7-4.18 below.

<sup>5</sup> See paras 4.19-4.29 below.

<sup>6</sup> See paras 4.30-4.34 below.

<sup>7</sup> The principle is based on the doctrine of separate corporate personality and on the early partnership principle that courts would not interfere between partners except to dissolve the partnership; see K W Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" [1957] CLJ 194, 196. See *Carlen v Drury* (1812) 1 V & B 154, 158; 35 ER 61, 62: "This Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom" *per* Lord Eldon LC.

<sup>8</sup> These principles were applied in the case of *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 and are often applied by the courts as "the rule in *Foss v Harbottle*". See K W Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" [1957] CLJ 194, 195-198. See also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, where the Court of Appeal referred to the rule in *Foss v Harbottle* as embracing both the "elementary" proper plaintiff principle and "... a related principle, that an individual shareholder cannot bring an action in the courts to complain of an irregularity ... if the irregularity is one which can be cured by a vote of the company in general meeting". *Ibid*, at p 210. See generally paras 4.4-4.6 below.

<sup>9</sup> See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210.

in relation to wrongs done to another could lead to multiple actions being brought against a single defendant in relation to a single wrong. As the company is, in law, a separate legal entity, it is the proper plaintiff where it has suffered injury, otherwise a defendant could face as many actions as there are shareholders.<sup>10</sup>

4.4 As mentioned above,<sup>11</sup> the restrictions arising from these principles are referred to as the rule in *Foss v Harbottle*. Were such restrictions to amount to an absolute prohibition on derivative actions, they would allow the majority to prevent an action to remedy a wrong done to the company by or with their support.<sup>12</sup> Hence the need to identify those cases where the rule will not apply.

4.5 We set out the statement by the Court of Appeal in *Edwards v Halliwell*<sup>13</sup> as restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>14</sup> of the rule in *Foss v Harbottle*:

(1) The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation.

(2) Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, no individual member of the corporation is allowed to maintain an action in respect of that matter because, if the majority confirms the transaction, *cadit quaestio* [the question is at an end]; or, if the majority challenges the transaction, there is no valid reason why the company should not sue.

(3) There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction.

(4) There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like,

<sup>10</sup> See *Gray v Lewis* (1873) 8 Ch App 1035, 1051, per Sir W M James LJ on the risk of multiple actions. See also *Spokes v Grosvenor and West End Railway Terminus Hotel Co Ltd* [1897] 2 QB 124, 126, per AL Smith LJ and at p 128, per Chitty LJ. Different procedures have been developed for personal actions by shareholders and for derivative actions to avoid this problem. See RSC, O 15, r 12A and paras 6.7-6.9 below.

<sup>11</sup> See n 8 above.

<sup>12</sup> See the court's rationale for the fraud on the minority exception restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* at para 4.7 below.

<sup>13</sup> [1950] 2 All ER 1064, 1066-1069, per Jenkins LJ. Cases in which the rule in *Foss v Harbottle* would not apply had traditionally been divided into the following four categories, and often called "exceptions" to the rule:

- (i) Personal actions.
- (ii) Actions relating to ultra vires/illegal transactions.
- (iii) Actions relating to transactions which require a special majority.
- (iv) Actions relating to transactions which constitute a "fraud on the minority".

As is clear from *Edwards v Halliwell*, the only true exception to the rule is the fourth category.

<sup>14</sup> [1982] Ch 204.

because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority.

(5) There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.<sup>15</sup>

- 4.6 The basic approach of the rule in *Foss v Harbottle* is a sound one. An individual shareholder should only be able to bring a derivative action in an exceptional situation. He should not be allowed for instance to bring an action to complain about a procedural irregularity which is of no consequence, for example where the company issues notice of a general meeting without the authority of a duly constituted board meeting. If the company passes the resolution, the lack of authority is cured. If the resolution fails, that is the end of the matter in any event. However, there can be no justification for a company acting ultra vires once the matter has been drawn to its attention and accordingly in that situation an individual shareholder should have the right to bring a derivative action to prevent his investment and that of other shareholders being misapplied in this way. Similarly, there can be no doubt that a company should observe a requirement to proceed by a special resolution though no doubt again if the requirement was alterable and the company made it clear that it would first propose the appropriate resolutions to remove the requirement, the court would stay the action to see whether the change was made. Suppose, however, that the shareholder wishes to obtain recompense for the company's benefit for a breach of duty by the directors. He can only enforce the company's claim if the breach of duty was a "fraud" and the wrongdoers were "in control". It is to that exception, commonly called "fraud on the minority", that we now turn. In the remainder of this part we deal with the other branches of the rule.

#### **Fraud on the minority**

- 4.7 After setting out the fraud on the minority exception to the rule in *Foss v Harbottle*, the Court of Appeal in *Edwards v Halliwell* explained why the exception is necessary. This explanation was set out as follows in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*:<sup>16</sup>

(5) There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court

<sup>15</sup> *Ibid*, at pp 210-211.

<sup>16</sup> [1982] Ch 204.

because the wrongdoers themselves, being in control, would not allow the company to sue.<sup>17</sup>

- 4.8 We will now consider what constitutes “fraud” and “control”.<sup>18</sup> We will then examine the circumstances in which the courts have held that if an “independent organ” of the company does not wish the action to proceed, an individual shareholder may be prevented from pursuing his action even though it is within the exception.<sup>19</sup>

#### *Fraud*

- 4.9 “Fraud” in this context means “... fraud in the wider equitable sense of that term”.<sup>20</sup> Essentially, the term encompasses situations such as “... where the majority are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders are entitled to participate ...”.<sup>21</sup> Therefore, attempts by the majority to sell worthless assets to the company,<sup>22</sup> to divert business from the company to themselves in breach of fiduciary duty,<sup>23</sup> or to compromise litigation against bodies in which the majority are interested on terms prejudicial to the company<sup>24</sup> have all been held to amount to “fraud” in this context, entitling minority shareholders to bring derivative actions.<sup>25</sup>

<sup>17</sup> *Ibid*, at p 211. The suggestion in *Edwards v Halliwell* [1950] 2 All ER 1064, 1067 that the rule in *Foss v Harbottle* should be relaxed “where necessary in the interests of justice” was considered but rejected in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 and by the Court of Appeal (Vinelott J, [1981] Ch 257, had accepted this further exception at first instance) in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (although in this latter case the Court of Appeal did not hear full argument on this point).

<sup>18</sup> See paras 4.9-4.17 below.

<sup>19</sup> See *Smith v Croft (No 2)* [1988] Ch 114, and the discussion at para 4.18 below.

<sup>20</sup> *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 12, *per* Sir Robert Megarry V-C, discussing the judgment of Templeman J in *Daniels v Daniels* [1978] Ch 406. See n 26 and n 27 below.

<sup>21</sup> See *Burland v Earle* [1902] AC 83 (PC), at p 93, *per* Lord Davey.

<sup>22</sup> See *Atwool v Merryweather* (1867) LR 5 Eq 464n where the plaintiff claimed rescission of a contract entered into by directors and the return of money and shares paid to them in consideration for the sale, claiming that they had made a concealed profit. The court held that the directors had acted fraudulently and upheld the plaintiff’s claim.

<sup>23</sup> See, for example, *Cook v Deeks* [1916] 1 AC 554 (PC). This question is discussed further at paras 5.6-5.16 below.

<sup>24</sup> See *Menier v Hooper’s Telegraph Works* (1874) 9 Ch App 350 where the plaintiff minority shareholder in E Ltd claimed that the defendant company, the majority shareholder in E Ltd, had used its votes to procure the diversion of E Ltd’s business to a third company. James LJ referred to *Atwool v Merryweather* (1867) LR 5 Eq 464n, and upheld the plaintiff’s claim. See also *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

<sup>25</sup> A purported ratification of wrongful acts might itself, in some circumstances, constitute a fraud on the minority. See para 5.7 below.

- 4.10 The term has also been applied to the negligent decision of directors, who were also the majority shareholders, to sell company assets to one of their number at an undervalue,<sup>26</sup> and to acts of a controlling shareholder which had the effect of stultifying the purpose for which the company was formed.<sup>27</sup>
- 4.11 “Fraud” does not, however, cover the situation where the wrongdoers do not themselves benefit. Thus it does not include mere negligence on the part of the directors,<sup>28</sup> so that a derivative action cannot be brought against directors who mismanage a company and cause it loss, even if they have control. The company can never itself enforce the right of action it has against them unless there is a change of control or a liquidator is appointed. However, even where the directors’ negligent mismanagement does not constitute “fraud” for the purposes of the rule in *Foss v Harbottle*, if directors procure the company to omit to take proceedings against them by use of their control, those actions may amount to fraud on the minority. In that case, it would have to be shown<sup>29</sup> that the directors were causing the company to omit to take proceedings for their own personal benefit, rather than in the interests of the company.

#### *Wrongdoer control*

- 4.12 The fraud on the minority exception is based on the court’s desire “... to give a remedy for a wrong which would otherwise escape redress”.<sup>30</sup> The court allows a derivative action to proceed because it recognises that where the person who has committed a

<sup>26</sup> See *Daniels v Daniels* [1978] Ch 406, where minority shareholders brought an action against the company’s directors, alleging they had caused the company to sell a piece of land to one of them at an undervalue. Templeman J referred to *Alexander v Automatic Telephone Co* [1900] 2 Ch 56, *Cook v Deeks* [1916] 1 AC 554 (PC) and *Pavlides v Jensen* [1956] Ch 565 and held that the plaintiffs could sue as the case should be covered by the fraud on the minority exception to the rule in *Foss v Harbottle*. If minority shareholders could sue where there was fraud, he saw no reason why they could not “... where the action of the majority and the directors, though without fraud, confers some benefit on those directors and majority shareholders themselves”. *Ibid*, at p 414.

<sup>27</sup> *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2. In that case, the Council had formed the plaintiff company to regulate the management of a block of 60 flats being sold off to owner-occupiers, each of whom acquired one of the 60 shares in the company when the sale went through. The Council covenanted with the company to use its best endeavours to sell all the flats. When 12 of the flats had been sold, control of the Council changed, a new housing policy was introduced and the remaining flats were used to house disadvantaged families. At the relevant time the Council had voting control of the company. One of the original occupiers of the flats (so a shareholder in the company) sought leave to bring a derivative action against the Council based on the breach of the covenant. Sir Robert Megarry V-C at p 12 upheld the plaintiff’s right to bring a derivative action, using the broad definition of fraud in *Daniels v Daniels* [1978] Ch 406 (see n 26 above) which he said was “... useful as preventing ‘fraud’ from being read too narrowly”.

<sup>28</sup> See *Pavlides v Jensen* [1956] Ch 565 where the plaintiff, a minority shareholder, brought an action against the defendant directors alleging that they had negligently sold a mine at a gross undervalue. Danckwerts J held that negligence did not fall within the fraud on the minority exception to the rule in *Foss v Harbottle* so that the plaintiff could not sue.

<sup>29</sup> At a preliminary hearing; see paras 4.17 and 6.6 below.

<sup>30</sup> *Burland v Earle* [1902] AC 83 (PC), at p 93, *per* Lord Davey.

wrong against the company is also in control of that company, he is unlikely to allow the company to bring proceedings against him.<sup>31</sup> Where the company is not under the control of the “wrongdoer” then the usual rule that the company is the proper plaintiff prevails. The court has always required that a shareholder should show “wrongdoer control” of the company before he is allowed to proceed with a derivative action.<sup>32</sup>

4.13 It is thus entirely logical for the courts to require the individual shareholder to show that the wrongdoers control the company. In a small private company this may not cause any difficulty in practice.<sup>33</sup> However, in a public listed company with a large share capital there are numerous shareholders (often thousands), and many shares are held by nominees and trustees, so that it is very difficult for an individual shareholder to show who controls the shares, or whether particular shareholders benefit in some way unconnected with the company from the action of which he complains, or have some commercial relationship with the wrongdoer which would cause them to vote with him.<sup>34</sup> Moreover, in a public company a person can, in practice, control votes if shareholders believe that he can produce outstanding profits for the company. There is a reluctance in that situation for shareholders to vote against the wishes of that person in case he decides to leave the company, though subsequently they may find that their belief in his abilities was misplaced. There is also in any listed company a substantial number of shareholders who do not vote at all,<sup>35</sup> so that in practice control can be exercised with as little as 20 or 30 per cent of the votes.<sup>36</sup>

4.14 The courts are aware of considerations like these and have accepted that the minority shareholder seeking to bring a derivative action under this “exception” need not show that the wrongdoer owns a majority of the company’s shares. However, as yet, there is little guidance as to what other circumstances would evidence “control”.<sup>37</sup>

<sup>31</sup> *Ibid*, at p 93.

<sup>32</sup> See *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482, *per* Jessel MR (as cited in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 219).

<sup>33</sup> *Eg Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

<sup>34</sup> Note s 214 of the Companies Act 1985, which allows members of a public company holding one tenth of the paid up voting share capital to requisition the company to exercise its powers under s 212 to investigate the share ownership of the company in the 3 years preceding the investigation.

<sup>35</sup> They may be dead, or the address to which the company sends notices may be out of date etc.

<sup>36</sup> Note that under r 9.1 of the Takeover Code, which applies principally to public companies, a person acquiring 30% or more of the voting power of a company must make an offer to purchase the shares of the remaining shareholders, unless the Panel on Takeovers and Mergers otherwise consents.

<sup>37</sup> Such control could arise on the basis of agreements or understandings between members, minority control through other members’ apathy or inability to participate, board control when no members hold sufficient votes to exercise control in larger companies, and personal influence between shareholders; see M A Pickering, “Shareholders’ Voting Rights and Company Control” (1965) 81 LQR 248, 269–272. See also K W Wedderburn’s theory in “Derivative Actions and *Foss v Harbottle*” (1981) 44 MLR 202, at p 205, that “... control exists if it would be futile to call a general meeting because the wrongdoers would directly or

4.15 In *Russell v Wakefield Waterworks Co*,<sup>38</sup> Jessel MR stated:

It is not necessary that the corporation should absolutely refuse by vote at the general meeting, if it can be shewn either that the wrong-doer had command of the majority of the votes, so that it would be absurd to call the meeting; or if it can be shewn that there has been a general meeting substantially approving of what has been done; or if it can be shewn from the acts of the corporation as a corporation, distinguished from the mere acts of the directors of it, that they have approved of what has been done, and have allowed a long time to elapse without interfering, so that they do not intend and are not willing to sue. In all those cases the same doctrine applies, and the individual corporator may maintain the suit.<sup>39</sup>

4.16 In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>40</sup> the Court of Appeal recognised that the term “control” “... embraces a broad spectrum extending from an overall absolute majority of votes at one end, to a *majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy*”.<sup>41</sup> However, this still means that control of over 50 per cent of the votes must be shown.

*When fraud and control must be shown*

4.17 In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>42</sup> the Court of Appeal held:

We do not think it right that the right to bring a derivative action should be decided as a preliminary issue upon the hypothesis that all the allegations in the statement of claim of “fraud” and “control” are facts, as they would be on the trial of a preliminary point of law. In our view, whatever may be the properly defined boundaries of the exception to the rule, the plaintiff ought at least to be required before proceeding with his action to establish a *prima facie* case (i) that the company is entitled to the relief claimed, and (ii) that the action falls within the proper boundaries to the rule in *Foss v Harbottle*.<sup>43</sup>

indirectly exercise a decisive influence over the result”.

<sup>38</sup> (1875) LR 20 Eq 474.

<sup>39</sup> *Ibid*, at p 482. Ratification as a possible manifestation of wrongdoer control and the effect of ratification on derivative actions is discussed at paras 5.2-5.17 below.

<sup>40</sup> [1982] Ch 204.

<sup>41</sup> *Ibid*, at p 219 (emphasis added). It is far from clear what degree of “influence” the wrongdoer must have over a particular shareholder for the shareholder’s votes to be under the wrongdoer’s control. Similarly there is little guidance as to what conduct by a shareholder would be sufficient to establish “apathy” in this context. See also the first instance decision of Vinelott J, [1981] Ch 257, which provides a useful discussion of these issues.

<sup>42</sup> [1982] Ch 204.

<sup>43</sup> *Ibid*, at pp 221-222.



This led in due course to the introduction of RSC, O 15, r 12A,<sup>44</sup> which now requires a preliminary application in all derivative actions. However, it will be appreciated from the explanation of the law given above,<sup>45</sup> that the factual difficulty of proving fraud and control will often make the preliminary application extremely complicated and lengthy. Moreover, if, as is almost inevitable, the application is opposed the defendants are likely to introduce a number of other issues said to be relevant to the question whether the derivative action should proceed. We return to these points below.<sup>46</sup>

*“Independent organ” does not wish the action to proceed*

- 4.18 In *Smith v Croft (No 2)*,<sup>47</sup> Knox J said “[u]ltimately the question which has to be answered in order to determine whether the rule in *Foss v Harbottle* applies to prevent a minority shareholder seeking relief as plaintiff for the benefit of the company is ‘Is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?’”<sup>48</sup> He held that, if an “independent organ” of the company considered that such an action would not be in the interests of the company, the action was properly prevented. What constitutes an independent organ is discussed later.<sup>49</sup> In many cases, there may not, as a matter of fact, be such an organ capable of making this decision.<sup>50</sup>

<sup>44</sup> See paras 6.7-6.9 below and see Appendix C.

<sup>45</sup> See paras 4.9-4.16 above.

<sup>46</sup> See generally, paras 6.6-6.9 below.

<sup>47</sup> [1988] Ch 114.

<sup>48</sup> *Ibid*, at p 185.

<sup>49</sup> See paras 4.28-4.29 below.

<sup>50</sup> See also the first instance decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 and *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237.

### Ultra vires transactions

4.19 The third part of the *Edwards v Halliwell* statement of the rule in *Foss v Harbottle*, was restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>51</sup> as follows:

(3) There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction.<sup>52</sup>

4.20 We next briefly examine the meaning of the term ultra vires and whether ultra vires acts can be ratified.

#### *Is the transaction ultra vires?*

4.21 Ultra vires acts include acts which are beyond the capacity of the company as prescribed by its memorandum.<sup>53</sup> The possibility of a transaction being ultra vires is greatly reduced now because of modern drafting techniques.<sup>54</sup> Ultra vires acts also include acts which are beyond the powers given to the company by the Companies Acts, as where a company repays its capital in a manner not authorised by the Companies Acts. Such a repayment would be an unlawful reduction of capital and ultra vires. However, where an act which a company commits is illegal it is not also ultra vires unless it is also beyond the capacity it is given by the Companies Acts. In *Smith v Croft (No 2)*,<sup>55</sup> the illegal act was conceded to be ultra vires because it involved the giving of financial assistance for the purpose of acquiring shares in the company in a manner which the Companies Act 1981 did not allow. The description of the rule in *Foss v Harbottle* that is given above applies to illegal acts which are ultra vires in this sense. Where the company proposes to do some other illegal act, a member may bring proceedings to restrain the company from so acting, but it is doubtful whether he can bring proceedings to recover damages for any loss which the company may suffer as a result without showing a fraud on the minority.

<sup>51</sup> [1982] Ch 204.

<sup>52</sup> *Ibid*, at p 210.

<sup>53</sup> *Ashbury Railway Carriage and Iron Co Ltd v Riche* (1875) LR 7 HL 653. Acts which are ultra vires the company should be distinguished from acts which are outside the powers of the directors (see paras 5.4-5.5 below and see the dicta of Slade and Browne-Wilkinson LJJ in *Rolled Steel Products (Holdings) Ltd v British Steel Corp*n [1986] Ch 246 at pp 297 and 302-304 respectively. Note also the discussion on challenging resolutions at paras 4.30-4.34 below).

<sup>54</sup> The standard practice is to include a long list of objects and powers in the memorandum covering every conceivable business activity. Under Companies Act 1985, s 3A, it is now possible for the memorandum to state that the object of the company is to carry on business as a general commercial company. This is then defined as meaning that the object of the company is to carry on any trade or business whatsoever, and the company has power to do all such things as are incidental or conducive to the carrying on of any trade or business by it. Because of doubts as to the precise effect of this provision, it does not appear to be being used as frequently as originally envisaged; see NJM Grier, "The Companies Act 1989 — a Curate's Egg?" (1995) 16 Co Law 3, 5.

<sup>55</sup> [1988] Ch 114.

- 4.22 At common law, shareholders could not approve ultra vires acts in advance.<sup>56</sup> As we have already noted,<sup>57</sup> shareholders could bring personal actions to restrain threatened ultra vires acts and this is still good law.
- 4.23 Moreover, shareholders could not ratify ultra vires acts at common law. Section 35(3) of the Companies Act 1985 has amended the law in this respect and provides that a company can ratify, by special resolution, a director's act which is ultra vires the company. This resolution of itself will not relieve directors of their liability to the company arising out of the ultra vires act, although section 35(3) allows members to pass a further special resolution absolving the directors from liability.
- 4.24 On normal principles, if a special resolution under section 35(3) was not passed bona fide in the interests of the company but to confer a benefit on the majority shareholders, a minority shareholder could bring a derivative action<sup>58</sup> on the basis of fraud on the minority, for a declaration that the resolution was not binding and for the recovery of damages from the directors. However, his action might be prevented if an independent organ of the company did not want it to proceed.<sup>59</sup>

*No need to show fraud on the minority*

- 4.25 In *Smith v Croft (No 2)*,<sup>60</sup> the transactions under consideration constituted unlawful financial assistance for the purchase of the shares of the company in issue,<sup>61</sup> and so were both ultra vires and illegal. The defendant wrongdoers held or controlled about 66 per cent of the voting rights in the company and the plaintiffs held (through themselves and other shareholders whom they controlled) about 14 per cent of the voting rights. About 19 per cent was held by a shareholder (who thus held a majority of the minority of approximately 33 per cent) who was held to be independent and who also opposed the action being brought.

<sup>56</sup> *Irvine v Union Bank of Australia* (1877) 2 App Cas 366.

<sup>57</sup> See para 2.29 above.

<sup>58</sup> Following *Smith v Croft (No 2)*, the passing of such resolutions is likely to be seen as a wrong to the company, so that a personal right of action would not lie. It is possible that other grounds of challenge could include those applied in the alteration of articles cases (see paras 2.31-2.38 above) or other grounds. In *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016, Oliver J held at p 1036 that the company could be restrained from acting on resolutions "... in appropriate circumstances, such as oppression or fraud on a minority". See also dicta in *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC), at pp 600-601, *per* Sir Richard Baggallay.

<sup>59</sup> See paras 4.27-4.29 below. See also the discussion of ratification as a possible bar to derivative actions at paras 5.2-5.17 below.

<sup>60</sup> [1988] Ch 114.

<sup>61</sup> Such transactions are prohibited under s 151 of the Companies Act 1985 and, at the time of the case, transgressed s 42 of the Companies Act 1981.

4.26 On the question of the nature of the wrong, Knox J held that where the plaintiffs sought compensation for the company for loss caused by ultra vires acts, the wrong was a wrong to the *company*, which had the right to redress.<sup>62</sup> However, Knox J held that it was not necessary in this situation to show fraud on the minority.<sup>63</sup>

*“Independent organ” does not wish the action to proceed*

4.27 Knox J accepted that the rule in *Foss v Harbottle* was inapplicable to proceedings to restrain ultra vires acts, as members could bring personal actions in that case. He also accepted that past ultra vires acts could not be ratified,<sup>64</sup> but distinguished resolutions “... abandoning, compromising or not pursuing rights of action arising out of a past ultra vires transaction”.<sup>65</sup> Such resolutions could prevent the company, and therefore a minority shareholder, from bringing an action. If an “independent organ” did not wish the action to proceed, it should not be allowed to do so.<sup>66</sup> The court would not necessarily require a meeting of the company to be held to discuss this issue.<sup>67</sup>

4.28 In considering the test of independence for these purposes, Knox J considered cases involving challenges to resolutions passed by or with the help of votes, the validity of which was impugned. He said that “... in general terms I would seek to apply the test applied by the Court of Appeal in *Allen v Gold Reefs of West Africa Ltd* <sup>68</sup>”.<sup>69</sup> However,

<sup>62</sup> [1988] Ch 114, 170. It appears that, before *Smith v Croft (No 2)*, shareholders brought personal actions in claims relating to past ultra vires acts. See, for example, *Holmes v Newcastle-upon-Tyne Freehold Abattoir Co* (1875) 1 Ch D 682 and see K W Wedderburn, “Shareholders’ Rights and the Rule in *Foss v Harbottle*” [1957] CLJ 194, 206. The effect of the decision in *Smith v Croft (No 2)* is to link the first limb (relating to the proper plaintiff) to the third limb (relating to ultra vires acts) of the *Edwards v Halliwell* rewording of the rule in *Foss v Harbottle* as restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*. Where there is a fraud on the minority, the fifth limb will also be relevant.

<sup>63</sup> [1988] Ch 114, 177.

<sup>64</sup> Section 35(3) was introduced into the Companies Act 1985 after the decision in *Smith v Croft (No 2)*. See further at para 5.3 below.

<sup>65</sup> [1988] Ch 114, 172.

<sup>66</sup> *Ibid*, at p 185. Knox J considered the decision in *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237, where the court had held that, although an ultra vires payment of union funds could not be ratified by the members, they could resolve to take no action to remedy the wrong, provided that such resolution was made in good faith and for the benefit of the union. Cf the test used by the court to assess the validity of resolutions amending the company’s articles, which was also used by Knox J in assessing the concept of the “independent organ” of the company; see paras 4.28–4.29 below.

<sup>67</sup> On the facts before him, there was no point in adjourning for a meeting to be called since it was quite plain that the votes would be cast as to 14% by the plaintiffs in favour of the action, as to 19% by the “independent” shareholder against the action and as to 66% by the defendants against the action. See also *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237 at n 66 above.

<sup>68</sup> [1900] 1 Ch 656, 671. The test was whether the votes in question were “exercised bona fide for the benefit of the company as a whole”. But contrast the views of Sir Robert Megarry V-C in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2. He noted that, to that date, the line of authority on resolutions altering the articles of association had never been applied to the exceptions to the rule in *Foss v Harbottle* and said “[i]f a case falls within one of the exceptions from *Foss v Harbottle*, I cannot see why

on the facts before him, he thought that it was possible to give a more specific test and held that "... votes should be disregarded if, but only if, the court is satisfied 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 is such that there is a substantial risk of that happening".<sup>70</sup> He continued, "[t]he court should not substitute its own opinion but can, and in my view should, assess whether the decision making process is vitiated by being or being likely to be directed to an improper purpose".<sup>71</sup>

- 4.29 It appears that the appropriate independent organ need not be a group of shareholders and may even be the directors or a committee of the directors.<sup>72</sup> Knox J suggested that "[t]he appropriate independent organ will vary according to the constitution of the company concerned and the identity of the defendants who will in most cases be disqualified from participating by voting in expressing the corporate will".<sup>73</sup> If the independent organ is a group of shareholders, they are not required to hold any particular percentage of shares, and so the percentage may be a small one.<sup>74</sup>

#### **Breaches of special resolution procedures**

- 4.30 We turn now to the fourth part of the *Edwards v Halliwell* definition of the rule in *Foss v Harbottle*:

(4) There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority.<sup>75</sup>

- 4.31 Shareholders are generally able to pursue derivative actions where a special majority procedure has not been followed as the majority rule principle cannot apply; otherwise the majority would have the power "... to do *de facto* by ordinary resolution that which

the right of the minority to sue under that exception should be taken away from them merely because the majority of the company reasonably believe it to be in the best interests of the company that this should be done. This is particularly so if the exception from the rule falls under the rubric of 'fraud on a minority'. *Ibid*, at p 12.

<sup>69</sup> [1988] Ch 114, 186.

<sup>70</sup> *Ibid*, at p 186.

<sup>71</sup> *Ibid*, at p 186.

<sup>72</sup> See D D Prentice, "Shareholder Actions: the Rule in *Foss v Harbottle*" (1988) 104 LQR 341, 345-6.

<sup>73</sup> [1988] Ch 114, 185.

<sup>74</sup> For further consideration of how the views of an independent organ should affect a shareholder's ability to bring a derivative action, see paras 16.35-16.37 below.

<sup>75</sup> As restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210.

according to its own regulations could only be done by special resolution”.<sup>76</sup> To this extent, the fourth limb of the rule is the natural corollary to the second.<sup>77</sup>

- 4.32 Members can, therefore, bring derivative actions to restrain breaches of special majority procedures and to prevent the company from acting on resolutions passed as a result of such breaches. They can also apply to the court to restrain the company from acting on an ordinary resolution if it should have been passed as a special or an extraordinary resolution.<sup>78</sup>
- 4.33 As we have seen, however, in some cases, the courts have held<sup>79</sup> that acts done in breach of the articles can be ratified by ordinary resolution, but, in other cases, a breach of the articles may involve a breach of a shareholder’s personal rights and found a personal action.<sup>80</sup>
- 4.34 In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>81</sup> the court held that shareholders would not be permitted to bring personal actions for damages for loss in the value of their shares to avoid the restrictions of the rule in *Foss v Harbottle*. In *Smith v Croft (No 2)*,<sup>82</sup> the court held that an action to recover damages for an ultra vires act was a derivative action. Accordingly, recent cases have had the effect of reducing the possibility of using the personal action as a means of avoiding the restrictions of a derivative action.

<sup>76</sup> *Edwards v Halliwell* [1950] 2 All ER 1064, 1067, *per* Jenkins LJ. The members of a trade union had obtained a declaration that a union decision increasing union dues was invalid as the requirement that a two thirds majority of members should agree had not been observed. See also *Cotter v National Union of Seamen* [1929] 2 Ch 58, 69-70, *per* Romer J, and *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503, where Lord Cozens-Hardy MR was “not prepared for one moment” to assent to the proposition “... that the company by an ordinary resolution can indirectly do that which ... can only be done by a special resolution”. *Ibid*, at p 515.

<sup>77</sup> It is generally assumed that a member can sue where there has been a breach of a special resolution, notwithstanding proof that those who oppose him are sufficiently numerous to pass the special resolution which is needed. See R J Smith, “Minority Shareholders and Corporate Irregularities” (1978) 41 MLR 147, who suggests, however, that “... an irregularity in a special resolution should be regarded as being ratifiable by a three-quarters majority ...” and that the concept “... that the irregularity must be ratifiable by straight majority seems linked to the use of the corporate name in litigation by the majority and the need to avoid a straight majority doing what a special majority is required for”. *Ibid*, at p 160. This point may be arguable in principle but it has not been applied by the courts.

<sup>78</sup> See *Edwards v Halliwell* [1950] 2 All ER 1064. See also provisions in the Companies Act 1985 which specify special resolution procedures; eg s 5 (amendments to the company’s memorandum; see para 12.11 below) and s 157 (financial assistance for the purchase of the company’s shares). Special resolutions amending the company’s articles which are not passed bona fide for the benefit of the company as a whole may themselves be challenged by members bringing personal actions. See paras 2.31-2.38 above.

<sup>79</sup> *Eg Normandy v Ind, Coope & Co Ltd* [1908] 1 Ch 84.

<sup>80</sup> See paras 2.23-2.27 above.

<sup>81</sup> [1982] Ch 204.

<sup>82</sup> [1988] Ch 114.

## Conclusion

4.35 The legal rules that determine whether or not a member of a company may bring an action on its behalf (a derivative action) are known as the rule in *Foss v Harbottle*.<sup>83</sup> This rule has been in a continuous state of development since the nineteenth century. It was authoritatively stated by Jenkins LJ in *Edwards v Halliwell*.<sup>84</sup> Like many rules developed by the courts, the rules have some capacity to continue to develop. Were the courts to restate the rule in *Foss v Harbottle* today there would, in addition to the five principles identified by Jenkins LJ, have to be further rules stating that an action by a minority shareholder to recover damages for an ultra vires act was within the rule (notwithstanding that an action by a minority shareholder to restrain an ultra vires act was a personal action). It would also have to be stated that if an independent organ of the company decided that the action should not proceed, the minority shareholder would be unable to maintain the action. The rule in *Foss v Harbottle* represents the courts' view that as a matter of policy the circumstances in which a shareholder can bring an action to enforce a cause of action vested in the company should be strictly limited; in the words of Knox J, the question is ultimately whether the plaintiff is being improperly prevented from bringing the action.<sup>85</sup> If the answer to that question is yes, he is permitted to bring a derivative action. However, the rule in *Foss v Harbottle* is not stated in terms of this underlying principle; rather, because the rule has been formulated as one which permits the derivative action only in set circumstances,<sup>86</sup> and this formulation has been approved by the Court of Appeal, the possibility that the rule could develop in a principled way to cover new situations is restricted.<sup>87</sup> Moreover, to obtain a proper understanding of the rule, one needs to examine numerous reported cases decided over a period of 150 years, thus the law in this respect is virtually inaccessible, save to lawyers specialising in the field.

<sup>83</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>84</sup> [1950] 2 All ER 1064, 1066-1067. These exceptions were restated with approval by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210-211.

<sup>85</sup> *Smith v Croft (No 2)* [1988] Ch 114, 185.

<sup>86</sup> Note *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, in which a threshold test of whenever the justice of the case required was rejected by the Court of Appeal as impractical. See also n 17 above.

<sup>87</sup> A claim for negligence is an example of this restriction. See para 4.11 above.

## **PART 5 RESTRICTIONS ON MEMBERS' ABILITY TO BRING ACTIONS ON BEHALF OF THE COMPANY**

### **Introduction**

5.1 In the last part we saw that the circumstances in which a minority shareholder could bring a derivative action were limited to the situations permitted by the rule in *Foss v Harbottle*<sup>1</sup> and that a minority shareholder could be prevented from proceeding with such an action by a decision of an independent organ of the company. In this part, we consider other restrictions which may prevent a minority shareholder from bringing a derivative action. These are in addition to any practical problems such as the cost of bringing proceedings.<sup>2</sup> The restrictions considered in this part are:

- (i) ratification;<sup>3</sup>
- (ii) inequitable conduct of the minority shareholder;<sup>4</sup>
- (iii) the availability of other adequate remedies;<sup>5</sup>
- (iv) the fact that the company is in liquidation.<sup>6</sup>

### **Ratification**

5.2 In some situations, the underlying wrong of which the minority shareholder complains can, as a matter of substantive law, be cured by ratification. Where ratification is effective in this way it will inevitably have an effect on a minority shareholder's action. It is not always clear when ratification will be effective.<sup>7</sup> It is outside the scope of this project to consider in depth the conditions necessary for effective ratification. However, we consider next in outline the effect of ratification on shareholders' actions as respects (i) acts ultra vires the company; (ii) acts outside the powers of the board but inside the powers of the company and (iii) acts in breach of the fiduciary duties of the directors.

<sup>1</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>2</sup> Costs and procedure are considered in Part 6 below.

<sup>3</sup> See paras 5.2-5.17 below. Although this topic is linked closely with fraud on the minority, it is dealt with separately here, rather than in paras 4.7-4.18 above because of its length and complexity and so that the inconsistencies in allowing derivative actions in cases which do not involve fraud on the minority can be highlighted more easily.

<sup>4</sup> See para 5.18 below.

<sup>5</sup> See para 5.19 below.

<sup>6</sup> See para 5.20 below.

<sup>7</sup> See, for example, *Rolled Steel Products (Holdings) Ltd v British Steel Corpn* [1986] Ch 246, 296, per Slade LJ.



*Ultra vires acts*

- 5.3 In Part 4, we considered transactions which are ultra vires the company.<sup>8</sup> In summary, it is not possible for a resolution passed in advance to bind the company to a future transaction which is ultra vires the company.<sup>9</sup> Under Companies Act 1985, section 35(3),<sup>10</sup> the past acts of directors which are ultra vires the company can be ratified (and, therefore, made binding on the company) by special resolution. Furthermore, under the same provision, another special resolution can be passed to relieve directors from liability for those acts.

*Acts outside the powers of the board*

- 5.4 At common law, an act by the board of directors which is not ultra vires the company but which is beyond the board's powers under the constitution can be ratified by ordinary resolution after the event. An ordinary resolution purporting to authorise such acts in advance would, however, be invalid.<sup>11</sup>
- 5.5 The Companies Act 1985 provides that in favour of third parties acting in good faith, the power of the board to bind the company or to authorise others to do so is deemed free of any limitation under the company's constitution. This does not make ratification irrelevant because section 35A(5) provides that the section does not take away claims against directors personally for unauthorised acts.<sup>12</sup> Section 35A(4) also preserves the right of shareholders to take proceedings to restrain the directors from entering into the transaction unless it is in fulfilment of a legal obligation previously entered into by the company.<sup>13</sup>

*Acts in breach of fiduciary duty*

- 5.6 We now turn to cases where a director's acts, which are not ultra vires the company or outside the powers of the board, but which involve a breach of duty because the director has misappropriated assets, or been interested in a transaction with the company, or made a secret profit from his position, or allotted shares for an improper

<sup>8</sup> See paras 4.19-4.29 above.

<sup>9</sup> See para 4.22 above.

<sup>10</sup> As amended by Companies Act 1989, s 108(1).

<sup>11</sup> See *Irvine v Union Bank of Australia* (1877) 2 App Cas 366 and *Grant v UK Switchback Railways Co* (1888) 40 Ch D 135.

<sup>12</sup> Although presumably, a resolution could release such liability. It is considered that a resolution of this kind would not be invalidated by s 310 of the Companies Act 1985.

<sup>13</sup> See also s 322A of the Companies Act 1985 which makes certain transactions entered into by directors voidable at the instance of the company where the board has exceeded its powers under the company's constitution.

purpose, have been ratified. We consider the effect of ratification on a derivative action.<sup>14</sup>

- 5.7 As we have already discussed, shareholders wishing to bring a derivative action under this head must be able to show both fraud and wrongdoer control.<sup>15</sup> Where they can do so, purported ratification of the acts in question will be a manifestation of wrongdoer control<sup>16</sup> and will not prevent a minority shareholder from bringing a derivative action.<sup>17</sup>
- 5.8 A classic example of fraud on the minority was *Cook v Deeks*.<sup>18</sup> The directors had breached their fiduciary duties by diverting business which belonged to the company for their own benefit. The Privy Council held that such a transaction could not be ratified by a resolution which was carried because the wrongdoing directors held the majority of the votes. Lord Buckmaster referred to earlier authorities on fraud on the minority<sup>19</sup> and commented, "... even supposing it be not ultra vires of a company to make a present to its directors, it appears quite certain that directors holding a majority of votes would not be permitted to make a present to themselves. This would be to allow a majority to oppress the minority".<sup>20</sup>
- 5.9 In *North-West Transportation Co Ltd v Beatty*,<sup>21</sup> one of the directors was interested in a contract with the company for the sale to it of a ship. The sale was at a proper price and the company required the ship for the purposes of its business. The transaction was approved by the shareholders, but the directors held a majority of the votes. The Privy Council held that any shareholder could vote at a general meeting as he thought fit. Ratification rendered the transaction binding on the company. The question of fraud on the minority did not arise and the minority shareholder's action to set the sale aside failed.

<sup>14</sup> We have not considered the situation where the effect of the director's action is a fraud on creditors or makes the company less than fully solvent (cf *Rolled Steel Products (Holdings) Ltd v British Steel Corpn* [1986] Ch 246, 296, *per* Slade LJ). We have assumed here that the director's action was *intra vires*.

<sup>15</sup> See para 4.6 above. The reason why shareholders are allowed to bring an action in such circumstances was set out in the fifth limb of the *Edwards v Halliwell* statement of the rule in *Foss v Harbottle*: "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". [1950] 2 All ER 1064, 1067, *per* Jenkins LJ.

<sup>16</sup> See, for example, *Cook v Deeks* [1916] 1 AC 554 (PC), at para 5.8 below.

<sup>17</sup> In some circumstances, the ratifying resolution might itself constitute a fraud on the minority.

<sup>18</sup> [1916] 1 AC 554 (PC).

<sup>19</sup> Including *Menier v Hooper's Telegraph Works* (1874) 9 Ch App 350; see para 4.9, n 24 above.

<sup>20</sup> *Cook v Deeks* [1916] 1 AC 554 (PC), at p 564.

<sup>21</sup> (1887) 12 App Cas 589 (PC).

- 5.10 The Privy Council held that the director whose interests were at stake was entitled to vote on the ratifying resolution because with regard to “... any question with which the company is legally competent to deal ... every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject matter opposed to, or different from, the general or particular interest of the company”.<sup>22</sup>
- 5.11 In *Regal (Hastings) Ltd v Gulliver*,<sup>23</sup> the directors took shares in a subsidiary company when the plaintiff holding company could not afford to take them up. The directors made a profit when both the holding company and the subsidiary were sold to a third party purchaser and they were held liable to account to the plaintiff holding company for that profit on the ground that they were in a fiduciary relationship with the company and had made the profit solely because of their position as its directors and in the course of carrying out their duties as such. Lord Russell suggested, however, that they could have protected themselves “... by a resolution (either antecedent or subsequent) of the Regal shareholders in general meeting”.<sup>24</sup>
- 5.12 Academic writers have questioned why ratification should have been considered effective in *Regal (Hastings) Ltd v Gulliver*<sup>25</sup> but not in *Cooks v Deeks*.<sup>26</sup> However, there are many points of distinction between the two cases, which may explain Lord Russell’s statement. *Regal (Hastings) Ltd v Gulliver* was not, like *Cook v Deeks*, a minority shareholder’s action. It was not a case of fraud; the directors in the *Regal* case had acted in good faith intending to benefit the company. There is no suggestion that they controlled a majority of the votes in general meeting. They were held liable because of the strict rule of substantive law that makes a fiduciary liable to account for a secret profit that he receives by reason of his fiduciary relationship. *Regal (Hastings) Ltd v Gulliver* was thus not a case where a minority shareholder could have brought an action on behalf of his company under the rule in *Foss v Harbottle*. But it follows from that case that, had he been able to do so, the action could not have been maintained if the company had in general meeting then passed a resolution ratifying the breach of fiduciary duty. There is nothing surprising in this result since it would be consistent with majority rule.

<sup>22</sup> *Ibid*, at p 593. However, such acts could be ratified, “... provided such affirmance or adoption is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards those shareholders who oppose it”. *Ibid*, at p 594.

<sup>23</sup> [1967] 2 AC 134n.

<sup>24</sup> *Ibid*, at p 150. See also n 26 below.

<sup>25</sup> [1967] 2 AC 134n.

<sup>26</sup> [1916] 1 AC 554 (PC). *Cook v Deeks* was not referred to in the judgments in *Regal (Hastings) Ltd v Gulliver*. *Gower’s Principles of Modern Company Law* (5th ed 1992) at p 595 concludes that “[a] satisfactory answer, consistent with common sense and with the decided cases is difficult (and perhaps impossible) to provide”. See also L S Sealy, “The Director as Trustee” [1967] CLJ 83, 102 and also L S Sealy, *Cases and Materials in Company Law* (5th ed 1992) p 269.

- 5.13 In *Queensland Mines v Hudson*,<sup>27</sup> the Privy Council considered the case of a managing director who, by reason of his position as such, was able to secure and exploit for himself a mining exploration licence. The company itself was not in a position to do this<sup>28</sup> and its board, on which representatives of its two shareholders sat, had, following full disclosure of the nature of the transaction, approved the defendant's actions.<sup>29</sup> The Privy Council held that the director was not liable to account for such benefits to the plaintiff company.
- 5.14 *North-West Transportation Ltd v Beatty, Regal (Hastings) Ltd v Gulliver* and *Queensland Mines v Hudson* are distinguishable from *Cook v Deeks*. In the first three cases, a reasonable shareholder could consider that the terms were beneficial to the company. In *Cook v Deeks*, however, the ratification procured by the directors involved a gift by the company to the directors.<sup>30</sup> In *Regal (Hastings) Ltd v Gulliver* and *Queensland Mines v Hudson*, the company could not itself benefit from the transaction. In *Queensland Mines v Hudson*, the director made full disclosure of the nature of the transaction and obtained approval from the company.
- 5.15 In *Hogg v Cramphorn*,<sup>31</sup> the directors had used their powers to issue shares for the purpose of forestalling a takeover bid. A minority shareholder brought a derivative action to have the issue set aside. The exercise of power for this purpose is a breach of fiduciary duty, even if the directors believe it to be in the interests of the company. In *Bamford v Bamford*,<sup>32</sup> there was an agreed point of law as to whether ratification in similar circumstances would be effective. In both cases the court held that the allotment could be cured by ratification. In both *Hogg v Cramphorn* and *Bamford v Bamford*, ratification defeated the actions, but the votes attached to the "tainted" shares were not exercised.
- 5.16 In *Hogg v Cramphorn*, the court also held that a minority shareholder could bring a derivative action.<sup>33</sup> (On the facts of that case the share issue was part of a scheme

<sup>27</sup> (1978) 52 ALJR 399 (PC).

<sup>28</sup> See *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n.

<sup>29</sup> See also dicta in *Bamford v Bamford* [1970] Ch 212.

<sup>30</sup> The Privy Council in *Cook v Deeks* distinguished *North-West Transportation Co Ltd v Beatty* on the grounds that the asset in that case on which the director had made a profit was his own rather than the company's (see [1916] 1 AC 554 (PC), 563-564). However, it is doubtful whether this point is enough in itself to make the transaction ratifiable.

<sup>31</sup> [1967] Ch 254.

<sup>32</sup> [1970] Ch 212.

<sup>33</sup> See *Re Sherbourne Park Residents Co Ltd* [1987] BCLC 82, where Hoffmann J appeared to suggest that only a personal action could lie in such situations. He held that "[a]lthough the alleged breach of fiduciary duty by the board is in theory a breach of its duty to the company, the wrong to the company is not the substance of the complaint. The company is not particularly concerned with who its shareholders are. The true basis of the action is an alleged infringement of the petitioner's individual rights as a shareholder ... An abuse of these powers

which constituted a fraud on the minority).<sup>34</sup> In *Bamford v Bamford*, the point was not taken that the proceedings did not come under the exceptions to the rule in *Foss v Harbottle* although they were brought by a minority shareholder.

- 5.17 In summary, in some circumstances ratification may bar a derivative action.<sup>35</sup> Moreover, as we saw in Part 4, if an independent organ of the company considers that it is not in the interests of the company to pursue a derivative action, the court may prevent the action from proceeding.<sup>36</sup> We turn now to consider other possible bars to derivative actions.

### **Inequitable conduct of the minority shareholder**

- 5.18 Derivative actions are allowed to proceed by virtue of an equitable concession by the Court of Chancery which makes an exception to the general rule that the proper plaintiff in an action seeking redress for a wrong done to a company is the company itself.<sup>37</sup> A shareholder wishing to take advantage of this concession may be prevented from doing so if there is evidence of "... behaviour by the minority shareholder, which, in the eyes of equity, would render it unjust to allow a claim brought by the company at his insistence to succeed".<sup>38</sup>

is an infringement of a member's contractual rights under the articles". *Ibid*, at p 84. In some such cases, wrongful acts may give rise to both personal and corporate rights of action.

<sup>34</sup> "The importance of the decision lies in the fact that shareholders were to be given an opportunity to ratify an issue of shares which had been successfully challenged by a minority shareholder suing in a representative capacity. Thus an exception was being recognised to the rule in *Foss v Harbottle*, although the action challenged could be ratified by an ordinary resolution"; see H Mason, "Ratification of the Directors' Acts: An Anglo Australian Comparison" (1978) 41 MLR 161, 162. See also H Lesser, "Organizing Resistance to Take-Over Bids — The Legality of Strategic Allotments of Shares" [1969] CLJ 198, 200, where he suggested that this judgment was a serious encroachment on minority protection and "... would deny the possibility of a minority action in cases of contravention of the articles or 'fraud on the minority', both of which are established 'exceptions' to the rule in *Foss v Harbottle*".

<sup>35</sup> For further consideration of how ratification may affect a shareholder's right to bring a derivative action, see paras 16.35-16.37 below.

<sup>36</sup> See paras 4.27-4.29 above and see *Smith v Croft (No 2)* [1988] Ch 114.

<sup>37</sup> See *Spokes v Grosvenor and West End Railway Terminus Hotel Co Ltd* [1897] 2 QB 124, 126, per AL Smith LJ and at p 128, per Chitty LJ.

<sup>38</sup> See *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378, per Browne-Wilkinson LJ. Thus, for example, a shareholder will not be able to proceed with a derivative action in relation to an ultra vires transaction if that shareholder has knowingly received the proceeds of the ultra vires transaction (*Towers v African Tug Co* [1904] 1 Ch 558), or in respect of a misappropriation of company assets where the shareholder has received a lump-sum settlement on divorce which has made allowance for the misappropriated assets (*Nurcombe v Nurcombe*). See also *Barrett v Duckett* [1995] 1 BCLC 243. So far as laches is concerned, see *Nurcombe v Nurcombe* at p 377, per Lawton LJ and at p 379, per Browne-Wilkinson LJ.

### Availability of other adequate remedies

5.19 In *Barrett v Duckett*,<sup>39</sup> Peter Gibson LJ said:

The shareholder will be allowed to sue on behalf of the company if he is bringing the action bona fide for the benefit of the company for wrongs to the company *for which no other remedy is available*. Conversely if the action is brought for an ulterior purpose or if another adequate remedy is available, the court will not allow the derivative action to proceed.<sup>40</sup>

In that case, one of the defendant shareholders had brought proceedings for winding up. The plaintiff did not have the means to pursue the derivative action and the Court of Appeal held that it was better for the liquidator to determine whether to pursue the action. Moreover, the plaintiff was acting for an ulterior purpose and not bona fide on behalf of the company.<sup>41</sup>

### Companies in liquidation

5.20 The derivative action is "... a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress".<sup>42</sup> Where a company has gone into liquidation, there is no need for such a device as the liquidator, an independent third party, will have taken control of the company's affairs from the alleged wrongdoers. If there is a reasonable cause of action against the wrongdoers, the liquidator can cause the company to bring an action<sup>43</sup> and, if the liquidator refuses, the complainant shareholder may be able to obtain either an order directing<sup>44</sup> the liquidator to bring such an action or an order allowing the shareholder to bring an action in the name of the company.<sup>45</sup>

<sup>39</sup> [1995] 1 BCLC 243.

<sup>40</sup> *Ibid*, at p 250 (emphasis added). In this case, Russell LJ agreed with the judgment of Peter Gibson LJ and the alternative remedy was winding up.

<sup>41</sup> For further consideration of the availability of alternative remedies, see paras 16.39-16.40 below.

<sup>42</sup> *Smith v Croft (No 2)* [1988] Ch 114, 185, *per* Knox J.

<sup>43</sup> It seems that the liquidator may alternatively assign the company's rights of action to a shareholder as part of the company's property, which under the terms of Insolvency Act 1986, ss 165 and 167 and Sched 4, para 6, may be sold to anybody by private contract: *Re Ayala Holdings Ltd (No 2)* [1996] 1 BCLC 467. The assignment in *Re Ayala* was held to be invalid as it was an attempt to assign rights conferred upon the liquidator, by the Insolvency Act 1986, which were not assets of the company. However, Knox J upheld the proposition that "[t]he property of a company includes rights of action against third parties vested in a company at the commencement of the winding up ... and such rights can ... be sold by a liquidator pursuant to para 6 of Sched 4". *Ibid*, at pp 480-481.

<sup>44</sup> See ss 112(1) and 168(5) of the Insolvency Act 1986.

<sup>45</sup> See *Ferguson v Wallbridge* [1935] 3 DLR 66, 83, *per* Lord Blanesburgh; *Fargro Ltd v Godfroy* [1986] 1 WLR 1134, 1136, *per* Walton J and *Barrett v Duckett* [1995] 1 BCLC 243, 255, *per* Peter Gibson LJ. But note that the courts are reluctant to interfere with a liquidator's decision unless he exercises his discretion mala fide or comes to a decision which no reasonable liquidator could have come to; see *Leon v York-O-Matic Ltd* [1966] 1 WLR 1450, 1455, *per* Plowman J.

# **PART 6**

## **PROCEDURE AND COSTS IN RESPECT OF ACTIONS ON BEHALF OF THE COMPANY**

### **Introduction**

- 6.1 In this part we look at a number of procedural and costs considerations in respect of actions on behalf of the company. First, we compare derivative actions with a number of other types of action which a shareholder may bring;<sup>1</sup> next, we consider the requirement that a member's standing to bring a derivative action must be determined as a preliminary issue;<sup>2</sup> we then examine recent amendments to the procedure relating to derivative actions introduced by RSC, O 15, r 12A;<sup>3</sup> finally we consider the position on costs.<sup>4</sup>

### **Types of action**

- 6.2 There are three types of action that shareholders may bring: personal actions, representative actions and derivative actions.
- 6.3 Personal actions are actions by individuals seeking to enforce their personal rights. Plaintiffs in such actions seeking damages will, if they are successful, receive individual benefit from the action. In derivative actions it is the company itself which receives the benefit.<sup>5</sup>
- 6.4 Representative actions are proceedings in which a plaintiff is permitted to bring a personal claim on behalf of himself and other persons with the same interest.<sup>6</sup> Specific procedural rules have evolved to deal with such actions.<sup>7</sup>

<sup>1</sup> See paras 6.2-6.5 below.

<sup>2</sup> See para 6.6 below.

<sup>3</sup> See paras 6.7-6.9 below.

<sup>4</sup> See paras 6.10-6.15 below.

<sup>5</sup> In *Spokes v Grosvenor and West End Railway Terminus Hotel Co Ltd* [1897] 2 QB 124, 128, the court stressed that, in the case of derivative actions, "... what is recovered cannot be paid to the plaintiff representing the minority, but must go into the coffers of the company".

<sup>6</sup> In Scottish procedure there has never been this distinction between "personal actions" and "representative actions". Virtually all actions have been raised by the individual shareholder without reference to others with the same rights. See A Paterson, "The Aggrieved Minority and Scottish Law" (1981) 2 Co Law 155 for all reported Scottish cases; the exceptional case, in which the shareholder raised the action "... on behalf of himself and all others (sic) shareholders ..." is *Lee v Crawford* (1890) 17 R 1094. A judgment in an action by one shareholder would, however, be binding in practice in relation to others with the same rights. We understand that the Scottish procedure has caused no practical difficulties.

<sup>7</sup> See RSC, O 15, r 12. See paras 6.7-6.9 below and Appendix C for the specific procedural rules introduced for derivative actions.

6.5 Derivative actions<sup>8</sup> are actions brought by an individual shareholder which seek redress for a wrong done to the company.<sup>9</sup> The title to the proceedings will state that the plaintiff sues on behalf of himself and all other shareholders in the company, other than the defendants. Because the plaintiff in a derivative action will be suing in respect of a wrong done to the company, the company must also be named as a defendant to the action. Until recently, there were no specific procedural rules governing derivative actions and new procedural rules<sup>10</sup> have not changed the basic form of such proceedings. It is not always clear simply from the title to the proceedings whether the shareholder is bringing a derivative action or is seeking to enforce personal rights common to himself and a group of other shareholders.<sup>11</sup>

### **Determining standing as a preliminary issue**

6.6 It has been clear since the Court of Appeal's ruling in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>12</sup> that minority shareholders must "... establish a prima facie case (i) that the company is entitled to the relief claimed, and (ii) that the action falls within the proper boundaries of the exception to the rule in *Foss v Harbottle*".<sup>13</sup> The Court of Appeal no doubt envisaged that the determination of this preliminary issue should involve a relatively short hearing.<sup>14</sup> However, the hearing of *Smith v Croft*

<sup>8</sup> A relatively new term for what was traditionally called a "minority shareholder's action"; see *Jaybird Group Ltd v Greenwood* [1986] BCLC 319, 320, per Michael Wheeler QC (sitting as a Deputy Judge of the High Court). The procedure set out in paras 6.5-6.9 below does not apply to an action before the Scottish courts. No special procedural rules apply, and the right of an individual shareholder to bring an action before the Scottish courts may be decided as a preliminary issue (see *Orr v Glasgow etc Railway Co* (1860) 3 Macq 799; *Lee v Crawford* (1890) 17 R 1094) or at the trial of the action (see *Brown v Stewart* (1898) 1 F 316; *Hannay v Muir* (1899) 1 F 306).

<sup>9</sup> See *Re Sherbourne Park Residents Co Ltd* [1987] BCLC 82. Also see *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 10, per Megarry V-C: "Derivative action", I may say, is the convenient name to apply to an action by a member of a company who sues on behalf of the company to enforce rights derived from that company". According to Lord Denning MR, derivative actions were first accepted by the courts as a method of avoiding the circuitous procedure involved in requiring minority shareholders to obtain leave to start a corporate action in the name of the company where the people who committed the wrong against the company were its directors. See *Wallersteiner v Moir (No 2)* [1975] QB 373, 390.

<sup>10</sup> See paras 6.7-6.9 below.

<sup>11</sup> In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, the plaintiff brought both personal and derivative claims in the same proceedings. This problem would be made worse were the view expressed by Lord Denning MR (that derivative actions need not be brought in "representative" form; see *Wallersteiner v Moir (No 2)* [1975] QB 373, 391) to be correct. For further criticism of the procedural aspects of the rule in *Foss v Harbottle*, see L S Sealy, "Problems of Standing, Pleading and Proof in Corporate Litigation" in *Company Law in Change, Current Legal Problems* (1987) p 1.

<sup>12</sup> [1982] Ch 204.

<sup>13</sup> *Ibid*, at p 222; ie unlike strike out applications and trials on a preliminary point of law, the court will not decide this issue "... upon the hypothesis that all the allegations in the statement of claim of 'fraud' and 'control' are facts". *Ibid*, at p 221.

<sup>14</sup> *Ibid*, at pp 221-222. It would appear that usually such a hearing will not be by way of oral evidence.



(No 2),<sup>15</sup> lasted 18 days. In that case complicated questions of law arose. Difficult questions of fact can also arise at this stage as the case of *Trusthouse Forte plc v The Savoy Hotel plc* illustrates.<sup>16</sup> This case did not in the end come to trial, and the events which led to the termination of the litigation are of interest.<sup>17</sup>

### **RSC, O 15, r 12A**<sup>18</sup>

6.7 A new procedural rule (RSC, O 15, r 12A)<sup>19</sup> has now been introduced which specifically deals with derivative actions. This rule came into force on 1 September 1994<sup>20</sup> and requires the plaintiff minority shareholder to apply<sup>21</sup> for leave to continue with his derivative action if the defendant has given notice of intention to defend.<sup>22</sup> Failure to make such an application entitles the defendant to apply for the action to be

<sup>15</sup> [1988] Ch 114.

<sup>16</sup> In 1981, Trusthouse Forte plc (“THF”) made an unsuccessful bid to acquire control of the Savoy Hotel plc (“Savoy”). Savoy’s share capital consisted of “A” shares and “B” shares. These shares carried the same rights except with respect to voting. On a poll the “B” shares were entitled to 48.55% of the votes even though they represented only 2.3% of the equity. (See *Re Savoy Hotel Ltd* [1981] Ch 351). Following THF’s bid, THF held 69% of the “A” shares but only 42% of the votes. “B” shares conferring some 5.77% of the votes capable of being cast on a poll were held by a Swiss foundation. In 1987, THF began a derivative action alleging that the then directors acted in breach of duty in allotting and issuing the shares registered in the name of the foundation. The circumstances in which the shares had been issued were complex and arose out of a transaction in 1970. Savoy applied to the court on a preliminary issue to determine whether or not THF could bring the action under the rule in *Foss v Harbottle*. Savoy contended that the action should be stayed on the grounds that THF was not entitled to bring the action on behalf of other shareholders. Lengthy affidavits were filed on both sides. At a late stage, pleadings were ordered. The preliminary stages of the application for a stay were heard by a Master in Chambers, as is usual in Chancery actions.

<sup>17</sup> In May 1988, Savoy convened a meeting of its shareholders to ratify the shareholding of the Swiss foundation and to authorise the discontinuance of the action. Savoy, acting by a litigation committee of the board of directors, issued a circular in which it was stated that if THF succeeded in the action it could, by purchases in the market, (and within the limits permitted by the Takeover Code), increase its percentage of the votes to 49% in little over a year, and that this would be likely to give THF effective control without having to make an offer for the remaining shares. The financial benefits to Savoy of cancelling the foundation shares were small, and the costs of defending the action were considerable. The circular further stated that THF’s predominant purpose in bringing the action was to enhance its ability to gain control of Savoy more cheaply than would otherwise be possible. This resolution was passed. THF continued to contend that it was entitled to bring its action. Savoy’s application had not yet been heard by the court when in November 1989, Savoy and THF came to an arrangement to end the litigation on terms that THF should not acquire any further shares in Savoy for five years, Savoy should not issue any further shares without the approval of THF for the same period and that THF should have two representatives on the board of Savoy. This arrangement was conditional on approval by the Savoy shareholders. This approval was given and the litigation was then brought to an end.

<sup>18</sup> See Appendix C.

<sup>19</sup> There is no equivalent provision in the RSC in Northern Ireland.

<sup>20</sup> See SI 1994 No 1975. Before it was introduced, there was doubt as to the correct procedure for establishing whether the action fell within the exceptions to the rule in *Foss v Harbottle*; see *Smith v Croft* [1988] Ch 114, 190, *per* Knox J.

<sup>21</sup> Within 21 days of service of the statement of claim or, if later, of service of the first notice of intention to defend (see RSC, O 15, r 12A(4) & (5)).

<sup>22</sup> See RSC, O 15, r 12A(2).

dismissed.<sup>23</sup> Even if the court grants leave to continue the action the defendant may bring a further application “... requiring the plaintiff to show cause why the Court should not dismiss the action ...”, if there has been “... a material change in circumstances after the Court has given leave”.<sup>24</sup>

- 6.8 The new rule does not require the plaintiff to state in the title to his action whether the action is personal and/or derivative. Accordingly, the new rule does not remove the possible confusion which can arise from the absence of such a statement in the title to the action.
- 6.9 RSC, O 15, r 12A does not clarify the issue of when a plaintiff will have standing to bring a derivative action. The new rule states when<sup>25</sup> and how the issue of standing should be brought before the court, and provides that all the preliminary procedural issues (such as locus standi and costs indemnity applications<sup>26</sup>) should be determined, as far as possible, at the same time. As envisaged by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>27</sup> the court will in an appropriate case grant an adjournment<sup>28</sup> to enable a shareholders’ meeting to be held to gauge the support amongst shareholders for the action.

### **Costs orders**<sup>29</sup>

#### *General principles*

- 6.10 The court has a discretion under section 51 of the Supreme Court Act 1981 to make costs orders in relation to proceedings before it. The discretion conferred by section 51

<sup>23</sup> See RSC, O 25, r 12A(9).

<sup>24</sup> See RSC, O 15, r 12A(12).

<sup>25</sup> It is desirable that the issue of standing should be determined at an early stage, not only to avoid unnecessary costs, but also to prevent damage to the company as a result of adverse publicity and loss of management time. See generally A F Bartlett, *Power, Prejudice and Pride* (1982).

<sup>26</sup> See paras 6.13-6.14 below.

<sup>27</sup> [1982] Ch 204, 222.

<sup>28</sup> See RSC, O 15, r 12A(8)(c).

<sup>29</sup> In Scottish procedure the equivalent of “costs” is “expenses”. The Scottish courts have an inherent common law power to determine expenses. The principles under which they exercise their discretion are, in practice, the same as those applied by the English courts. The only practical difference between the powers of the Scottish and English courts is that the former seem to have no common law power to require the company to indemnify the shareholder pursuer in advance in relation to expenses (see paras 6.13-6.14 below). The Scottish courts should have power to order the company to pay the expenses incurred by an unsuccessful shareholder (see para 6.11 below). See *Paterson v R Paterson & Sons Ltd* 1916 SC 452, 1917 SC(HL) 13, as an example of the flexibility of the Scottish courts’ power; in that case, the directors were held liable in the expenses of an unsuccessful appeal by the company.

is a wide one but must be exercised in accordance with both the rules of court and established principles.<sup>30</sup> The general principle is set out in RSC, O 62, r 3(3):<sup>31</sup>

If the Court in the exercise of its discretion sees fit to make any order as to the costs of any proceedings, the Court shall order the costs to follow the event, except when it appears to the Court that in the circumstances of the case some other order should be made as to the whole or any part of the costs.

*Costs in derivative actions*

6.11 In derivative actions<sup>32</sup> a shareholder will not be entitled to legal aid,<sup>33</sup> but the courts have held that a shareholder who brings the action may be entitled to be indemnified by the company at the end of the trial for any costs he has incurred, provided he acted reasonably in bringing the action, even if it fails. As Buckley LJ said in *Wallersteiner v Moir (No 2)*:<sup>34</sup>

... where a shareholder has in good faith and on reasonable grounds sued as a plaintiff in a minority shareholder's action,<sup>35</sup> the benefit of which, if successful, will accrue to the company and only indirectly to the plaintiff as a member of the company, and which it would have been reasonable for an independent board of directors to bring in the company's name, it would, I think, clearly be a proper exercise of judicial discretion to order the company to pay the plaintiff's costs.<sup>36</sup>

6.12 In that case, the Court of Appeal suggested that the shareholder should apply<sup>37</sup> at an early stage (as soon as possible after issuing proceedings) for directions as to whether he should proceed. If he obtained such a direction, he could be confident that, when

<sup>30</sup> In *Aiden Shipping Ltd v Interbulk Ltd* [1986] AC 965, 975, Lord Goff of Chieveley commented: "Such a provision is consistent with a policy under which jurisdiction to exercise the relevant discretionary power is expressed in wide terms, thus ensuring that the court has, so far as possible, freedom of action, leaving it to the rule-making authority to control the exercise of discretion (if it thinks it right to do so) by the making of rules of court, and to the appellate courts to establish principles upon which the discretionary power may, within the framework of the statute and the applicable rules of court, be exercised".

<sup>31</sup> In Northern Ireland, RSC, O 62 r 3(3).

<sup>32</sup> In contrast to proceedings brought under s 459 of the Companies Act 1985, see para 11.26 below.

<sup>33</sup> As legal aid is only available to individuals, not to companies. See *Wallersteiner v Moir (No 2)* [1975] QB 373.

<sup>34</sup> [1975] QB 373.

<sup>35</sup> Ie a derivative action.

<sup>36</sup> [1975] QB 373, 403-404 (footnote added).

<sup>37</sup> To the Master "... supported by an opinion of counsel as to whether there is a reasonable case or not". *Ibid*, at p 392, *per* Lord Denning MR. Note that, since 1990, it has become the practice that Masters should not deal with applications by minority shareholders for an indemnity out of the assets of a company "other than in plain cases"; see *Practice Direction (Chancery: Masters' Powers)* [1990] 1 WLR 52, para A1(g).

the court came to deal with costs at the end of the trial, he would be treated as between himself and the company as having acted reasonably. The court would thus be likely to order the company to reimburse him for the costs he had incurred and to indemnify him against costs which he was ordered to pay any other party. The court may also at an earlier stage make an order in respect of costs to be incurred after the date of the order and such an order was made in *Wallersteiner v Moir (No 2)*.<sup>38</sup>

6.13 RSC, O 15, r 12A(13)<sup>39</sup> now provides that:

The plaintiff may include in an application under paragraph (2) an application for an indemnity out of the assets of the company in respect of costs incurred or to be incurred in the action and the Court may grant such indemnity upon such terms as may in the circumstances be appropriate.

6.14 In *Smith v Croft*,<sup>40</sup> Walton J held that a shareholder's ability to finance the action himself will be relevant to the question of whether the court will make such a costs order. Walton J also said that, if an order was made, a percentage of the costs should still be paid by the shareholder, even if he was impecunious; this requirement would be a financial spur to ensure that the plaintiff proceeded diligently with the action.<sup>41</sup>

#### *Conditional fees*

6.15 In *Wallersteiner v Moir (No 2)*,<sup>42</sup> Lord Denning MR was prepared to agree, in principle, that contingency fees could be used as a mechanism to fund derivative actions.<sup>43</sup> The majority of the Court of Appeal disagreed with this view, however. Buckley and Scarman LJ took the view that the court had neither the power nor good reason (given the jurisdiction to make indemnity orders) to sanction a contingency fee agreement.<sup>44</sup> Section 58 of the Courts and Legal Services Act 1990 provides for the introduction, in limited circumstances, of "conditional fee agreements" but the orders made so far by the Lord Chancellor under section 58 do not cover derivative actions.<sup>45</sup>

<sup>38</sup> [1975] QB 373.

<sup>39</sup> Which came into force on 1 September 1994.

<sup>40</sup> [1986] 1 WLR 580.

<sup>41</sup> *Ibid*, at pp 597-598, *per* Walton J. Cf *Jaybird Group Ltd v Greenwood* [1986] BCLC 319, 327-8, *per* Michael Wheeler QC (sitting as a Deputy Judge of the High Court). Even if an indemnity is given, the order will normally be limited to the costs of taking specific steps in the conduct of proceedings and will not extend to all the steps up to and including trial: *McDonald v Horn* [1995] 1 All ER 961, 975, *per* Hoffmann LJ.

<sup>42</sup> [1975] QB 373.

<sup>43</sup> Provided the agreement had received "... the permission, first of the Council of the Law Society and next of the courts". *Ibid*, at p 396.

<sup>44</sup> *Ibid*, at p 403, *per* Buckley LJ, and at pp 408-409, *per* Scarman LJ.

<sup>45</sup> Contingency fees are also prohibited under Scots law. The Courts and Legal Services Act 1990 does not apply to Scotland. The broad equivalent is s 61A(3) of the Solicitors (Scotland) Act 1980 (added in 1990) and r 42.17 of the Court of Session Rules 1994. The

Court and Legal Services Act 1990 also does not apply in Northern Ireland.

# SECTION C UNFAIR PREJUDICE REMEDY

## PART 7 INTRODUCTION AND HISTORY OF SECTIONS 459-461 OF THE COMPANIES ACT 1985

### Introduction<sup>1</sup>

- 7.1 Sections 459-461 of the Companies Act 1985 provide a remedy for a shareholder where a company's affairs are being conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself).
- 7.2 Common allegations made in petitions under section 459 include exclusion of a minority shareholder from management,<sup>2</sup> or a misappropriation or diversion of corporate assets.<sup>3</sup> Other typical allegations include failure to provide information,<sup>4</sup> improper increases in share capital,<sup>5</sup> excessive remuneration and non payment or payment of inadequate dividends.<sup>6</sup> A number of allegations concern conduct which, prior to the introduction of the oppression remedy, might have been the subject of a derivative action<sup>7</sup> or a personal action under section 14 of the Companies Act 1985.<sup>8</sup>
- 7.3 Once unfairly prejudicial conduct has been established, the court has a very wide range of powers under section 461.<sup>9</sup> The section provides that the court may make such order as it thinks fit for giving relief in respect of the matters of which the petitioner complains.<sup>10</sup> However, the order most frequently sought (and granted) is that the

<sup>1</sup> Sections 459-461 and their statutory predecessors apply equally to companies registered in Scotland. The substantive law, but not the procedural details, are therefore the same as shown in the English cases. The only case under s 210 of the Companies Act 1948 to go to the House of Lords, *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324 (“*SCWS v Meyer*”) was, in fact, a Scottish case; the Scottish citation is *Meyer v Scottish Co-operative Wholesale Society* 1958 SC(HL) 40. The equivalent Northern Ireland provisions are contained in arts 452-454 of the Companies (Northern Ireland) Order 1986.

<sup>2</sup> See further at para 9.34 below.

<sup>3</sup> See further at para 9.40 below.

<sup>4</sup> See further at para 9.35 below.

<sup>5</sup> See further at paras 9.36-9.38 below.

<sup>6</sup> See further at paras 9.41-9.43 below.

<sup>7</sup> Eg misappropriation of corporate assets. See also the recent decision in *Lowe v Fahey* [1996] 1 BCLC 262.

<sup>8</sup> Eg non payment of a declared dividend.

<sup>9</sup> See further below in Part 10 for discussion as to the range of remedies available.

<sup>10</sup> Section 461(1).

petitioner's shares should be purchased by the majority shareholder(s).<sup>11</sup> The court will give directions as to the basis upon which the shares are to be valued.<sup>12</sup> It is also open to the court to make orders regulating the conduct of the company's affairs,<sup>13</sup> requiring the company to do, or refrain from doing, certain acts,<sup>14</sup> and authorising civil proceedings to be brought in the name of and on behalf of the company.<sup>15</sup>

- 7.4 In order fully to understand the nature and scope of the unfair prejudice remedy it is helpful to know something of its history. This is set out briefly in the remainder of this part. As we shall see, the remedy was introduced to give the courts more flexibility and as an alternative to winding up a company on just and equitable grounds. Nevertheless, the relationship between winding up under section 122(1)(g) of the Insolvency Act 1986 and the unfair prejudice remedy remains important. This is dealt with in the following part (Part 8). We then go on to examine, in Part 9, the substantive requirements of unfair prejudice petitions, in Part 10, the remedies available under section 461 and, in Part 11, their procedural aspects.<sup>16</sup>

#### **History of sections 459-461**

- 7.5 Prior to the introduction of section 210 of the Companies Act 1948,<sup>17</sup> a minority shareholder was often unable to obtain any redress from the courts to stop the majority shareholders from acting in an oppressive manner. In limited circumstances, however, the remedy of applying to the court for winding up on the just and equitable ground was available.<sup>18</sup> The position of minority shareholders was considered in the report of the Committee on Company Law Amendment ("the Cohen Committee") in 1945.<sup>19</sup>
- 7.6 The Cohen Committee drew attention to the need to strengthen the position of those entitled to a minority shareholding where the directors refused to register a transfer of shares (particularly on death) and where the directors received an undue proportion of the company's profits as remuneration, leaving little available for distribution as dividend.<sup>20</sup> As was emphasised in the report of the Company Law Committee ("the

<sup>11</sup> Section 461(2)(d). See further at paras 10.10-10.25 below.

<sup>12</sup> Eg whether the value of the shareholding should be discounted to reflect that it is a minority shareholding. See further at paras 10.12-10.17 below.

<sup>13</sup> Section 461(2)(a). See further at paras 10.4-10.5 below.

<sup>14</sup> Section 461(2)(b). See further at paras 10.6-10.7 below.

<sup>15</sup> Section 461(2)(c). See further at paras 10.8-10.9 below.

<sup>16</sup> See also paras 14.5-14.6 below which summarise the main problems with this remedy.

<sup>17</sup> The precursor to the current s 459.

<sup>18</sup> Formerly s 168(6) of the Companies Act 1929, now s 122(1)(g) of the Insolvency Act 1986.

<sup>19</sup> Report of the Committee on Company Law Amendment (1945) Cmd 6659.

<sup>20</sup> *Ibid*, at paras 58-59.

Jenkins Committee”)<sup>21</sup> some 17 years later, the changes recommended by the Cohen Committee were designed to strengthen the position of minorities “... primarily but not exclusively in private companies ...”.<sup>22</sup>

- 7.7 The conclusions reached by the Cohen Committee highlighted the difficulties faced by reformers in the area of company law:

We have carefully examined suggestions intended to strengthen the minority shareholders of a private company in resisting oppression by the majority. The difficulties to which we have referred ... are, in fact, only illustrations of a general problem. It is impossible to frame a recommendation to cover every case ... In many cases ... the winding up of the company will not benefit the minority shareholders, since the break up value of the assets may be small, or the only available purchaser may be that very majority whose oppression has driven the minority to seek redress.<sup>23</sup> We, therefore, suggest that the Court should have, in addition, the power to impose upon the parties to a dispute whatever settlement the Court considers just and equitable. This discretion must be unfettered, for it is impossible to lay down a general guide to the solution of what are essentially individual cases. We do not think that the Court can be expected in every case to find and impose a solution; but our proposal will give the Court a jurisdiction which it at present lacks, and thereby at least empower it to impose a solution in those cases where one exists.<sup>24</sup>

- 7.8 As a result of the Cohen Committee’s recommendations, section 9 of the Companies Act 1947, which became section 210 of the Companies Act 1948,<sup>25</sup> was introduced.<sup>26</sup> However, the new section was under-utilised and successful actions were rarely brought.<sup>27</sup> When the Jenkins Committee considered the law in this area in 1962, it drew attention to a number of defects in the section and recommended changes to meet them:<sup>28</sup>

<sup>21</sup> Report of the Company Law Committee (1962) Cmnd 1749.

<sup>22</sup> *Ibid*, at para 199.

<sup>23</sup> See also the comments of Nourse J in *Re Bird Precision Bellows Ltd* [1984] Ch 419, 428 at para 8.13, n 40 below.

<sup>24</sup> Report of the Committee on Company Law Amendment (1945) Cmd 6659, para 60 (footnote added).

<sup>25</sup> This section came into force on 1 July 1948.

<sup>26</sup> For the wording of s 210 see Appendix D.

<sup>27</sup> Only two successful applications for relief were reported under this section: *SCWS v Meyer* [1959] AC 324 (see paras 9.10-9.11 below) and *Re HR Harmer Ltd* [1959] 1 WLR 62 (see para 10.4, n 15 below).

<sup>28</sup> The Jenkins Committee also recommended the change mentioned in para 7.11 below.



- (i) The manner in which the section was linked with the winding up jurisdiction: “The effect of this is that the applicant in order to succeed must show not only that the company’s affairs are being conducted in a manner oppressive to some part of the members ..., but also ... ‘that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up’”.<sup>29</sup> Evidence was given to the Jenkins Committee that “... a case for winding up under the just and equitable rule at the instance of a contributory is difficult to establish ...”<sup>30</sup> and “... that there is no sufficient reason for making the establishment of such a case an essential condition of intervention by the Court”.<sup>31</sup> The Jenkins Committee accepted these criticisms and recommended the repeal of the sub-section which linked the remedy with the winding up jurisdiction.<sup>32</sup>
- (ii) The fact that a single act could not constitute “oppression”;<sup>33</sup> rather, conduct had to be of a continuing nature. The section indicated “... a course of conduct as distinct from an isolated act”.<sup>34</sup> The Jenkins Committee recommended that the section be amended to make it clear that it also covered isolated acts.<sup>35</sup>
- (iii) The courts construed “oppression” as meaning “burdensome, harsh and wrongful”<sup>36</sup> and not simply unfair. The Jenkins Committee were of the view that, if the section was to afford effective protection, “... it must extend to cases in which the acts complained of fall short of actual illegality”.<sup>37</sup> They considered that the section should “... cover complaints not only to the effect that the affairs of the company were being conducted in a manner oppressive ... to the members concerned but also to the effect that those affairs were being conducted in a manner unfairly prejudicial to the interests of those members”.<sup>38</sup>
- (iv) Omissions and future conduct did not come within the section. The Jenkins Committee agreed that the section should allow the court to restrain the

<sup>29</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 201.

<sup>30</sup> *Ibid*, at para 201.

<sup>31</sup> *Ibid*, at para 201.

<sup>32</sup> *Ibid*, at para 212.

<sup>33</sup> *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042.

<sup>34</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 202.

<sup>35</sup> *Ibid*, at para 212.

<sup>36</sup> *SCWS v Meyer* [1959] AC 324, 342, *per* Viscount Simonds LC.

<sup>37</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 203.

<sup>38</sup> *Ibid*, at paras 204 and 212.

commission or continuance of any act which would suffice to support a petition under the section.<sup>39</sup>

- (v) The section did not cover personal representatives. The Jenkins Committee recommended express provision within the section entitling personal representatives to present a petition under the section.<sup>40</sup>

7.9 One additional point is that the courts excluded negligence and mismanagement from the types of conduct falling within the term “oppression”.<sup>41</sup> However, it is not clear whether the Jenkins Committee intended the remedy to be available in cases of mismanagement.<sup>42</sup>

7.10 The Jenkins Committee recognised, as had the Cohen Committee, that it was impossible to frame a recommendation to cover every case. However, illustrations were given of the types of situations in which action under section 210 might be appropriate, such as the excessive remuneration of directors,<sup>43</sup> which might lead to non payment or payment of inadequate dividends to members; the issue of shares to directors and others on advantageous terms; directors, with power under the articles to refuse to register personal representatives, forcing personal representatives to sell their shares to

<sup>39</sup> *Ibid*, at para 208.

<sup>40</sup> *Ibid*, at para 209.

<sup>41</sup> See *Re Five Minute Car Wash Service Ltd* [1966] 1 WLR 745. In this case, Buckley J, in dismissing the petition, concluded that the allegations suggested that the chairman/managing director was “... unwise, inefficient and careless in the performance of his duties as managing director and chairman of the board of the company”. However, he could find in them “... no suggestion that he has acted unscrupulously, unfairly, or with any lack of probity towards the petitioner ..., or that he has overborne or disregarded the wishes of the board of directors, or that his conduct could be characterised as harsh or burdensome or wrongful towards any member of the company”. *Ibid*, at p 752.

<sup>42</sup> The only reference to such cases appears in the Jenkins Committee’s consideration of the rule in *Foss v Harbottle* at para 207 of the report, where they considered the risks in introducing the remedy that now appears in s 461(2)(c). See further para 7.11 below. However, the question whether the court should authorise proceedings against a director for breach of his duty of care is a separate question, since the issue in such a case under the statutory remedy is whether the company’s failure to bring such proceedings, not the subject matter of such proceedings, is within the section. On the question of whether mismanagement is now covered under s 459 see paras 9.44-9.48 below.

<sup>43</sup> Which had previously been held by the courts not to constitute oppression; see *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042.

the directors at an inadequate price; and the passing of non-cumulative preference dividends<sup>44</sup> on shares held by the minority.<sup>45</sup>

7.11 The Jenkins Committee also highlighted indirect wrongs to minority shareholders, where a wrong was done to the company and the control vested in the majority was wrongfully used to prevent action being taken against the wrongdoer. They accepted the force of the criticism that the fraud on the minority exception to the rule in *Foss v Harbottle*<sup>46</sup> was too restrictive, and recommended an extension to section 210 to allow the court, upon hearing a petition under the section, to authorise proceedings to be brought against a third party in the name of the company.<sup>47</sup> The Jenkins Committee referred to evidence that the derivative action had been abused in the United States of America, but said:

It is not our intention to encourage litigation in cases in which, for instance, an independent majority has reached a *bona fide* decision to the effect that in the interests of the company as a whole no action should be taken. But we think that the discretion we propose should be given to the Court in such cases and the probable liability for costs of an unsuccessful litigant will be sufficient safeguards against abuse.<sup>48</sup>

7.12 The Jenkins Committee's recommendations formed the basis of what was eventually enacted as section 75 of the Companies Act 1980,<sup>49</sup> which subsequently became sections 459-461<sup>50</sup> of the Companies Act 1985.<sup>51</sup> A further amendment was made by

<sup>44</sup> This is a dividend payable only out of the profits of each year, determined to be distributed in priority to the subordinate class of shares. If such profits are insufficient, the deficiency is extinguished instead of being carried forward as against subsequent profits, as would be the case with a cumulative preferential dividend. The difference means that for the latter, if the dividend for any year is passed, there is still the certainty that it will have to be paid before the subordinate shares get any dividend in the future. With a non cumulative dividend, if any year is passed, the preferential dividend may be entirely lost, as each year is treated as a separate venture. See generally *Palmer's Company Law* (25th ed 1992) para 6.102.

<sup>45</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 205.

<sup>46</sup> See further paras 4.7-4.18 above.

<sup>47</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 206.

<sup>48</sup> *Ibid*, at para 207.

<sup>49</sup> In the report of Standing Committee A, Mr Reginald Eyre, the Under Secretary of State for Trade, confirmed that the clause was based on the recommendations of the Jenkins Committee and implemented the main recommendations made in their report; see Report of Standing Committee A on the Companies Bill [Lords] (1979-80) HC 326, 22 November 1979, col 302. For the full text of s 75 see Appendix D.

<sup>50</sup> Section 75 came into force on 22 December 1980 and ss 459-461 on 1 July 1985.

<sup>51</sup> A distinction between s 459 and s 210, as one writer has pointed out (G Stapledon, "Mismanagement and the Unfair Prejudice Provision" (1993) 14 Co Law 94), is the different focus of the two sections. With the old s 210, the focus was on the motive of the alleged oppressors and the nature of the conduct. Under the new section the test is generally regarded as being concerned with the impact of the conduct upon the petitioner. See *Re Bovey Hotel*

the Companies Act 1989<sup>52</sup> to address the question of the application of the section where the conduct of a company's affairs was unfairly prejudicial to the interests of *all* of its members.<sup>53</sup>

*Ventures Ltd* 31 July 1981 (unreported, Slade J) and *Re RA Noble & Sons (Clothing) Ltd* [1983] BCLC 273, 290-291, *per* Nourse J (“*Re RA Noble*”). For the full text of s 459, prior to its amendment in 1989, see Appendix D.

<sup>52</sup> Section 145, (Sched 19, para 11). The amendments came into force on 4 February 1991.

<sup>53</sup> See *Re a Company (No 00370 of 1987)*, *ex parte Glossop* [1988] 1 WLR 1068, 1073-75, *per* Harman J and *Re Carrington Viyella plc* (1983) 1 BCC 98,951, 98,959, *per* Vinelott J; cf *Re Sam Weller & Sons Ltd* [1990] Ch 682, 688-693, *per* Peter Gibson J.

## **PART 8 RELATIONSHIP WITH JUST AND EQUITABLE WINDING UP**

### **Background**

- 8.1 The remedy under section 122(1)(g) of the Insolvency Act 1986<sup>1</sup> of winding up on just and equitable grounds is important to the consideration of section 459 for two main reasons. First, it is common for section 122(1)(g) to be pleaded in the alternative to section 459.<sup>2</sup> Secondly, the principles developed by the courts in construing the meaning of “just and equitable” in this context have, to a certain extent, been imported into their consideration of the requirements of section 459.<sup>3</sup>
- 8.2 We consider in turn, who may bring a petition under section 122(1)(g),<sup>4</sup> the grounds for a petition under section 122(1)(g),<sup>5</sup> the restrictions on bringing a petition under section 122(1)(g) where an alternative remedy exists,<sup>6</sup> and the practice of pleading sections 122(1)(g) and 459 in the alternative.<sup>7</sup>

### **Who may petition**

- 8.3 Section 124 of the Insolvency Act 1986<sup>8</sup> sets out who may apply for the company to be wound up. Section 124(2) permits an application to be made by any “contributory”<sup>9</sup> who has had shares allotted to him or held by him and registered in his name for at least six months during the 18 months before the commencement of the winding up.<sup>10</sup> Section 124(3) also permits some former members to petition under section 122(1)(g).<sup>11</sup> However, whilst the definition of a contributory obviously

<sup>1</sup> Formerly s 222(f) of the Companies Act 1948. This section was initially taken from a similar ground in the law of partnership. It has existed since the Joint Stock Companies Winding Up Act 1848, and has been in this form since the Companies Act 1862. The Northern Ireland equivalent is art 102(g) of the Insolvency (Northern Ireland) Order 1989.

<sup>2</sup> See further at para 8.18 below.

<sup>3</sup> See further at paras 8.7-8.10 and 9.24 below.

<sup>4</sup> See paras 8.3-8.4 below.

<sup>5</sup> See paras 8.5-8.12 below.

<sup>6</sup> See paras 8.13-8.17 below.

<sup>7</sup> See paras 8.18-8.24 below.

<sup>8</sup> Article 104 of the Insolvency (Northern Ireland) Order 1989.

<sup>9</sup> Section 79 of the Insolvency Act 1986 defines a “contributory” as every person liable to contribute to the assets of a company in the event of its being wound up.

<sup>10</sup> Section 124(2)(b) of the Insolvency Act 1986. This is subject to minor exceptions, which are not relevant for present purposes. Section 124(2)(a) states that a contributory may also present a petition if the number of members is reduced below 2 or if the shares devolved on him through the death of a former owner.

<sup>11</sup> See ss 74 and 76 of the Insolvency Act 1986. A former member is barred from bringing a petition under s 459. This is a difference between s 122(1)(g) and s 459; see para 11.13 below. As discussed at para 20.32 below, this is also different from the position in some

encompasses shareholders who hold partly paid up shares, fully paid up shareholders are not always able to bring winding up proceedings.<sup>12</sup> The courts have held that a fully paid up member who is not liable to contribute has to show that he has a tangible interest in the winding up.<sup>13</sup> Thus there must be a likelihood of surplus assets<sup>14</sup> remaining after the creditors have been paid for distribution amongst the shareholders.<sup>15</sup>

- 8.4 In addition to the above conditions, where misconduct by the petitioner is “causative” of the breakdown in confidence/relations between parties upon which the petition is based the court will not make an order under section 122(1)(g).<sup>16</sup> However, conduct by the petitioner which occurs after relations between the parties have irretrievably broken down would not be a bar to the making of a winding up order on just and equitable grounds.<sup>17</sup>

### **Grounds for a petition**

- 8.5 The court may make an order to wind up a company under section 122(1)(g) of the Insolvency Act 1986 if it “... is of the opinion that it is just and equitable that the company should be wound up”.<sup>18</sup> Strong grounds need to be shown before the court will make a winding up order at the instance of a minority shareholder.<sup>19</sup> In what is

foreign jurisdictions.

<sup>12</sup> Although in *Re Anglesea Colliery Co* (1866) 1 Ch App 555, the court held that a holder of fully paid shares was a contributory.

<sup>13</sup> *Re Rica Gold Washing Co* (1879) 11 Ch D 36 approved in *Re Chesterfield Catering Co Ltd* [1977] Ch 373. However, note the following exception to this rule (although this only applies to prevent the petition from being struck out at an interlocutory stage: *Re Commercial and Industrial Insulations Ltd* [1986] BCLC 191). In *Re Newman and Howard Ltd* [1962] Ch 257, Pennycuik J held that the need to show a tangible interest was qualified when information which would allow the petitioner to determine whether he had such an interest was withheld. See also *Re a Company (No 007936 of 1994)* [1995] BCC 705.

<sup>14</sup> Although note Oliver J’s comments in *Re Chesterfield Catering Co Ltd* [1977] Ch 373 that the tangible interest of a fully paid up shareholder need not necessarily relate to the existence of a surplus, it may be a liability.

<sup>15</sup> See *Farrar’s Company Law* (3rd ed 1991) p 455. See also L S Sealy, “No Relief for the Minority Shareholder” (1995) 16 Co Law 178, 179, where he observes that this rule could leave a petitioner, in some situations, with no remedy to pursue.

<sup>16</sup> See the comments of Lord Oliver in *Vujnovich v Vujnovich* [1990] BCLC 227 (PC), at pp 231-232, citing Lord Cross in *Ebrahimi* [1973] AC 360. Cf Plowman J in *Re Lundie Bros Ltd* [1965] 1 WLR 1051, 1056, where he said that a person could still obtain a winding up order where the breakdown “... has not been caused exclusively by the person seeking to take advantage of it”.

<sup>17</sup> [1990] BCLC 227 (PC), at p 232, *per* Lord Oliver.

<sup>18</sup> Whilst under s 124(1) of the Insolvency Act 1986 such petitions can also be brought by the company, the directors, or creditors, this paper will, in accordance with the terms of reference, only consider petitions brought by a contributory or contributories.

<sup>19</sup> See, for example, *Buckley on the Companies Acts* (14th ed 1981) Vol 1 pp 527-532, and the criticism of s 210(2)(b) made to the Jenkins Committee; see para 7.8(i) above.

now the leading case of *Ebrahimi*,<sup>20</sup> however, the House of Lords considered some of the circumstances in which a winding up order could be so made.

- 8.6 In that case the petitioner and the second respondent (“Nazar”), having been in partnership for a number of years, decided to incorporate. The petitioner and Nazar became directors of the company and soon afterwards Nazar’s son (the third respondent) also became both a director and shareholder. Nazar and his son held the majority of shares. No dividends were paid, and all profits were distributed as directors’ remuneration. There was a breakdown in the relationship between the parties and Nazar and his son, in accordance with the articles, removed the petitioner as director. The petitioner commenced proceedings under both the old section 210 oppression remedy and section 222(f) of the Companies Act 1948 (now section 122(1)(g) of the Insolvency Act 1986) for winding up on just and equitable grounds.
- 8.7 At first instance,<sup>21</sup> Plowman J ordered the company to be wound up.<sup>22</sup> This order was reversed by the Court of Appeal<sup>23</sup> but reinstated by the House of Lords. The decision of the House of Lords is important for two reasons. First, it stresses the wide discretionary jurisdiction which the provision confers on the court.<sup>24</sup> The House of Lords held that the “... tendency to create categories or headings under which cases must be brought if the clause is to apply ...” was “wrong”. “Illustrations may be used, but general words should remain general and not be reduced to the sum of particular instances”.<sup>25</sup> The House of Lords also held that, provided the petitioner was qualified to petition as a shareholder, he was not prevented “... from relying on any circumstances of justice or equity which affect him in his relations with the company, or ..., with the other shareholders”.<sup>26</sup>
- 8.8 Secondly, the House of Lords considered whether the power to order a company to be wound up on the grounds that it was “just and equitable” could be exercised where the members of the company were in substance partners and the court would (if there had been a partnership) have ordered that the partnership be dissolved on the grounds that dissolution of the partnership was just and equitable. Lord Wilberforce said:

<sup>20</sup> [1973] AC 360.

<sup>21</sup> [1970] 1 WLR 1378.

<sup>22</sup> He dismissed the petition under s 210 as not proved and no appeal was made with respect to this finding.

<sup>23</sup> [1971] Ch 799.

<sup>24</sup> The court rejected previous attempts to restrict its operation by reading it *eiusdem generis* with the preceding paragraphs of the section. See *Re Agriculturist Cattle Insurance Co, ex parte Spackman* (1849) 1 Mac & G 170, 174; 41 ER 1228, 1230 and *Re Anglo-Greek Steam Co* (1866) LR 2 Eq 1.

<sup>25</sup> [1973] AC 360, 374-375, *per* Lord Wilberforce.

<sup>26</sup> *Ibid*, at p 375.

The words [“just and equitable”] are a recognition of the fact that a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure ... The “just and equitable” provision does not ... entitle one party to disregard the obligations he assumes by entering a company, nor the court to dispense him from it. It does, as equity always does, enable the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.<sup>27</sup>

8.9 Whilst acknowledging that it was both impossible and undesirable to give an exhaustive definition of the circumstances in which such considerations might arise, the House of Lords indicated that they might include one or more of the following elements:

- (i) an association formed or continued on the basis of a personal relationship, involving mutual confidence — this element will often be found where a pre-existing partnership has been converted into a limited company;
- (ii) an agreement, or understanding, that all, or some (for there may be “sleeping” members<sup>28</sup>), of the shareholders shall participate in the conduct of the business;
- (iii) restriction upon the transfer of the members’ interest in the company — so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.<sup>29</sup>

8.10 The House of Lords noted that the phrase “quasi-partnership” had often been used to describe companies in which one or more of these elements had been found to exist. It indicated that, although convenient, this expression may be confusing.<sup>30</sup> Subsequent

<sup>27</sup> *Ibid*, at p 379.

<sup>28</sup> See Megarry J in *Re Fildes Bros Ltd* [1970] 1 WLR 592, 596.

<sup>29</sup> [1973] AC 360, 379 (footnote added). Lord Wilberforce stressed that the fact that a company was small or private was not enough, as many of these types of companies were based on an association which was purely commercial and the basis of the association would be adequately and exhaustively laid down in the articles. To superimpose such equitable considerations required “something more”. *Ibid*, at p 379.

<sup>30</sup> “[T]he expressions may be confusing if they obscure, or deny, the fact that the parties ... are now co-members in a company, who have accepted, in law, new obligations”. *Ibid*, at p 380, *per* Lord Wilberforce.



cases have, however, continued to use it.<sup>31</sup> Whatever the de-merits of the term “quasi-partnership”, the distinction between companies where equitable considerations arise and those where they do not has been drawn, both in cases where winding up on the just and equitable ground is claimed, and cases where relief from unfairly prejudicial conduct is sought.<sup>32</sup>

8.11 In *Ebrahimi*, although the petitioner had been removed from his directorship under a power valid in law, the circumstances were such that Nazar and his son were not entitled, in equity, to make use of their powers of expulsion and the only just and equitable course was for the company to be wound up. The court could grant relief where it was unjust or inequitable to allow the majority to insist on its strict legal rights.<sup>33</sup>

8.12 Lord Wilberforce also commented on the phrase “bona fide in the interests of the company”. He said that this phrase should not become little more than an alibi for a refusal to consider the merits of a case. On the present facts, it meant little more than “... in the interests of the majority”.<sup>34</sup>

#### **Relief under section 122(1)(g) where an alternative remedy is available**

8.13 Prior to 1948, the court could not grant a winding up order if there was some alternative remedy available to the petitioner.<sup>35</sup> This rule was relaxed following the recommendations of both the Cohen Committee<sup>36</sup> and the Jenkins Committee,<sup>37</sup> and the present position is contained in section 125(2) of the Insolvency Act 1986.<sup>38</sup>

<sup>31</sup> As is illustrated further below, this distinction has also been incorporated into the consideration of cases under s 459; see paras 9.24 and 10.15-10.16 below. It would seem to be the case that as a result of both the judgment in *Ebrahimi* and later jurisprudence, the law on shareholder remedies recognises two types of company, namely the quasi-partnership and other companies.

<sup>32</sup> The distinction is also reflected in the new additional unfair prejudice remedy which we put forward for consultees’ views in Part 18 below.

<sup>33</sup> Lord Wilberforce also rejected the proposition that the section applied only in circumstances where there was deadlock between the parties. [1973] AC 360, 376.

<sup>34</sup> *Ibid*, at p 381; where he considered the argument that the petitioner’s removal from directorship was “in the interests of the company”.

<sup>35</sup> See *Re Professional, Commercial & Industrial Benefit Building Society* (1871) 6 Ch App 856, 862 and *Re Pioneers of Mashonaland Syndicate* [1893] 1 Ch 731. Although no oppression remedy existed at that time, there were a number of other statutory and common law alternatives that a shareholder could pursue, for example, an injunction or an action for breach of contract, or the requisitioning of a meeting.

<sup>36</sup> Report of the Committee on Company Law Amendment (1945) Cmd 6659, para 60.

<sup>37</sup> Report of the Company Law Committee (1962) Cmnd 1749, paras 199 and 503(i).

<sup>38</sup> Article 105(2) of the Insolvency (Northern Ireland) Order 1989.

Section 125(2)<sup>39</sup> provides that if a petition is presented under the just and equitable ground:

... the court, if it is of opinion —

(a) that the petitioners are entitled to relief either by winding up the company or by some other means, and

(b) that in the absence of any other remedy it would be just and equitable that the company should be wound up,

shall make a winding up order; but this does not apply if the court is also of the opinion both that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy.<sup>40</sup>

The effect of this section is to impose “... a mandatory duty on the court to make a winding up order with a discretion not to make one if ... it is of the opinion that [the petitioner] has another available remedy and is unreasonably failing to pursue it”.<sup>41</sup>

8.14 Whether a petitioner will be held to be acting unreasonably under the proviso in section 125(2) if he does not pursue a remedy under section 459, will depend on the facts of the case.<sup>42</sup> It often arises that a petitioner seeks both a winding up on just and equitable grounds and relief under section 459 and the court is then invited to strike out those parts of the petition relating to winding up on the basis of the proviso. It may well not be possible for the court to decide this issue on an interlocutory application.<sup>43</sup>

<sup>39</sup> Previously s 225(2) of the Companies Act 1948.

<sup>40</sup> The proviso recognises that whilst the courts should have the discretion to make a winding up order if they consider it just and equitable to do so, it should necessarily be a remedy of last resort. One reason for this was mentioned by Nourse J in *Re Bird Precision Bellows Ltd* [1984] Ch 419, 428, where he said “... except perhaps in cases such as those of property and investment companies, the net benefit to a minority shareholder in a liquidation will often, perhaps usually, be less than the price which he would receive for his shares on a discounted basis”.

<sup>41</sup> *Vujnovich v Vujnovich* [1990] BCLC 227 (PC), at p 232, *per* Lord Oliver. The Jenkins Committee had expressed the view that “... the Court should be completely free in the exercise of its discretion to wind up a company on the ground that it would be just and equitable to do so”; see Report of the Company Law Committee (1962) Cmnd 1749, para 503(i). Notwithstanding the mandatory duty, it is the discretion mentioned by Lord Oliver that is the determining factor and which arguably achieves the right balance as to when a winding up on just and equitable grounds will be available.

<sup>42</sup> *Re a Company (No 001363 of 1988)*, *ex parte S-P* [1989] BCLC 579, 586. See also the decision of the Privy Council in *Vujnovich v Vujnovich* [1990] BCLC 227 (PC), where they considered the applicability of the New Zealand equivalent of s 125(2).

<sup>43</sup> *Re a Company (No 001354 of 1991)* 20 August 1992 (unreported, CA); and see *Re a Company (No 001363 of 1988)*, *ex parte S-P* [1989] BCLC 579, 586, *per* Warner J.

- 8.15 The court will not only consider whether the petitioner is behaving unreasonably in failing to pursue a remedy under section 459, but also the availability of other non statutory remedies. It has been held that such a remedy can include the rejection by a petitioner of a fair offer made to purchase his shares. In *Re a Company (No 002567 of 1982)*,<sup>44</sup> the petitioner was willing to sell his shares to the respondents if a fair price could be agreed, taking into account compensation for loss of office and loss of employment. The parties could not agree a price and the petitioner presented a petition to wind up the company on the just and equitable ground. The respondents subsequently offered to buy the shares at a fair market value fixed by an independent expert and not discounted to reflect a minority holding. The petitioner rejected the offer. On the facts it was held that the petitioner was acting unreasonably in refusing the respondents' subsequent offer to purchase his shares at a value reached by machinery which met all his reasonable objections.<sup>45</sup>
- 8.16 A similar approach has been adopted in subsequent cases involving applications under section 459. In *Re a Company (No 003096 of 1987)*<sup>46</sup> one of the petitioner's applications before the court was for leave to amend the petition to include, as an alternative to winding up under section 122(1)(g), relief under section 459.<sup>47</sup> The petitioners did not dispute that a fair offer had been made for their shares, but did dispute that they should leave the company. The court held that there had been an irretrievable breakdown in the relationship of the parties and that there had to be a parting of the ways. The main question was which party should leave and whether it was plain and obvious that it was the petitioners. On the evidence before the court it was plain and obvious<sup>48</sup> and because a fair offer had been made for their shares which they had unreasonably refused, the petition was bound to fail and leave to amend was refused.
- 8.17 The conclusion which seems to be drawn from the above cases is that, if a fair offer is made that meets all of the petitioner's reasonable objections, then it is possible,

<sup>44</sup> [1983] 1 WLR 927.

<sup>45</sup> This approach was subsequently followed in *Re a Company (No 003843 of 1986)* [1987] BCLC 562 and *Re a Company (No 003096 of 1987)* (1988) 4 BCC 80. Note, however, that a petitioner's desire to continue participating in the company's business may make it reasonable to pursue a winding up petition, even when a remedy under s 459 is sought or a fair offer made. See *Re a Company (No 001354 of 1991)* 20 August 1992 (unreported, CA).

<sup>46</sup> (1988) 4 BCC 80.

<sup>47</sup> Another was an application by the respondents to strike out the petition.

<sup>48</sup> The court relied on various factors: there were no allegations of impropriety in the running of the company and the petitioners had from time to time been prepared to contemplate the purchase of their shares, whereas this had never been the case with respect to the respondents. See also *Re a Company (No 003843 of 1986)* [1987] BCLC 562.

depending on the facts of the case,<sup>49</sup> that he will not get relief either under section 122(1)(g) or under sections 459-461.<sup>50</sup>

### **Pleading section 122(1)(g) and section 459 in the alternative**

#### *Reasons for pleading in the alternative*

- 8.18 Section 122(1)(g) is commonly pleaded in the alternative to section 459 for three main reasons.<sup>51</sup> First, facts which satisfy the test under section 459, may not necessarily satisfy the test under section 122(1)(g) and vice versa.<sup>52</sup> Secondly, winding up is not available as a remedy under sections 459-461.<sup>53</sup> Pleading the two in the alternative therefore gives the court more flexibility to deal with the case. Thirdly, it may put pressure on the majority in the company.<sup>54</sup>

#### *Effect of pleading winding up in the alternative — section 127 of the Insolvency Act 1986*

<sup>49</sup> Matters that appear to be relevant are whether it is obvious that the petitioner should be the one to go and whether there are any allegations of impropriety on the part of the respondents. See also *Re a Company (No 001354 of 1991)* 20 August 1992 (unreported, CA), where an allegation that assets had been misappropriated was a factor taken into account by the court in refusing to strike out a petition under s 122(1)(g) where what was said to be a fair offer had been made. Cf the decision of Millett J in *Re a Company (No 003843 of 1986)* [1987] BCLC 562, 571, where he held that claims of impropriety by the directors could be taken into account by a valuer in valuing shares in the company.

<sup>50</sup> However, note the approach of the courts, discussed further at paras 9.49-9.52 below, where a provision exists in the company's articles for valuation of a member's shares.

<sup>51</sup> Initially, one of the reasons for pleading these remedies in the alternative was the difficulty of obtaining a remedy under s 210. The amendment to the section in 1980 removed this reason. Of 156 petitions under s 459 presented at the High Court during 1994 and 1995, just under 40% pleaded s 122(1)(g) in the alternative. See Appendix E, Table 1.

<sup>52</sup> Contrast the cases of *Re RA Noble* [1983] BCLC 273 and *Re a Company (No 00314 of 1989)*, *ex parte Estate Acquisition and Development Ltd* [1991] BCLC 154. For the facts of *Re RA Noble*, see para 9.29, n 60 below. In this case, the petition failed to satisfy the s 459 test, *inter alia*, on the basis that the treatment of the petitioner whilst prejudicial, was not unfair. His exclusion from participation in the company's affairs was to a large extent due to his own lack of interest. A winding up order was nevertheless made because the mutual confidence in the personal relationship between the parties had been destroyed and the *Ebrahimi* test was satisfied. In *Re a Company (No 00314 of 1989)*, *ex parte Estate Acquisition and Development Ltd*, the petitioner became a director of a company, later acquiring a minority shareholding. She was subsequently made an offer for her shares by a co-director, who shortly afterwards suggested that she resign as a director. The petition complained of several attempts to alter the memorandum and articles, proposals to remove the petitioner as a director and appoint other directors, exclusion from management and failure to provide information. On a strike out application, Mummery J struck out those parts of the petition seeking a winding up order on the basis that the *Ebrahimi* test was not satisfied. The petition did not allege that the company had been formed out of any special relationship of mutual confidence, or that there was any special obligation entitling the petitioner to continue to participate in management. However, he held that the totality of the allegations relating to whether the petitioner's complaint would satisfy the test under s 459 was not so clearly unarguable and that part of the claim was not struck out. (Note, however, that the s 459 petition failed at the full hearing before Ferris J: see *Re a Company (No 00314 of 1989)*, *ex parte Estate Acquisition and Development Ltd* [1995] BCC 338.)

<sup>53</sup> See *Re Full Cup International Trading Ltd* [1995] BCC 682. For further consideration of this issue see paras 20.24-20.28 below.

<sup>54</sup> See paras 8.19-8.21 below.

- 8.19 Seeking a winding up order in the alternative to relief under section 459 can have serious consequences for the company's business. This is because of the effect of section 127 of the Insolvency Act 1986,<sup>55</sup> which provides that any disposition of the company's property made after the commencement of the winding up is void unless the court otherwise orders. The winding up is deemed to have commenced at the time of the presentation of the petition.<sup>56</sup>
- 8.20 The effect of section 127 is that any payments out of the company's bank account after presentation of the petition can be set aside and reclaimed by the liquidator once the company has been wound up.<sup>57</sup> In practice this means that as soon as a bank receives notice of a winding up petition it will freeze the company's bank accounts.<sup>58</sup> As a general rule, however, unless a contributory can adduce compelling evidence proving a disposition likely to injure the company, the court will validate a transaction which falls within the powers of the directors where there is evidence that it is necessary or expedient in the opinion of the directors in the interests of the company, and the reasons given for it are ones which an intelligent and honest man could reasonably hold.<sup>59</sup> Furthermore, it is open to the company to apply to the court to validate payments in advance.
- 8.21 If the making of such an order is contested, this may involve the company in the expense both in time and money of a contested court hearing.<sup>60</sup> Historically, the tactic of pleading a winding up petition as an alternative to section 459, even where this was not an appropriate remedy, allowed the petitioner to put the maximum pressure possible on the respondents to settle the case as soon as possible.<sup>61</sup>

<sup>55</sup> Article 107 of the Insolvency (Northern Ireland) Order 1989.

<sup>56</sup> Section 129 of the Insolvency Act 1986.

<sup>57</sup> *Re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711.

<sup>58</sup> See the comments of Warner J in *Re a Company (No 001363 of 1988), ex parte S-P* [1989] BCLC 579, 586 and Hoffmann J in *Re XYZ Ltd* [1987] 1 WLR 102, 110. See also the recent case of *Re Doreen Boards Ltd* [1996] 1 BCLC 501.

<sup>59</sup> See the comments of Slade J in *Re Burton & Deakin Ltd* [1977] 1 WLR 390. The guidelines in this case were in relation to winding up petitions in solvent companies; *ibid*, at p 396. The case concerned a contributory's petition and the reasoning behind the guidelines, together with the facts of the case, suggest that the test was only to be applied on validation orders relating to contributories' petitions.

<sup>60</sup> In addition, see the comments of Warner J in *Re a Company (No 001363 of 1988), ex parte S-P* [1989] BCLC 579, 586 that such a hearing puts the directors to the cost and trouble of collecting and submitting evidence to demonstrate to the court that the company is solvent and able to pay its debts. See also *Re Ringtower Holdings plc* [1989] BCLC 427.

<sup>61</sup> There is also the possibility that contracts or leases taken out by the company may provide for that contract/lease to be determined where such proceedings had been commenced. Although we understand that this rarely occurs now in practice, practitioners inform us that such clauses in agreements are regarded as oppressive and unreasonable.

*1990 practice direction*<sup>62</sup>

- 8.22 A practice direction in 1990<sup>63</sup> discouraged the practice of pleading the two petitions in the alternative. The direction stated that it was undesirable to include as "... a matter of course, a prayer for winding up as an alternative to an order under section 459 ... It should be included only if that is the relief which the petitioner prefers or if it is considered that it may be the only relief to which he is entitled".
- 8.23 The practice direction also introduced a standard section 127 validation order. The effect of such an order is that, notwithstanding the presentation of the petition, payments made out of the company's bank accounts, or dispositions of the property of the company made for proper value in the ordinary course of the business of the company between the date of presentation of the petition and the date of judgment or further order, in the meantime, shall not be void by virtue of section 127 in the event of a winding up order being made. The petitioner now has to state in advance whether he consents or objects to a section 127 validation order in the standard form. If the petitioner does consent, the registrar will make the validation order without further inquiry, unless a judge has otherwise ordered in the meantime. If the petitioner objects, the company may make an application, *ex parte* if urgent, to the judge for an order.
- 8.24 The practice direction has alleviated some of the earlier difficulties for companies, where the effects of section 127 were overlooked or ignored by the petitioner.<sup>64</sup> However, a section 127 validation order still restricts companies to transactions in the normal course of business. In respect of all other matters, the parties have to go back to the court for authorisation. With the real possibility of a considerable amount of time passing between the presentation of the petition and the final disposal of the case, this restriction can have adverse effects on the smooth running of the company.<sup>65</sup>

<sup>62</sup> There is no equivalent practice note in Scottish procedure, thus, there is no standard s 127 validation order. Similarly, there is no equivalent in Northern Ireland.

<sup>63</sup> Practice Direction (Ch D) (Companies Court: Contributory's Petition) [1990] 1 WLR 490.

<sup>64</sup> However, despite the existence of the practice direction, there would still seem to be occasions where parties omit to include a statement about the applicability of s 127 relief in the petition. See *Re Whitchurch Insurance Consultants Ltd* [1993] BCLC 1359, 1361, *per* Harman J.

<sup>65</sup> See *Re a Company (No 001354 of 1991)* 20 August 1992 (unreported, CA). However, this restriction will probably only cause difficulties in unusual cases in practice.

# **PART 9 SUBSTANTIVE REQUIREMENTS FOR UNFAIR PREJUDICE REMEDY**

## **Introduction**

### 9.1 Section 459(1) states:

A member of a company may apply to the court by petition for an order under this Part<sup>1</sup> on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial<sup>2</sup> to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

### 9.2 In this part we examine these requirements under the following headings:

- (i) Meaning of “affairs are being or have been conducted”;<sup>3</sup>
- (ii) What constitutes “the company's affairs”;<sup>4</sup>
- (iii) Meaning of “interests”;<sup>5</sup>
- (iv) Meaning of “unfairly prejudicial”;<sup>6</sup>
- (v) Meaning of “some part of the members or members generally (including at least himself)”;<sup>7</sup>
- (vi) Review of effect of different allegations brought under section 459;<sup>8</sup>
- (vii) Effect of pre-emption articles on a petitioner's ability to bring proceedings under section 459;<sup>9</sup>
- (viii) Instances of the involvement of public companies in section 459 proceedings.<sup>10</sup>

<sup>1</sup> Ie Part XVII of the Companies Act 1985.

<sup>2</sup> The phrase “unfairly prejudicial” is not exclusive to s 459. Note two comparable provisions in s 27 of the Insolvency Act 1986 and s 127 of the Companies Act 1985. See paras 12.3-12.8 and 12.16-12.17 below on these and other examples.

<sup>3</sup> See paras 9.3-9.4 below.

<sup>4</sup> See paras 9.5-9.16 below.

<sup>5</sup> See paras 9.17-9.20 below.

<sup>6</sup> See paras 9.21-9.30 below.

<sup>7</sup> See paras 9.31-9.32 below.

<sup>8</sup> See paras 9.33-9.48 below.

<sup>9</sup> See paras 9.49-9.52 below.

<sup>10</sup> See paras 9.53-9.54 below.

### **Meaning of “affairs are being or have been conducted”**

- 9.3 Section 459 allows a member to petition not only where the unfairly prejudicial conduct is continuing, but also where the conduct has finished by the time of the presentation of the petition.<sup>11</sup>
- 9.4 In addition, the section allows a member to petition in respect of threatened future conduct. It will generally be sufficient that the act has been proposed and, if carried out or completed, would be unfairly prejudicial.<sup>12</sup> But the proposal must be at a sufficiently advanced stage, mere discussions which could result in a proposal being tabled at a future meeting are unlikely to provide sufficient grounds for a successful petition.<sup>13</sup>

### **What constitutes “the company’s affairs”**

- 9.5 There is no definition within the Companies Act 1985 of what constitutes the “company’s affairs”, in the context of section 459. In *Re a Company (No 001761 of 1986)*,<sup>14</sup> Harman J made the distinction between conduct “in the company” and conduct “dehors” the company. In that case the main allegation was that the respondent shareholder had paid off the company’s bank loan and taken a transfer of the bank’s security. It was held that this was an act by the respondent in her personal capacity. It amounted merely to a change in the identity of the mortgagee and did not affect the mortgagor company’s position.<sup>15</sup>
- 9.6 Other examples can be given. The actions of a director who, like the petitioner, is a 50 per cent shareholder and who sets up a rival business and siphons work off to the new company has been found to be misconduct of the affairs of the company whose

<sup>11</sup> See Harman J’s comments in *Re a Company (No 001761 of 1986)* [1987] BCLC 141, 143 that “[i]t is not going to be a defence to a s 459 petition to say that the conduct of which complaint is made has ceased six months before the petition was presented ...”. But note Peter Gibson J’s comments in *Re DR Chemicals Ltd* [1989] BCLC 383, 397-398 that laches may bar relief on a s 459 petition, although such a delay must have been inexcusable.

<sup>12</sup> See *Re Kenyon Swansea Ltd* [1987] BCLC 514 and *Whyte, Petitioner* 1984 SLT 330. Both cases concerned resolutions tabled at meetings to amend articles, which, if carried, would have had unfairly prejudicial consequences for the minority shareholders. In both cases the court granted an injunction to restrain the meeting.

<sup>13</sup> *Re a Company (No 004475 of 1982)* [1983] Ch 178. In this case, the majority in a private family company wanted to use the company’s assets to buy a wine bar, although no final decision had been made on this. The minority shareholders were executors holding shares on behalf of the testator’s two young children. They wished to sell the shares to put the children through school. They alleged, inter alia, that the suggested purchase was unfairly prejudicial as the company’s liquid resources might then be insufficient to buy out the shareholding. The court held that their petition, in so far as it related to this allegation, was premature as it had not yet been decided if the proposal was to be adopted.

<sup>14</sup> [1987] BCLC 141.

<sup>15</sup> Examples of other acts held to be personal rather than conduct of the company’s affairs, were rude and aggressive behaviour towards both customers and staff and asking the secretary to park the director’s car: *Re a Company (No 001761 of 1986)* [1987] BCLC 141, 145. See further *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609 at para 9.16 below.



interests are thus subordinated.<sup>16</sup> But the actions of a director who steals from the company safe are not those of the company and in removing the money the director cannot be said to be conducting the company's affairs. However, the position would be different if the board took no action as a result.<sup>17</sup>

9.7 So far as shareholders are concerned, a distinction is drawn between their votes as members, which are a private right<sup>18</sup> and can be exercised as they choose,<sup>19</sup> and the resolution itself, which is an act of the company and can, in certain circumstances, found the basis of a section 459 petition.<sup>20</sup>

9.8 Two particular types of situation have given rise to difficulty. The first concerns parent companies. The second relates to shareholder agreements.

#### *Parent companies*

9.9 The issue here is whether conduct of the affairs of a parent company as majority shareholder in a subsidiary can be conducted in the affairs of the subsidiary. This appears to be of particular relevance where the subsidiary contains an independent minority of shareholders. It clearly has implications in certain limited circumstances for the freedom of the parent company to run its affairs.

9.10 In *SCWS v Meyer*<sup>21</sup> the petitioners were minority shareholders and two of the five directors of a textile company ("the subsidiary"). The other three directors were nominees of the holding company and majority shareholder, the Scottish Co-operative Wholesale Society ("the parent company"). They were also directors of the parent company. When the parent company no longer needed the subsidiary for the purposes of its own business, it deliberately ran down the subsidiary's business and started a similar business itself. It instructed its factory only to offer supplies to the subsidiary at excessive prices. Although the nominee directors knew of this policy, they did not pass the information on to the petitioners and did nothing to stop it. The shares in the subsidiary became worthless.

<sup>16</sup> *Re Stevarts (Brixton) Ltd* [1985] BCLC 4.

<sup>17</sup> See the comments of Harman J in *Re a Company (No 001761 of 1986)* [1987] BCLC 141, 148.

<sup>18</sup> *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC). This principle is subject to the qualifications described in para 2.38 above.

<sup>19</sup> *Re Ringtower Holdings plc* [1989] BCLC 427, 449, *per* Peter Gibson J and *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 611, *per* Harman J.

<sup>20</sup> *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 611, *per* Harman J. See also his later comments at pp 622-23 that a shareholder could act with malice when voting his shares against a resolution. Arguably, Harman J goes too far with this particular proposition. See D D Prentice, "Restraints on the Exercise of Majority Shareholder Power" (1976) 92 LQR 502.

<sup>21</sup> [1959] AC 324.

- 9.11 The House of Lords held that the parent company had acted towards the petitioners in an oppressive manner and that this conduct, through the nominee directors, amounted to conduct in the affairs of the subsidiary. “By subordinating the interests of the [subsidiary] to those of the [parent company], [the nominee directors] conducted the affairs of the [subsidiary] in a manner oppressive to the other shareholders”.<sup>22</sup> The court considered the point that the directors had not actively done anything oppressive to the minority, but held that “... the affairs of the company can ... be conducted oppressively by the directors doing nothing to defend its interests when they ought to do something — just as they can conduct its affairs oppressively by doing something injurious to its interests when they ought not to do it”.<sup>23</sup>
- 9.12 The reasoning of the House of Lords in the above case was developed further in *Nicholas v Soundcraft Electronics Ltd*.<sup>24</sup> This case involved a parent company’s failure to pay amounts to a subsidiary due in respect of sales of the subsidiary’s products effected by the parent company. Unlike in *SCWS v Meyer*, the two companies were not in the same line of business. However, the parent did exert a large degree of control over the subsidiary.<sup>25</sup> The court was satisfied that on the facts the parent company’s control over the subsidiary was such that decisions made by the parent company amounted to conduct of the subsidiary’s affairs.<sup>26</sup>
- 9.13 The above cases illustrate that in section 459 proceedings the court has regard to “... the business realities of a situation”.<sup>27</sup>

#### *Shareholder agreements*

- 9.14 Shareholder agreements are likely to be relevant to proceedings under section 459.
- 9.15 When the court examines whether the conduct of which complaint is made is wrongful, the court has to consider the parties’ rights under the articles and other agreements

<sup>22</sup> *Ibid*, at p 367, *per* Lord Denning.

<sup>23</sup> *Ibid*, at p 367, *per* Lord Denning.

<sup>24</sup> [1993] BCLC 360.

<sup>25</sup> As Fox LJ said: “[the parent company] was, in effect, treating the financial affairs of the two companies as that of a single enterprise over which it had control”. Elements of control included key areas such as administration of export sales; personnel recruitment; supervision of the subsidiary by non executive directors appointed by the holding company; negotiating overdraft borrowing limits for the group; and supervision of finances by the holding company’s finance director. *Ibid*, at pp 363-364.

<sup>26</sup> However, such conduct was not unfairly prejudicial. It was in the interests of the parent company, which was in financial difficulty, to delay payment in order to keep the group afloat. *Ibid*, at p 366.

<sup>27</sup> *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360, 368, *per* Ralph Gibson LJ and see also *SCWS v Meyer* [1959] AC 324, 343, *per* Viscount Simonds. For consideration of the issue of multiple derivative actions see para 16.51 below.

which govern the relationship between the shareholders.<sup>28</sup> Likewise, when the court determines whether there are mutual understandings between the parties which are not expressed in the articles, or any oral or written agreements, the court will have regard to what was actually agreed between the shareholders.

- 9.16 However, actions by shareholders under private contractual agreements may not constitute conduct in “the affairs of the company”. In *Re Unisoft Group Ltd (No 3)*,<sup>29</sup> the court struck out paragraphs in the petition concerning allegations about the activities of shareholders under a shareholder agreement. The court did not consider that these allegations related to the ordinary conduct of the affairs of the company.

### **Meaning of “interests”**

- 9.17 Under section 459, a petitioner must show that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally, including at least himself. The fact that the word “interests” is wider than the strict legal rights of a member has frequently been recognised in the cases.<sup>30</sup> It is also important to any consideration of the meaning of this term to recognise that it is impossible to separate the concept of “unfairness” from that of “interests”. As the case law considered below illustrates, these terms taken together are what gives the section its breadth of application.

- 9.18 However, it is clear that the word “interests” is not intended to include every interest of a petitioner. It must be the petitioner’s interests *as a member* (or “qua member”) which must have been unfairly prejudiced. This restriction was recognised by Lord Grantchester QC in the first reported case under section 75 of the Companies Act 1980,<sup>31</sup> *Re a Company (No 004475 of 1982)*,<sup>32</sup> in the following terms:

... in passing section 75 [of the Companies Act 1980], Parliament did not intend to give a right of action to every shareholder who considered that some act or omission by his company resulted in unfair prejudice to himself ... In my judgment section 75 is to be construed as confined to “unfair prejudice” of a petitioner “qua

<sup>28</sup> *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155, 238.

<sup>29</sup> [1994] 1 BCLC 609. According to the report of the case, there seem to have been no allegations of facts that could give rise to “legitimate expectations” (on which, see paras 9.24-9.25 below). See also para 11.10, n 40, for further comments of the court in this case.

<sup>30</sup> *Re a Company (No 00477 of 1986)* [1986] BCLC 376, 378, *per* Hoffmann J; *Re a Company (No 008699 of 1985)* [1986] BCLC 382, 387, *per* Hoffmann J; *Re Blue Arrow plc* [1987] BCLC 585, 590, *per* Vinelott J; *Re Ringtower Holdings plc* [1989] BCLC 427, 437, *per* Peter Gibson J; *Re a Company (No 00314 of 1989)*, *ex parte Estate Acquisition and Development Ltd* [1991] BCLC 154, 160, *per* Mummery J.

<sup>31</sup> Now s 459 of the Companies Act 1985.

<sup>32</sup> [1983] Ch 178.

member”; or, put in another way, the word “interests” in section 75 is confined to “interests of the petitioner as a member”.<sup>33</sup>

9.19 Thus, for example, in *Re JE Cade & Son Ltd*<sup>34</sup> the petitioner was the freeholder of a farm which had been farmed rent free by a family company, of which he was a minority shareholder, on the basis that no tenancy would be created.<sup>35</sup> Contrary to the agreement, the majority shareholder later asserted that the company’s occupation of the premises was protected under the Agricultural Holdings Act 1986. The petitioner started possession proceedings, but also issued a petition under section 459. On the respondents’ application the petition was struck out. The court held that in seeking possession of the farm the petitioner was pursuing his interests as a freeholder of the farm and not his interests as a member of the company.<sup>36</sup>

9.20 However, as we shall see when we come to consider the meaning of “unfairly prejudicial”,<sup>37</sup> in companies where there are considerations of a personal character between shareholders which make it unjust to insist on legal rights,<sup>38</sup> and where shareholders took their shares on the basis that they would be entitled to participate in the management of the company, their interests may include an expectation that they will continue to be involved in the management of the company.

#### **Meaning of “unfairly prejudicial”**

9.21 As was discussed earlier,<sup>39</sup> section 210 of the Companies Act 1948 used the word “oppression” and was restrictively interpreted by the courts, which led the Jenkins Committee to recommend the introduction of the phrase “unfairly prejudicial”. The aim of the Jenkins Committee was to afford more effective protection to minority shareholders and they were anxious that the section extended to cases “... in which the

<sup>33</sup> *Ibid*, at p 189.

<sup>34</sup> [1992] BCLC 213.

<sup>35</sup> This was part of a larger arrangement involving the disposal of a number of former partnership assets.

<sup>36</sup> The court also pointed out that the petitioner’s interests as a freeholder were in fact adverse to his interests as a member of the company. For another example of what the court has held not to constitute an interest of the petitioner qua member, see *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 626, *per* Harman J.

<sup>37</sup> See paras 9.21-9.30 below.

<sup>38</sup> See *Ebrahimi* [1973] AC 360.

<sup>39</sup> See para 7.8(iii) above.

acts complained of fall short of actual illegality“.<sup>40</sup> In *Saul D Harrison*,<sup>41</sup> the Court of Appeal laid down guidelines as to when conduct will be “unfairly prejudicial”.

9.22 In that case, Hoffmann LJ accepted that the test of unfairness was objective but he considered that rather than referring to a “reasonable bystander” it was more useful “... to examine the factors which the law actually takes into account in setting the standard”.<sup>42</sup> In his judgment “... keeping promises and honouring agreements is probably the most important element of commercial fairness ...”,<sup>43</sup> therefore, the starting point in any case under section 459 will be to ask whether or not the conduct is in accordance with the articles of association. He further held that:

The answer to this question often turns on the fact that the powers which the shareholders have entrusted to the board are fiduciary powers, which must be exercised for the benefit of the company as a whole. If the board act for some ulterior purpose, they step outside the terms of the bargain between the shareholders and the company ... This seems to me in principle the correct point at which to start the inquiry into both whether the conduct in question could justify a just and equitable winding up and also whether it is unfair for the purposes of section 459.<sup>44</sup>

9.23 Hoffmann LJ also held that conduct could be unlawful but, nevertheless, might not be unfairly prejudicial, so it followed that “... trivial or technical infringements of the articles were not intended to give rise to petitions under section 459”.<sup>45</sup>

9.24 As for the circumstances in which lawful conduct which might form the basis of a successful petition, Hoffmann LJ held that this could be the case where the articles did not “ ... fully reflect the understandings upon which the shareholders [were]

<sup>40</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 203.

<sup>41</sup> [1995] 1 BCLC 14. The case involved a company incorporated in 1947 and run by four brothers. There was various restructuring of the shares over the years and at the time of the petition there were 3 main types of shares: A, B and C Ordinary shares, all of which were fully paid up, although only the A shares carried voting rights, with no right to a dividend or to company assets should the company be wound up. With respect to profits, these produced a percentage dividend to the B and C shares, which also had various rights should the company be wound up. The main allegation was that the directors and holders of the A shares were running the company solely for their own benefit and were ignoring the interests of, inter alia, the C shareholders, of which the petitioner was one. The A shareholders were being remunerated as directors, but, because of the poor performance of the company, no dividends were being paid to the B and C shareholders.

<sup>42</sup> *Ibid*, at p 17.

<sup>43</sup> *Ibid*, at p 18.

<sup>44</sup> *Ibid*, at p 18.

<sup>45</sup> *Ibid*, at p 18.

associated”.<sup>46</sup> He said that Lord Wilberforce “... drew attention to such cases ...”<sup>47</sup> in *Ebrahimi*<sup>48</sup> and that the same concept of unfairness applied in section 459 cases as formed the basis of a just and equitable winding up.<sup>49</sup> In such cases shareholders could have what he referred to as a “legitimate expectation” that the board would not exercise the powers conferred on it in the articles.

9.25 Neill LJ thought that the protection offered by section 459 would have to be worked out on a “case by case basis”,<sup>50</sup> but considered that some guidelines as to the correct approach to the concept of “unfairly prejudicial” had been developed. He set them out in ten paragraphs.<sup>51</sup> Among his points were the following: the words “unfairly prejudicial” should be applied flexibly;<sup>52</sup> that the width of the jurisdiction meant it should be carefully controlled or it could itself be a means of oppression; the conduct complained of must be both prejudicial and unfairly so;<sup>53</sup> the petitioner’s legal rights were to be found in the memorandum and articles because they constituted the contract setting out his rights and liabilities as a shareholder; that the court should take account not only of his legal rights but also consider whether there were any equitable considerations “... such as the petitioner’s legitimate expectations ...”<sup>54</sup> which could arise from agreements or understandings between members or between members and directors and that similar considerations to those explained by Lord Wilberforce in *Ebrahimi* are capable of being introduced into section 459 cases by the concept of fairness in the phrase “unfairly prejudicial”. Moreover, a managerial decision would be unlikely to amount to unfairly prejudicial conduct even if it damaged the petitioner’s interest, although it was open to the court to find unfair prejudice if serious mismanagement occurred.

<sup>46</sup> *Ibid*, at p 19.

<sup>47</sup> *Ibid*, at p 19.

<sup>48</sup> [1973] AC 360, 379 and see para 8.9 above.

<sup>49</sup> Hoffmann LJ accepted Lord Wilberforce’s comment in *Ebrahimi* that “[i]t would be impossible, and wholly undesirable, to define the circumstances in which these considerations may arise”. *Ibid*, at p 379.

<sup>50</sup> [1995] 1 BCLC 14, 30.

<sup>51</sup> *Ibid*, at pp 30-32.

<sup>52</sup> He also emphasised the difference between the remedies available under s 122(1)(g) and s 459. He cited with approval Mummery J in *Re a Company (No 00314 of 1989), ex parte Estate Acquisition and Development Ltd* [1991] BCLC 154, 161, who said: “Under ss 459 to 461 the court is not, therefore, faced with a death sentence decision dependent on establishing just and equitable grounds for such a decision. A court is more in the position of a medical practitioner presented with a patient who is alleged to be suffering from one or more ailments which can be treated by an appropriate remedy applied during the course of the continuing life of the company”.

<sup>53</sup> See also Peter Gibson J in *Re Ringtower Holdings plc* [1989] BCLC 427, 437.

<sup>54</sup> [1995] 1 BCLC 14, 31.

- 9.26 The Court of Appeal unanimously upheld Vinelott J's decision at first instance to strike out the petitioner's claim.<sup>55</sup> Although the company had traded unsatisfactorily, the directors had made some changes and considered that the business was viable and capable of expansion. The court was satisfied that there was no basis for alleging that the company had conducted its affairs in an unfairly prejudicial manner.
- 9.27 More recently, in *Re BSB Holdings Ltd (No 2)*,<sup>56</sup> Arden J, having reviewed the judgments in the above case, said:

... in my judgment, it is not the effect of *Re Saul D Harrison & Sons plc* that a remedy under section 459 can be given only if the directors have acted in breach of duty or if the company has breached the terms of its articles or some other relevant agreement. These matters constitute in most cases the basis for deciding what conduct is unfair. But the words of the section are wide and general and ... the categories of unfair prejudice are not closed. The standards of corporate behaviour recognised through section 459 may in an appropriate case thus not be limited to those imposed by enactment or existing case law.<sup>57</sup>

*Conduct of petitioner*<sup>58</sup>

- 9.28 Unlike the "just and equitable" winding up remedy, section 459 is not an equitable jurisdiction. There is, therefore, no requirement that the petitioner come to court with "clean hands".<sup>59</sup> However, the conduct of the petitioner will always be an important factor, because the court will examine all the facts of the case and weigh the conduct of the petitioner and that which is alleged to be unfairly prejudicial.
- 9.29 The consequence of this balancing act may be that if both parties have acted equally unreasonably the respondent's conduct will not be found to be unfair.<sup>60</sup> However, this

<sup>55</sup> The third member of the court, Waite LJ, concurred with the judgments of Hoffmann and Neill LJJ.

<sup>56</sup> [1996] 1 BCLC 155. See also Arden J in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354 and Vinelott J in *Re a Company (No 002612 of 1984)* [1986] 2 BCC 99,453, 99,461, on appeal *sub nom Re Cumana Ltd*, where both seem unwilling to limit the wide discretion that the words of the statute imply. They adopt a similar approach to that of the Jenkins Committee, looking instead for a visible departure from the standards of "fair dealing".

<sup>57</sup> [1996] 1 BCLC 155, 243. See also her comments at p 237.

<sup>58</sup> For the relevance of a petitioner's conduct to the issue of the court's discretion to grant relief under s 461 and to the issue of valuation where a purchase order is sought, see paras 10.3 and 10.14, n 40 below.

<sup>59</sup> *Re London School of Electronics Ltd* [1986] Ch 211.

<sup>60</sup> Eg *Re RA Noble* [1983] BCLC 273. This case involved a company with two 50% shareholders, A and B. B was the financier of the company and held his shares through his company, Anafield. A ran the company but it was agreed he would consult B on important matters. The relationship between the two men broke down and, although A continued to run the business, contact between the two men became less and less frequent. Anafield commenced proceedings under s 75 (now s 459) and in the alternative under s 122(1)(g). The grounds of the petition were wide ranging, but broadly alleged that neither Anafield nor

will not be the case if on the facts, the respondent's conduct is disproportionate to any act done by the petitioner.<sup>61</sup>

*Meaning of prejudicial*

- 9.30 To prove prejudice, a petitioner need not establish that the conduct has damaged or seriously jeopardised the value of his shareholding.<sup>62</sup> Such damage, or risk of such damage, is only one example of the type of prejudice that is said to fall within the section. Thus, in *Re RA Noble*, although there was no evidence of such damage, the court was prepared to find that exclusion from making major decisions affecting the company could in itself have been unfairly prejudicial.<sup>63</sup>

**Meaning of “some part of the members or members generally (including at least himself)”**

- 9.31 Section 459 was amended by the Companies Act 1989<sup>64</sup> to make it clear that section 459 applied where the conduct of a company's affairs was unfairly prejudicial to the interests of *all* of its members.<sup>65</sup> Such conduct would include matters which are wrongs to the company, as well as matters affecting all shareholders, such as the failure to pay dividends.
- 9.32 However, because of the breadth of section 461, petitioners are able to seek other remedies<sup>66</sup> in preference to seeking an order to allow them to bring an action on behalf of the company where they bring a claim under section 459. This has obvious advantages from their point of view as they will receive a more direct and immediate

B had been adequately consulted on important transactions and that B had been excluded from involvement in the running of the company's affairs. The court held that the treatment of the petitioner was not unfairly prejudicial within the meaning of s 75 because his exclusion from participation in the company's affairs was to a large extent due to his lack of interest. The respondent had merely wanted to get on with the management of the company's affairs and was not guilty of any underhand conduct. See also para 8.18, n 52 above on this case.

<sup>61</sup> Eg *Re London School of Electronics Ltd* [1986] Ch 211, where the court held that whilst the petitioner was shown to have been difficult and unreliable in the discharge of his duties, it did not consider that such behaviour justified the actions of the respondents in diverting students to another course run by a company in which they (but not the petitioner) had an interest.

<sup>62</sup> Whilst a member who can show that the value of his shareholding has diminished will be able to bring himself within the section, this is without prejudice to the generality of the section. See *McGuinness v Bremner plc* [1988] BCLC 673, 678-679, *per* Lord Davidson and *Re RA Noble* [1983] BCLC 273, 290, *per* Nourse J citing with approval Slade J in *Re Bovey Hotel Ventures Ltd* 31 July 1981 (unreported).

<sup>63</sup> [1983] BCLC 273, 291. See also Warner J in *Re Elgindata Ltd* [1991] BCLC 959 and Evans-Lombe J in *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636. And note Harman J's comments in *Re Unisoft (No 3) Ltd* [1994] 1 BCLC 609, that “prejudice” was harm “... in a commercial sense, not in a merely emotional sense”; *ibid*, at p 611. See also Arden J in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 404.

<sup>64</sup> Section 145, (Sched 19, para 11). The amendments came into force on 4 February 1991.

<sup>65</sup> Contrast the decisions of Harman J in *Re a Company (No 00370 of 1987)*, *ex parte Glossop* [1988] 1 WLR 1068 and Peter Gibson J in *Re Sam Weller & Sons Ltd* [1990] Ch 682.

<sup>66</sup> Eg a purchase order. See generally Part 10 below on remedies available under s 461.



benefit from the proceedings, rather than simply the right to bring an action, the benefit of which will accrue to the company as a whole. The effect of these two factors<sup>67</sup> means that petitions are brought under section 459 seeking a “personal” remedy, such as a purchase order, for breaches by the directors of their duties to the company. Following *Saul D Harrison*,<sup>68</sup> this may happen more frequently because in many cases it will be necessary for the petitioner to show that the directors have acted in breach of duty in order to establish that the company’s affairs have been conducted in a manner which is “unfairly prejudicial”.

### **Review of the effect of different allegations brought under section 459**

- 9.33 Any attempt at categorising the cases brought under section 459 by reference to the types of allegations made can be misleading, not least because it is common for there to be a number of different allegations in one petition.<sup>69</sup> However, such categorisation can assist in identifying the sorts of factual situations in which the section may be used successfully.<sup>70</sup> It also assists in identifying particular legal issues arising in practice, which may not be of general application to all petitions under the section.

#### *Exclusion from management*<sup>71</sup>

- 9.34 One of the most common allegations in petitions under section 459 is that the petitioner has been excluded from the management of the company.<sup>72</sup> As *Saul D Harrison* shows,<sup>73</sup> the courts have held in a number of cases that the petitioner had a legitimate expectation of being able to participate in the management of the company and that exclusion from management could be unfairly prejudicial to his interests qua member.<sup>74</sup> Even where continued involvement in the management of the company may be regarded as part of the petitioner’s legitimate expectations, his exclusion will not necessarily be unfair. The court will look at the conduct leading up to the exclusion to

<sup>67</sup> In the wide availability of “personal” remedies under s 461 and the fact that wrongs to the company can form the basis of a petition.

<sup>68</sup> [1995] 1 BCLC 14.

<sup>69</sup> Eg an allegation of exclusion from management may well be linked with allegations of unfair share issues because an effective way to reduce a shareholder’s influence is to issue more shares in order to reduce that shareholder’s voting power. This makes it easier to vote them off the board.

<sup>70</sup> See in particular Appendix E, Table 1, which shows details of 156 petitions filed between January 1994 and December 1995.

<sup>71</sup> Often in such cases the petitioner will bring a separate claim for unfair dismissal. This is a good example of a situation where a respondent company might suddenly find itself party to several different sets of proceedings. See *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280 and *Re Ringtower Holdings plc* [1989] BCLC 427.

<sup>72</sup> 67.3% of 156 petitions filed in 1994-1995 contained such an allegation. See Appendix E, Table 1.

<sup>73</sup> [1995] BCLC 14, 19.

<sup>74</sup> See also *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280 and *Re a Company (No 007623 of 1984)* [1986] BCLC 362.

see if it was justified and, more importantly, at the terms on which the exclusion was effected to see if they were fair.<sup>75</sup>

*Failure to provide information*<sup>76</sup>

- 9.35 An allegation commonly found in exclusion from management cases is that the majority shareholder(s) has failed to provide information about how the company is being run.<sup>77</sup> Where the failure to provide information constitutes a deliberate policy not to consult the petitioner on major decisions on which he ought to be consulted, this could amount to unfairly prejudicial conduct.<sup>78</sup> However, often the allegation would seem to be included simply to “... lend ballast to more serious allegations ...”<sup>79</sup> or there is no legitimate expectation that the petitioner would receive the particular information.<sup>80</sup>

*Increase of issued share capital*<sup>81</sup>

- 9.36 There are two different types of situation that are covered under this heading. The first situation involves an issue and allotment of shares, which is proposed or carried out in accordance with the provisions of the Companies Act 1985 but there has been a breach of duty by the directors of the company. The second type of situation is where an allotment is proposed or carried out in breach of statutory requirements.

<sup>75</sup> *Re a Company (No 007623 of 1984)* [1986] BCLC 362 and *Re XYZ Ltd* [1987] 1 WLR 102.

<sup>76</sup> See paras 12.24-12.39 below for further discussion of a shareholder’s rights of access to information.

<sup>77</sup> Such a failure may also be relevant in other cases, eg to provide information necessary to assess an offer to purchase shares: see *Re a Company (No 00314 of 1989)*, *ex parte Estate Acquisition and Development Ltd* [1991] BCLC 154; and where a winding up petition has been presented and the petitioner is unable to state that the company is solvent because of the company’s failure to provide information: *Re a Company (No 007936 of 1994)* [1995] BCC 705. See further para 8.3, n 13 above.

<sup>78</sup> See *Re RA Noble* [1983] BCLC 273, 289, *per* Nourse J, although on the facts of the case the court was not prepared to make such a finding.

<sup>79</sup> *Rudall v S & F (Quarries) Ltd* 12 October 1994 (unreported, CA) at p 4, *per* Roch LJ commenting on the judgment of the court at first instance. See also *Re Ringtower Holdings plc* [1989] BCLC 427, 443, *per* Peter Gibson J, where he described an allegation that the directors had failed to file accounts as trivial. In this case the initial failure was admitted, but was rectified and the accounts were filed. Counsel had not alleged on the facts of the case that the petitioner was prejudiced by the failure.

<sup>80</sup> See, for example, *Rudall v S & F (Quarries) Ltd* 12 October 1994 (unreported, CA). In that case, the petitioner alleged, *inter alia*, that since his retirement as a director the other directors had failed to keep him informed of the company’s negotiations for a joint venture with another company to exploit a quarry, which was the company’s main asset. The court held that there was no legitimate expectation available to the petitioner that he would receive information on the details of the negotiations. See also *Re Elgindata Ltd* [1991] BCLC 959, where an allegation about failure to provide information concerning an approach that had been made to buy out the company was held not to be unfairly prejudicial conduct. 41.7% of 156 petitions filed in 1994-1995 contained an allegation relating to a failure to provide information. See Appendix E, Table 1.

<sup>81</sup> 10.3% of 156 petitions filed in 1994-1995 contained such an allegation. See Appendix E, Table 1.

- 9.37 In considering the first type of situation, a petitioner may succeed if he can prove that in carrying out the allotment the board have acted in breach of their fiduciary powers.<sup>82</sup> If the board act "... for some ulterior purpose, they step outside the terms of the bargain between the shareholders and the company".<sup>83</sup> The court will examine the motives of the board in proposing it<sup>84</sup> to see, for example, if the dominant purpose is to reduce the petitioner's shareholding.<sup>85</sup> The fact that the majority knows that the petitioner does not have the money to take up his rights may be an important consideration.<sup>86</sup>
- 9.38 So far as the second type of situation is concerned, an issue and allotment will generally not be held to be unfair where the breach of the legal requirements is merely technical.<sup>87</sup> However, where there is a substantial breach of a statutory provision,<sup>88</sup> the allotment is likely to be held to be unfairly prejudicial.<sup>89</sup>

*Alteration of articles of association*

- 9.39 A not uncommon allegation, which is related to an issue already touched upon earlier, concerns the situation where the majority attempt to alter a company's articles of association by special resolution. We have already examined the circumstances in

<sup>82</sup> Which must be exercised for the benefit of the company as a whole.

<sup>83</sup> *Saul D Harrison* [1995] 1 BCLC 14, 18, *per* Hoffmann LJ.

<sup>84</sup> *Re a Company (No 007623 of 1984)* [1986] BCLC 362. In that case, the court found on the facts that the board genuinely believed that the company required additional capital and that it was reasonable for them to believe that this was the case.

<sup>85</sup> *Re a Company (No 002612 of 1984)* [1985] BCLC 80, where Harman J granted an injunction preventing the issue pending the full hearing of the case. See (1986) 2 BCC 99,453 for the full hearing on this case and [1986] BCLC 430 (*sub nom Re Cumana Ltd*) for the hearing on appeal.

<sup>86</sup> *Re a Company (No 002612 of 1984)* [1985] BCLC 80, 82, *per* Harman J. See also *Re a Company (No 007623 of 1984)* [1986] BCLC 362.

<sup>87</sup> *Re DR Chemicals Ltd* [1989] BCLC 383, 396, *per* Peter Gibson J.

<sup>88</sup> In *Re DR Chemicals Ltd* [1989] BCLC 383 the allotment of shares was carried out unilaterally by the majority shareholder without reference to the minority shareholder, resulting in a substantial dilution of the minority's shareholding. This was in breach of s 17 of the Companies Act 1980, (now s 89 of the Companies Act 1985). The court held that there was a substantial contravention of s 17, which embodied "... ordinary and basic notions of fairness as between shareholders inter se and governing those with the power to allot shares". *Ibid*, at p 396. In addition it held that the allotment was invalid in that it was made for an improper purpose, namely to change the balance of voting power inside the company. Accordingly the allotment was unfairly prejudicial to the interests of the petitioner.

<sup>89</sup> Note that to challenge an actual or proposed allotment a shareholder need not necessarily bring proceedings under s 459. Other statutory and common law remedies might be available. See paras 5.15-5.16 above and para 12.23 below. See also *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821 (PC). In this case the shareholder brought a personal action challenging the issue and allotment of shares and the Privy Council upheld his challenge on the grounds that the issue of shares by directors with the main purpose of forestalling a takeover bid was an improper exercise of the directors' power to issue shares. See also para 2.33, n 69 above.

which a resolution altering the articles of association can be challenged at common law.<sup>90</sup> The tests laid down in *Allen v Gold Reefs of West Africa Ltd*<sup>91</sup> and *Greenhalgh v Arderne Cinemas Ltd*<sup>92</sup> were that the resolution must be passed bona fide for the benefit of the company as a whole, and that the effect of the resolution must not be to discriminate between the majority and minority shareholders so as to give the former an advantage of which the latter is deprived.<sup>93</sup> It has been said that a special resolution which is valid according to the test in *Greenhalgh v Arderne Cinemas Ltd* could nevertheless amount to unfair prejudice under section 459,<sup>94</sup> but following *Saul D Harrison*, it is not clear whether (in the absence of some legitimate expectation) this is possible.

*Diversion of company business and misappropriation of assets*

- 9.40 A number of successful cases have been brought under section 459 on the basis that there has been a deliberate diversion of a company's business by those in control to another business owned by them,<sup>95</sup> or that there has been misappropriation of company assets.<sup>96</sup> These cases illustrate the fact that proceedings are brought under section 459 to obtain a personal remedy for what are effectively breaches of fiduciary duty.<sup>97</sup>

*Excessive remuneration<sup>98</sup> and non payment of dividends<sup>99</sup>*

<sup>90</sup> See paras 2.31-2.38 and 4.30-4.32 above.

<sup>91</sup> [1900] 1 Ch 656.

<sup>92</sup> [1951] Ch 286. Both cases concerned similar facts and were brought as derivative actions as an exception to the rule in *Foss v Harbottle*.

<sup>93</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286, 291, *per* Evershed MR.

<sup>94</sup> *Re Ringtower Holdings plc* [1989] BCLC 427, 450, *per* Peter Gibson J. In this case, resolutions were passed depriving the petitioners of pre-emption rights and seeking to re-register the company as a private company in order to facilitate a takeover by another company. The court found that the resolutions were passed bona fide and that there was no intention to discriminate because the purchasing company always intended to make its offer to buy the majority's shareholding available to the minority shareholder as well. Although potentially prejudicial to the petitioners, the resolution could not be said to be unfair given the alterable nature of the articles and the offer by the purchasing company to them.

<sup>95</sup> *Eg Re London School of Electronics Ltd* [1986] Ch 211; *Re Cumana Ltd* [1986] BCLC 430 (at first instance *sub nom Re a Company (No 002612 of 1984)*); *Re Stewarts (Brixton) Ltd* [1985] BCLC 4.

<sup>96</sup> *Eg Re Elgindata Ltd* [1991] BCLC 959 and *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636, where in the latter case, the allegations related, *inter alia*, to a breach of trust by the sale of the company business to another company at an undervalue.

<sup>97</sup> 41% of 156 petitions filed in 1994-1995 involved such allegations. See Appendix E, Table 1.

<sup>98</sup> 11.5% of 156 petitions filed in 1994-1995 involved such allegations. See Appendix E, Table 1.

<sup>99</sup> 25% of 156 petitions filed in 1994-1995 involved such allegations. See Appendix E, Table 1.

- 9.41 As we have already noted,<sup>100</sup> both the Cohen Committee<sup>101</sup> and the Jenkins Committee<sup>102</sup> considered the problem of excessive remuneration and the resulting effect of such payments on shareholder dividends. The Cohen Committee talked of directors absorbing “... an undue proportion of the profits of the company in remuneration for their services so that little or nothing is left for distribution among the shareholders by way of dividend”.<sup>103</sup> The Jenkins Committee made a similar point.<sup>104</sup>
- 9.42 In *Re a Company (No 002612 of 1984)*,<sup>105</sup> the allegation was one of three main allegations, the others being wrongful diversion of company business and an improper rights issue. All of these grounds were successful, and it was held that remuneration of an estimated £365,000 paid to the respondent over a 14 month period was plainly in excess of anything that he had earned and was so large as to be unfairly prejudicial to the petitioner’s interests.<sup>106</sup>
- 9.43 As noted above,<sup>107</sup> there is often a link between excessive remuneration and the failure to pay adequate dividends. It used to be the case that it was not enough for a petitioner in a section 459 petition to allege that the directors had failed to pay reasonable dividends out of the substantial profits because the conduct complained of was not discriminatory between shareholders.<sup>108</sup> Section 459 has now been amended<sup>109</sup> and it is clear that there is jurisdiction under section 459 notwithstanding that the failure to pay dividends affects all members alike.<sup>110</sup> However, it is not clear whether such a

<sup>100</sup> See para 7.10 above.

<sup>101</sup> In the Report of the Committee on Company Law Amendment (1945) Cmd 6659.

<sup>102</sup> In the Report of the Company Law Committee (1962) Cmnd 1749.

<sup>103</sup> Report of the Committee on Company Law Amendment (1945) Cmd 6659, para 59.

<sup>104</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 205.

<sup>105</sup> (1986) 2 BCC 99,453, on appeal *sub nom Re Cumana Ltd* [1986] BCLC 430.

<sup>106</sup> An interesting point which this case illustrates is that in deciding whether the amount of remuneration is unfairly prejudicial the courts will compare it to the recipient’s contribution to the company. An interesting parallel to this approach can be found in the recent Greenbury Report, amongst whose recommendations there was a certain emphasis on performance related pay; see particularly paras 6.12, 6.17, 6.20 and 6.38. In addition the Listing Rules have, in their Best Practice Provisions (Section B, para 8), emphasised the need for performance criteria when granting incentives or share option schemes. See generally paras 12.34-12.39 below on directors remuneration.

<sup>107</sup> See para 9.41 above.

<sup>108</sup> See *Re a Company (No 00370 of 1987)*, *ex parte Glossop* [1988] 1 WLR 1068.

<sup>109</sup> Companies Act 1989, s 145, (Sched 19, para 11).

<sup>110</sup> See *Re Sam Weller & Sons Ltd* [1990] Ch 682. See also the remarks of Hoffmann LJ in *Saul D Harrison* [1995] 1 BCLC 14, 18 discussing both this case and the earlier case of *Re a Company (No 00370 of 1987)*, *ex parte Glossop* [1988] 1 WLR 1068.

failure would amount to unfairly prejudicial conduct in the absence of a breach of duty by the directors or of some relevant legitimate expectation.<sup>111</sup>

#### *Mismanagement*

- 9.44 Mismanagement is another example of an allegation which may be a corporate wrong as well as being capable in certain circumstances of forming the basis of proceedings under section 459. Under section 210 of the Companies Act 1948, as stated earlier,<sup>112</sup> the courts excluded negligence and mismanagement from the types of conduct falling within the term “oppression”.<sup>113</sup>
- 9.45 Under section 459 there are two reported decisions which have directly considered the question of when mismanagement may constitute conduct which is unfairly prejudicial to the interests of the minority.<sup>114</sup> What is clear from these cases is the type of mismanagement which will not constitute unfairly prejudicial conduct. Thus “... cases where there is a disagreement between petitioners and respondents as to whether a particular managerial decision was, as a matter of commercial judgment, the right one to make, or as to whether a particular proposal relating to the conduct of the company’s business is commercially sound”<sup>115</sup> will not satisfy the test under section 459.<sup>116</sup>
- 9.46 However, in *Re Elgindata Ltd*, Warner J also said “I do not doubt that in an appropriate case it is open to the court to find that serious mismanagement of a company’s business constitutes conduct that is unfairly prejudicial to the interests of minority shareholders ... [but] the court will normally be very reluctant to accept that managerial decisions can amount to unfairly prejudicial conduct”.<sup>117</sup>
- 9.47 In *Re Elgindata Ltd*, the court emphasised the fact that “... a shareholder acquires shares in a company knowing that their value will depend in some measure on the competence of the management. He takes the risk that that management may prove not to be of the highest quality. Short of a breach by a director of his duty of skill and

<sup>111</sup> *Saul D Harrison* [1995] 1 BCLC 14.

<sup>112</sup> See para 7.9 above.

<sup>113</sup> *Re Five Minute Car Wash Service Ltd* [1966] 1 WLR 745, 752, per Buckley J and see para 7.9, n 41 above.

<sup>114</sup> *Re Elgindata Ltd* [1991] BCLC 959 and *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354.

<sup>115</sup> *Re Elgindata Ltd* [1991] BCLC 959, 993-994, per Warner J.

<sup>116</sup> Warner J made it clear that a court was ill qualified to resolve such disagreements and that “... there can be no unfairness to the petitioners in those in control of the company’s affairs taking a different view from theirs on such matters”. *Ibid*, at p 994.

<sup>117</sup> *Ibid*, at p 993, cited with approval by Neill LJ in *Saul D Harrison* [1995] 1 BCLC 14, 31.

care ... there is prima facie no unfairness to a shareholder in the quality of the management turning out to be poor".<sup>118</sup>

9.48 In *Re Elgindata Ltd*,<sup>119</sup> it was held that what the acts complained of were about was essentially a lack of purposefulness as opposed to a breach of duty of care and skill, and no remedy was available under section 459.<sup>120</sup> However, it is clear that where the allegations concern serious acts of mismanagement a remedy will be available under section 459.<sup>121</sup> In *Re Macro (Ipswich) Ltd*,<sup>122</sup> the court gave some guidance as to what type of conduct might fall within this category. It was held that the allegations made in that case were not just of poor quality management, but specific acts of mismanagement which had been repeated over many years and which the respondent had failed to prevent or rectify. Those acts and failures were held to be serious enough to justify the court's intervention.<sup>123</sup>

### **Effect of pre-emption articles on a petitioner's ability to bring proceedings under section 459**

9.49 It is common for private companies to have articles of association which contain pre-emption rights, giving the company or the remaining shareholders the right (or in some cases the obligation) to purchase the shares of a member who is leaving the company. Some provisions may oblige a member to sell his shares in certain circumstances (for

<sup>118</sup> [1991] BCLC 959, 994. See also Arden J in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 404-405. This approach has been regarded by some as unnecessarily restrictive. Whilst recognising the need to expect commercial risks to be taken, it is argued that there is a distinction between detriment to the company arising from the taking of reasonable commercial risks and negligence, gross inefficiency or carelessness: G Stapledon, "Mismanagement and the Unfair Prejudice Provision" (1993) 14 Co Law 94, 95.

<sup>119</sup> [1991] BCLC 959. The petition contained four broad allegations, one being that the respondent "... neglected and was incompetent in the management of the company's business". *Ibid*, at p 992. The others were (i) that the petitioner had been excluded from management decisions and his legitimate expectations frustrated; (ii) that there was late payment of a dividend; and (iii) that the respondent had used assets of the company for his personal benefit and the benefit of his family and friends.

<sup>120</sup> Although the court did hold that unfairly prejudicial conduct existed on other grounds.

<sup>121</sup> A further point also remains unresolved by the case law with respect to s 459. In *Re Elgindata Ltd* the court considered that one example of a case where there was no breach of the duty of care and skill, but where the court might nonetheless find that there was unfair prejudice to minority shareholders, would be where the majority shareholders, for reasons of their own, persisted in retaining in charge of the management of the company's business a member of their family who was demonstrably incompetent.

<sup>122</sup> [1994] 2 BCLC 354. The conduct which it was held amounted to mismanagement of the property companies included: dishonest "pocketing" of commissions; failure to obtain competitive tenders for repairs; failure to conduct regular inspections of the properties so that defective work was not noticed and therefore builders were overpaid; failure to let the properties on the most advantageous terms; late registration of rent; and overpayment of management fees.

<sup>123</sup> *Ibid*, at p 406. However, see JP Lowry, "The Elasticity of Unfair Prejudice: Stretching the Ambit of the Companies Act 1985, Section 459" [1995] LMCLQ 337, 339. This article canvasses differing views as to directors' duty of care and skill and comments on this decision.

example, on his ceasing to be a director or an employee), others may simply set out a procedure to follow should he choose to transfer his shares. There will generally be a mechanism for ascertaining the fair value of the shares in the event of disagreement. The articles may provide for this to be ascertained by the company's auditors,<sup>124</sup> or by an independent valuer.<sup>125</sup> The fair value of a minority shareholding will frequently be on a discounted basis.<sup>126</sup>

9.50 Two early first instance decisions suggested that the failure of a dissatisfied shareholder to use provisions of this kind could constitute a bar to a remedy under section 459.<sup>127</sup> However, this approach was rejected by the Court of Appeal in *Viridi v Abbey Leisure Ltd*<sup>128</sup> in the context of an application for winding up under section 122(1)(g).<sup>129</sup> The case concerned a quasi-partnership type company which (it was accepted for the purposes of the striking out application) had been formed on the understanding that it would undertake a single venture. The venture was completed but a new one was contemplated which the petitioner did not wish to pursue. The respondents made an open offer to buy the petitioner's shares and to have them valued in accordance with a pre-emption provision in the articles of association<sup>130</sup> but the petitioner refused to accept this offer and commenced proceedings under section 122(1)(g) and section 459. The issue was whether the petitioner was acting unreasonably in seeking to have the company wound up instead of pursuing another remedy.<sup>131</sup>

9.51 The Court of Appeal held that the petitioner's failure to take advantage of the valuation procedure in the pre-emption provision was not unreasonable conduct. The company had been formed for a single venture which had come to an end and the assets of the company were almost entirely in cash. On a winding up this would have been

<sup>124</sup> Eg *Re a Company (No 007623 of 1984)* [1986] BCLC 362 and *Re XYZ Ltd* [1987] 1 WLR 102.

<sup>125</sup> Eg *Re Abbey Leisure Ltd* [1989] BCLC 619 (Ch D), on appeal *sub nom Viridi v Abbey Leisure Ltd* [1990] BCLC 342 (CA).

<sup>126</sup> This is because a minority shareholding is usually regarded as being of a lower value per share than a majority shareholding. This stems from the fact that a minority may have limited voting power and therefore less control over management and day to day running of the company. See further para 10.14 below.

<sup>127</sup> *Re a Company (No 007623 of 1984)* [1986] BCLC 362 and *Re XYZ Ltd* [1987] 1 WLR 102.

<sup>128</sup> [1990] BCLC 342 (CA).

<sup>129</sup> Although the petition contained an application under s 459 in the alternative, the application for winding up was treated as the primary claim for relief and the Court of Appeal did not consider the applicability of their approach to petitions brought under s 459.

<sup>130</sup> The provision did not oblige the petitioner to sell, but did contain valuation machinery to determine the price of the shares of a member who chose to do so. It provided for an independent accountant to determine a fair value "... as between a willing seller and a willing buyer"; [1990] BCLC 342, 344. This should be contrasted with the pre-emption provision in *Re a Company (No 00330 of 1991)*, *ex parte Holden* [1991] BCLC 597, which did in fact oblige the petitioner to sell; see n 138 below.

<sup>131</sup> Section 125(2) of the Insolvency Act 1986; see paras 8.13-8.17 above.



distributed to the shareholders pro rata. On the other hand, had the mechanism in the articles been adopted, the petitioner was likely to receive a discounted valuation of his shares.<sup>132</sup> Balcombe LJ,<sup>133</sup> held that it was not unreasonable for the petitioner to refuse to run that risk. He referred to a line of authority in relation to valuation of shareholdings in quasi-partnership companies, in all of which the petitioner had been entitled to a pro rata rather than discounted valuation.<sup>134</sup> He considered that on winding up there was machinery available for proper determination of the value of the shares and that it would be preferable to an accountant's estimate and he was not convinced that it would be more expensive.<sup>135</sup>

9.52 The decision in *Viridi v Abbey Leisure Ltd* was followed in *Re a Company (No 00330 of 1991)*, *ex parte Holden*.<sup>136</sup> In this case the court considered that it "... was not unreasonable for the petitioner to refuse to accept a valuation under [a compulsory transfer procedure in] the articles",<sup>137</sup> invoked after the petitioner had been excluded from management, and held that the existence of a provision for valuation in the

<sup>132</sup> Being a minority shareholding; see para 10.14 below.

<sup>133</sup> With whom Sir George Waller, the other member of the court agreed.

<sup>134</sup> [1990] BCLC 342, 349-350.

<sup>135</sup> Note the slightly different approach of the courts, at paras 8.15-8.17 above, where a fair offer has been made which meets all the petitioner's reasonable objections. There are many possible distinguishing features between the factual situation in *Re a Company (No 002567 of 1982)* [1983] 1 WLR 927, discussed at para 8.15 above, and the factual situation faced by the Court of Appeal in *Viridi v Abbey Leisure Ltd*. In the first case the offer to purchase the shares was on a non discounted basis and the company was a going concern, (a fact which was emphasised by Balcombe LJ in his judgment; [1990] BCLC 342, 349). The petitioner was willing to sell his shares and the price was the best that he could reasonably expect to achieve. In *Viridi*, as Balcombe LJ remarked, the petitioner was not a willing seller who wished to transfer his shares pursuant to the relevant provision in the articles and there was a risk that his shares could be discounted as a minority shareholding.

<sup>136</sup> [1991] BCLC 597. The company's articles had a mandatory share purchase provision, which provided that a member of the company who ceased to work for it was deemed to have served a transfer notice in respect of his shares. Such shares would then be valued by the company's auditor or an independent valuer at a "fair" value. The case did not primarily relate to whether a petition under s 459 could be brought where pre-emption provisions existed, but rather whether such provisions could actively be used to undermine such a petition once started, by depriving the petitioner of his shareholding and therefore his locus standi to bring proceedings under s 459. However, the respondents also argued that there was no serious question to be tried under the petition, as the existence of the pre-emption provision meant that the petition would have failed, and this point was dealt with in the judgment.

<sup>137</sup> *Ibid*, at p 603. The court observed that, on the facts of the case, a valuation under the articles would be carried out by the valuer as an expert, who would give "... no explanation as to how he has come to his decision, leaving it unassailable even if apparently low or high". *Ibid*, at p 603. The petitioner would have no right to make representations and there was no proper machinery to assist the expert in evaluating claims against the company, so that they might be inadequately taken into account. Furthermore, at the date of valuation dictated by the directors' election to implement the pre-emption provisions, there were taxation considerations which meant the shares may have been worth less than they might have been after that accounting period.

articles was no longer determinative of the right to petition under section 459.<sup>138</sup> The judgment in *Virdi v Abbey Leisure Ltd* had “... changed the whole approach of the court to petitions under sections 459 and 461”.<sup>139</sup> It had established “... that a petitioner is entitled to refuse to accept a risk — any risk — in an accountant’s valuation of his interest if such risk can be seen to be one that would depreciate in any way the valuation”.<sup>140</sup>

### **Instances of the involvement of shareholders of public companies in section 459 proceedings**

9.53 Whilst, as was emphasised by the Jenkins Committee,<sup>141</sup> the changes recommended by the Cohen Committee<sup>142</sup> were primarily to strengthen the position of minority shareholders in private companies,<sup>143</sup> section 459 is also available to shareholders in public companies. Case law illustrates, however, that the different nature of these companies means that different considerations will apply. In *Re Blue Arrow plc*,<sup>144</sup> Vinelott J was asked to decide whether the petitioner, a shareholder in a public listed company, could have legitimate expectations founded on an undisclosed agreement. Striking out the petitioner’s claim, he said:

... it must be borne in mind that this is a public company, a listed company, and a large one ... Outside investors were entitled to assume that the whole of the constitution was contained in the articles ... There is in these circumstances no room for any legitimate expectation founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the Unlisted Securities Market.<sup>145</sup>

<sup>138</sup> Harman J observed that the decision in *Virdi v Abbey Leisure Ltd* had “... altered the balance against the view that shareholders who enter into a company with articles allowing for compulsory transfer are bound to go through compulsory transfer provisions rather than exercising their statutory rights and are unreasonable if they do not accept the transfer provisions”. [1991] BCLC 597, 604.

<sup>139</sup> However, it is interesting to note that Balcombe LJ, in *Virdi v Abbey Leisure Ltd*, did not actually consider whether the petitioner would have achieved the same result on a s 459 petition.

<sup>140</sup> [1991] BCLC 597, 603, *per* Harman J.

<sup>141</sup> In the Report of the Company Law Committee (1962) Cmnd 1749.

<sup>142</sup> In the Report of the Committee on Company Law Amendment (1945) Cmd 6659.

<sup>143</sup> Report of the Company Law Committee (1962) Cmnd 1749, para 199. See para 7.6 above.

<sup>144</sup> [1987] BCLC 585. The petitioner had been a significant shareholder and active participant in the running of a company which was later floated on the Unlisted Securities Market (“USM”) and then listed on the Stock Exchange. Her shareholding was reduced substantially during the flotation and she gradually retired from active participation, although she remained president. The board sought to prevent her subsequent attempts to resume participation in management by taking steps to alter the articles and remove her as president.

<sup>145</sup> *Ibid*, at p 590. The inability of a member of a listed company to rely on undisclosed understandings was also emphasised by Sir Donald Nicholls V-C in *Re Tottenham Hotspur plc* [1994] 1 BCLC 655, 659-660. Cf *Bradman v Trinity Estates plc* [1989] BCLC 757, where a shareholder sought an injunction to prevent a meeting taking place on the grounds, *inter alia*,

9.54 A further example of public company involvement in section 459 proceedings is *McGuinness v Bremner plc*,<sup>146</sup> which was a successful petition for an order regulating the company's affairs by requiring the holding of an EGM, as requisitioned by the petitioner, without the delay of several months proposed by the respondents.<sup>147</sup>

that he intended to bring proceedings under s 459. One of the allegations in the petition under s 459 was that the proposed acquisition of another company would be a departure from what was held out in the prospectus.

<sup>146</sup> [1988] BCLC 673.

<sup>147</sup> See para 10.4, n 14 below for further details of the order made. Yet a further example of public company involvement in s 459 proceedings is provided by the petition presented under Companies Act 1980, s 75 by the Post Office Superannuation Fund (Possfund) against Associated Communications Corporation plc to prevent a large payment of compensation for loss of office to a director (see *Financial Times* 7 January 1982). The payment was eventually prevented by a resolution passed at an EGM (see *Financial Times* 29 September 1982) and Possfund terminated its proceedings.

# PART 10

## REMEDIES AVAILABLE UNDER SECTION 461

### Introduction

- 10.1 The remedies which the court may give to a shareholder who brings a petition under section 459 are set out in section 461<sup>1</sup> of the Companies Act 1985.<sup>2</sup> Section 461(1) gives the court a discretion, in the most general terms, “... to make such order as it thinks fit for giving relief in respect of the matters complained of”. Section 461(2) sets out a number of specific powers, which are without prejudice to the wide terms of section 461(1). The specific powers include: regulating the conduct of the company’s affairs;<sup>3</sup> requiring the company to do, or refrain from doing certain acts;<sup>4</sup> authorising civil proceedings to be brought in the name and on behalf of the company;<sup>5</sup> and ordering the purchase of shares.<sup>6</sup> The shareholder must specify the relief he seeks.<sup>7</sup>

### *Discretion*

- 10.2 It is also important to note that the court has a discretion as to what type of relief should be granted, and even as to whether relief should be granted at all. Accordingly, a court may refuse relief where, on the facts, it considers that the relief sought would not constitute an appropriate remedy or where some other course of action is preferable, even where it has held that the petition is well founded.<sup>8</sup>

### *Conduct relevant to relief*

<sup>1</sup> Article 454 of the Companies (Northern Ireland) Order 1986.

<sup>2</sup> However, it is important to note that before the court can make any order under s 461, it must first make a finding of unfair prejudice under s 459; see *Re Bird Precision Bellows Ltd* [1986] Ch 658, 672, *per* Oliver LJ.

<sup>3</sup> Section 461(2)(a).

<sup>4</sup> Section 461(2)(b).

<sup>5</sup> Section 461(2)(c).

<sup>6</sup> Section 461(2)(d).

<sup>7</sup> *Re Antigen Laboratories Ltd* [1951] 1 All ER 110, cited with approval by Warner J in *Re JE Cade & Son Ltd* [1992] BCLC 213, 223. The court will not, therefore, award relief which the petitioner does not seek. The court may make an order which is not in the terms originally sought by the petitioner, provided that any variation is accepted by the petitioner, as in *Re HR Harmer Ltd* [1959] 1 WLR 62, 68. See n 15 below.

<sup>8</sup> *Re Full Cup International Trading Ltd* [1995] BCC 682. Although, on the facts of the case, the court held that the petition under s 459 was well founded, it was not prepared to grant the relief sought (the purchase of the petitioner’s shares by the respondents). Such an order on the facts would have involved the court in a laborious and expensive valuation process. Other relevant factors were that the company was completely dormant and neither side had any use for it. The petitioner would receive no more on a purchase order than on liquidation.

10.3 In exercising its discretion, the court will consider the conduct of both the petitioner and the respondent.<sup>9</sup> In *Re Bird Precision Bellows Ltd*<sup>10</sup> the parties had attempted to bypass lengthy section 459 proceedings<sup>11</sup> and focus solely on the valuation of the shares. They had, therefore, consented to an order that the shares should be purchased by the majority at a fair price. Unfortunately, they did not address the issue of conduct in the consent order. The courts, both at first instance and on appeal, held that the conduct of the parties was relevant to the valuation as well as to the applicability of section 459.<sup>12</sup> As Oliver LJ said, “[u]nless unfair prejudice was proved, the court was simply being asked to undertake a sort of arbitration in vacuo, which it had no jurisdiction to do”.<sup>13</sup>

#### **Section 461(2)(a)**

10.4 This sub-section states that the court’s order may “... regulate the conduct of the company’s affairs in the future”. The order may be relatively straight forward, such as requiring the company to convene a meeting on specified terms,<sup>14</sup> or it may be much more complex and set out detailed requirements for the future running of the business, tailored to the particular facts of the case.<sup>15</sup>

10.5 In any event, the court will consider what relief should best be granted in all the circumstances of the case for the purpose mentioned in section 461(1). In *Re Macro (Ipswich) Ltd*<sup>16</sup> the court refused to make an order appointing additional directors as it believed that “[t]hat course might well simply exacerbate, rather than resolve, the disputes between the parties”.<sup>17</sup>

<sup>9</sup> The petitioner’s conduct may also be so serious that, as a result, the respondent’s actions, whilst prejudicial, are not unfair; see paras 9.28-9.29 above.

<sup>10</sup> [1984] Ch 419 (Ch D); [1986] Ch 658 (CA).

<sup>11</sup> Or rather their equivalent under s 75 of the Companies Act 1980.

<sup>12</sup> See also the comments of Nourse J in *Re London School of Electronics Ltd* [1986] Ch 211, 222.

<sup>13</sup> [1986] Ch 658, 672.

<sup>14</sup> Eg in the Scottish case of *McGuinness v Bremner plc* [1988] BCLC 673, on an interim application under s 459, the court ordered the directors of the company to convene an EGM on a specified date, to give 14 days written notice of the meeting to the company’s members and to appoint a firm of accountants to act as independent scrutineers to be responsible for counting the votes cast at the meeting.

<sup>15</sup> Eg in *Re HR Harmer Ltd* [1959] 1 WLR 62 the terms of the order were, inter alia:

- (i) that the company should contract for the services of the second respondent as philatelic consultant at a named salary;
- (ii) that the second respondent should not interfere in the affairs of the company otherwise than in accordance with the valid decisions of the board of directors;
- (iii) that the second respondent should be appointed president of the company for life, but that the office should not impose any duties or rights or powers.

<sup>16</sup> [1994] 2 BCLC 354. An appeal (on other grounds) was dismissed by the Court of Appeal, 22 May 1996 (unreported).

<sup>17</sup> [1994] 2 BCLC 354, 408, *per* Arden J. Similarly, in *Jaber v Science and Information Technology Ltd* [1992] BCLC 764 the court refused to grant an interim application that receivers and managers be appointed, holding that this would have an adverse effect on the company’s

## Section 461(2)(b)

10.6 Section 461(2)(b) states that the court may “... require the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do”. The most common application under this section is for an order that the company refrain from specified actions. This can include proposed future acts of the company, which could themselves constitute unfairly prejudicial conduct for the purposes of section 459.<sup>18</sup>

10.7 In order to preserve the position during the inevitable delay between the presentation of a petition and the final hearing, petitioners will frequently seek interlocutory injunctions.<sup>19</sup> There is nothing within the Companies Act 1985, or the Companies (Unfair Prejudice Applications) Proceedings Rules 1986,<sup>20</sup> which specifically deals with interlocutory injunctions and so the general rules apply, in particular RSC, O 29, r 1.<sup>21</sup> Thus, in order to succeed, the applicant must show that there is a serious question to be tried<sup>22</sup> and that the balance of convenience<sup>23</sup> favours the granting of an injunction.<sup>24</sup>

business, would be very expensive, and no real case had been made out that the assets of the company were in jeopardy.

<sup>18</sup> Eg *Whyte Petitioner* 1984 SLT 330, where an order was granted restraining the company from holding a meeting at which a resolution was proposed which would have placed control of legal proceedings in the hands of someone who had an interest in their failing. See also para 9.4 above.

<sup>19</sup> Examples of cases where interlocutory injunctions have been granted are: *Re a Company (No 002612 of 1984)* [1985] BCLC 80; *Malaga Investments Ltd & Others, Petitioners* (1987) 3 BCC 569; *Re Mountforest Ltd* [1993] BCC 565; and *Safinia v Comet Enterprises Ltd* [1994] BCC 883.

<sup>20</sup> SI 1986 No 2000; see para 11.6 below. The 1986 Rules apply only in English procedure and there are no equivalent Scottish procedural rules for s 459 applications. The Scottish courts have a common law power to make interim orders; see s 47(2) of the Court of Session Act 1988. The equivalent of an interlocutory injunction is an interim interdict and the test is broadly the same as under English law.

<sup>21</sup> The statutory basis for this rule is s 37 of the Supreme Court Act 1981.

<sup>22</sup> Ie make out a case on all the elements which are required for him to succeed in the final s 459 hearing. See *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8, where Hoffmann J refused to grant an injunction where the applicant could not show that he had grounds for a legitimate expectation that the directors would exercise their powers in a particular way.

<sup>23</sup> The court will consider the effect on both parties of granting or not granting an injunction, and will consider whether it will substantially interfere with the smooth running of the company, or whether the act to be prevented can properly be restrained until after the substantive hearing; *Re a Company (No 002612 of 1984)* [1985] BCLC 80, 82-83, per Harman J. In particular, the court will consider whether the applicant can be adequately compensated at the main hearing for any losses incurred if an injunction is not awarded; *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8 and *Re a Company (No 00330 of 1991), ex parte Holden* [1991] BCLC 597. Damages would not appear to be available per se under s 461; see para 10.27 below. But where a purchase order is made, this may include a compensatory element; see paras 10.21-10.22 below. The availability of damages in other actions will also be relevant; see *Jaber v Science and Information Technology Ltd* [1992] BCLC 764, where the petitioners could claim damages for unfair dismissal. However, the fact that a petitioner could be adequately compensated at the substantive hearing is not per se an answer to the injunction sought; *Safinia v Comet Enterprises Ltd* [1994] BCC 883.

<sup>24</sup> *American Cyanamid v Ethicon* [1975] AC 396, 406-407, per Lord Diplock.

### **Section 461(2)(c)**

10.8 Section 461(2)(c) gives the court power to make an order to “... authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct”. In other words, it allows a petitioner who succeeds in proving unfairly prejudicial conduct under section 459 to then bring a derivative action in the name of the company.

10.9 It appears that relief under section 461(2)(c) is rarely ordered in practice and few reported cases exist in which such an order has been made.<sup>25</sup> Such a remedy can be a lengthy and potentially expensive procedure as the petitioner is required to prove his entire case under section 459 before an action on behalf of the company can be commenced.<sup>26</sup>

### **Section 461(2)(d)**

10.10 Section 461(2)(d) states that the court may “... provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company’s capital accordingly”. A purchase order is by far the most commonly sought remedy under section 461.<sup>27</sup> Unfortunately, it may also be the most costly.<sup>28</sup>

#### *The concept of “fairness”*

10.11 The key issue in any valuation exercise in the context of section 459 petitions is the requirement of “fairness”. In *Re Bird Precision Bellows Ltd*<sup>29</sup> Nourse J considered the starting point in any valuation under section 461(2)(d) to be that “... it is axiomatic that a price fixed by the court must be fair. While that which is fair may often be generally predicated in regard to matters of common occurrence, it can never be conclusively judged in regard to a particular case until the facts are known”.<sup>30</sup> This

<sup>25</sup> One case in which an order was granted was *Re Cyphon Developments Ltd* 3 March 1982 (unreported, CA). There are other cases where such an order has been requested, though refused; eg *Re Hailey Group Ltd* [1993] BCLC 459.

<sup>26</sup> For further consideration of this sub-section see para 16.3 below.

<sup>27</sup> Of 156 s 459 petitions issued during 1994-1995, 69.9% sought an order that the petitioner’s shares be bought and 20.5% sought an order that the respondents sell their shares. See Appendix E, Table 1. The remedy is usually sought by shareholders in private or unlisted companies where there is no ready market for their shares. For a shareholder in a listed public company this problem does not often arise, as it is possible to dispose of his shareholding on the open market. However, there may well be situations where such a shareholder will not wish to sell his shares in this way, such as where the value of his shareholding has reduced because of the conduct complained of, or where the market is low and the member would get a bad price for his shares.

<sup>28</sup> See, for example, *Re Elgindata Ltd* [1991] BCLC 959.

<sup>29</sup> [1984] Ch 419.

<sup>30</sup> *Ibid*, at p 429.

view was endorsed and followed in the Court of Appeal<sup>31</sup> and all subsequent cases on share valuation.<sup>32</sup>

- 10.12 This has led the court into consideration of two particular matters which are often in dispute: the basis of valuation of the shareholding<sup>33</sup> and the date on which it is to be valued.<sup>34</sup> We also go on to consider court adjustments to valuation,<sup>35</sup> expert evidence,<sup>36</sup> and the type of order that the court will be prepared to make.<sup>37</sup>

*Basis of valuation*

- 10.13 Where a purchase order is sought, the decision as to what is the proper basis of valuation of a minority shareholding is one which the courts reserve to themselves.<sup>38</sup> The overriding criterion that the valuation should be fair means that no general rule can be drawn as to whether shares should be bought on a pro rata or a discounted basis, although some guidance can be derived from the cases.

- 10.14 A minority shareholding in a company is generally regarded as having a lower value per share than a majority shareholding. This reflects the fact that a minority shareholder, depending on the size of his shareholding, may have limited voting power and therefore control over the management and day to day running of the affairs of the company.<sup>39</sup> Where the valuation is reduced to reflect this the shares are said to be valued on a “discounted” basis.<sup>40</sup> However, this is not the case with all minority shareholdings.

<sup>31</sup> [1986] Ch 658. “It seems to me that the whole framework of the section ... is to confer on the court a very wide discretion to do what is considered fair and equitable in all the circumstances of the case ...”, *per* Oliver LJ, at p 669.

<sup>32</sup> *Eg Re DR Chemicals Ltd* [1989] BCLC 383, where Peter Gibson J stated at p 398, “[i]t is apparent from the authorities that there is no hard and fast rule ... Given the breadth of the discretion given to the court by s 461 that is hardly surprising and the court must be guided by what is fair in the particular circumstances”.

<sup>33</sup> See paras 10.13-10.17 below.

<sup>34</sup> See paras 10.18-10.20 below.

<sup>35</sup> See paras 10.21-10.22 below.

<sup>36</sup> See para 10.23 below.

<sup>37</sup> See paras 10.24-10.25 below.

<sup>38</sup> Although the amount of any discount is a matter on which the court will hear expert evidence prior to making any finding.

<sup>39</sup> *Eg*, with a 90% shareholding, a member’s powers include the ability to pass special resolutions, appoint and remove directors and liquidate the company. Someone with a 50% shareholding may still have control of the company, depending on how the other shares are held. If, however, there is only one other shareholder, such a block is clearly worth much less than 51%. A member with between 11 and 25% can avoid having his shares compulsorily purchased on a takeover, can requisition a general meeting and can call a poll at a general meeting.

<sup>40</sup> A discount will usually be applied where a minority shareholder has bought his shareholding as a commercial venture at a discounted value. It may also be appropriate where the petitioner’s conduct is such that it merits his exclusion from the company; see *Re Bird Precision Bellows Ltd* [1984] Ch 419, where Nourse J held that such conduct could be taken as



When the court considers that it will achieve a fair result, the price will be fixed pro rata according to the value of the shares in the company as a whole and without any discount. The cases show that a pro rata basis of valuation is generally ordered where *Ebrahimi*<sup>41</sup> type considerations are present.<sup>42</sup>

10.15 In *Re Bird Precision Bellows Ltd*<sup>43</sup> the Court of Appeal approved the judgment of Nourse J<sup>44</sup> in which he considered that of prime concern was whether the minority shareholder held his shares purely as a form of investment,<sup>45</sup> or whether he had a more active involvement in the company,<sup>46</sup> terming the latter type of company a “quasi-partnership”.<sup>47</sup>

10.16 In *Re Bird Precision Bellows Ltd*,<sup>48</sup> Nourse J also made the point that these considerations must be applied “at the material time”.<sup>49</sup> It might be the case that, whilst on incorporation the relationship between the parties had contained special features which would have justified a pro rata valuation of the petitioner’s shares at that time, the working relationship changed over time so that a discounted valuation was later appropriate. This was the case in *Re DR Chemicals Ltd*,<sup>50</sup> where the court found that although the parties’ relationship was originally one where they had been engaged in a joint venture in trust and reliance on each other, at the time of the unfairly

a constructive election to sever his connection with the company. As a result, any purchase order made would be on the basis that the shares should be valued as if sold voluntarily.

<sup>41</sup> [1973] AC 360.

<sup>42</sup> In those which Lord Wilberforce had considered in *Ebrahimi* might entitle a petitioner to rely on wider equitable considerations to justify a winding up of the company; see para 8.9 above. Cf *Re DR Chemicals Ltd* [1989] BCLC 383, 399, *per* Peter Gibson J. See also Nourse J in *Re Bird Precision Bellows Ltd* [1984] Ch 419, 430, where he emphasised that these elements are not exhaustive and suggested that the provision of capital by a shareholder is another important consideration.

<sup>43</sup> [1986] Ch 658.

<sup>44</sup> [1984] Ch 419. Nourse J specifically referred to *Ebrahimi* in considering what type of circumstances would be sufficient to render a discounted valuation unfair.

<sup>45</sup> In which case a discounted form of valuation might well be appropriate.

<sup>46</sup> The Court of Appeal also took account of the terms of a pre-emption provision contained in the company’s articles which it was held effectively provided for a pro rata valuation on sale. It was submitted that where such a provision existed in relation to sale, valuation under s 461 (or s 75) should be on at least as good a basis: [1986] Ch 658, 675-676, *per* Oliver LJ.

<sup>47</sup> In which case a pro rata valuation was likely to be appropriate. Note also the observations made earlier with respect to the phrase “quasi-partnership” at para 8.10 above.

<sup>48</sup> [1984] Ch 419.

<sup>49</sup> *Ibid*, at p 431. It is not sufficient to consider only the moment at which the petitioner joined the company, though this should be considered to see the basis on which he joined; see para 10.15, n 45 above.

<sup>50</sup> [1989] BCLC 383.

prejudicial conduct the nature of the relationship had changed and a discounted valuation was appropriate.<sup>51</sup>

- 10.17 Even where *Ebrahimi* type considerations have been found, there is no automatic right to a pro rata valuation. It is still a matter for the discretion of the court.<sup>52</sup>

*Date of valuation*

- 10.18 Another important consideration for the court is the date at which the shares are to be valued. This may be as important to the parties as the basis of valuation, since the value of the shares may have varied considerably between the date of the respondent's conduct and the date of the court order. As is the case with the basis of valuation, there is no rule to be followed in every case, the overriding requirement being that the order should be fair. Various options are available to the courts, including: the date of the unfairly prejudicial conduct; the date of the petition; the date of the order; and the date at which the valuation was carried out.

- 10.19 Different judges have put forward differing views about what date should be used as a general rule, and, indeed, whether there should be a general rule at all. Lord Denning<sup>53</sup> and Vinelott J<sup>54</sup> have both advocated a general rule that valuation should be as at the date of the petition, as being the date upon which the petitioner elected to be bought out. In contrast, Nourse J<sup>55</sup> considered that the date of the order was more appropriate, as “[p]rima facie an interest in a going concern ought to be valued at the date on which it is ordered to be purchased”.<sup>56</sup> In a similar vein, in *Re Macro (Ipswich) Ltd*,<sup>57</sup> Arden J took as the date of valuation “... the financial year end nearest the date of my order”.<sup>58</sup>

- 10.20 The current trading record of the company may be relevant. Where a company is doing well it will benefit the minority shareholder to value the shares at a later date,

<sup>51</sup> See also *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, where at p 408 Arden J said, “[w]hatever may have been the position in this case in (say) 1960, mutual trust and confidence does not in my judgment exist between the members of the companies at today’s date. In all the circumstances, I hold that the companies are not now, and have not at any stage in these proceedings been, quasi-partnerships”.

<sup>52</sup> To award what is fair in all the circumstances of the case; see *Re Bird Precision Bellows Ltd* [1984] Ch 419, 430, *per* Nourse J, and [1986] Ch 658, 669, *per* Oliver LJ.

<sup>53</sup> *SCWS v Meyer* [1959] AC 324, 369.

<sup>54</sup> *Re a Company (No 002612 of 1984)* (1986) 2 BCC 99,453, 99,492-99,493; on appeal *sub nom Re Cumana Ltd*.

<sup>55</sup> *Re London School of Electronics Ltd* [1986] Ch 211.

<sup>56</sup> *Ibid*, at p 224. In *Re DR Chemicals Ltd* [1989] BCLC 383, 399, Peter Gibson J, whilst not laying down a general rule, held that valuation should be at the date of the order.

<sup>57</sup> [1994] 2 BCLC 354.

<sup>58</sup> *Ibid*, at p 409.

such as the date of the order or of the actual valuation. The opposite may be the case where the company is in financial difficulty or has been restructured, and it may even be the case that fairness requires a valuation to relate back to a date earlier than the date of the petition.<sup>59</sup> The conduct of the parties will also be relevant.<sup>60</sup>

*Adjustments to valuation*

10.21 However, it may be that the circumstances of the case are such that the court does not consider that any date will give a fair valuation without other factors being taken into account. This will be particularly true where there has been a misappropriation of assets or mismanagement. In such cases, the court may order that the valuation be carried out on the basis that such misappropriation or mismanagement had not occurred, and a theoretical accounting to the company for the lost assets take place for the purposes of the valuation.<sup>61</sup>

10.22 It is clear that by ordering the valuation to be carried out on a pro rata basis, and determining the date on which valuation is to take place, together with any adjustments to take account of misappropriation, the courts could be said to be compensating the petitioner for the unfairly prejudicial conduct of the respondent, as the petitioner will receive more than the market value of the shares. The courts have acknowledged this and have considered it to be part of their discretion to do what is fair as between the parties.<sup>62</sup>

*Expert evidence*

10.23 Expert evidence is admissible on matters of share valuation but such evidence is likely to increase the length and cost of the court proceedings. In this respect, the problems are not very different from those which occur in any case where expert evidence is required.<sup>63</sup> The courts and the parties have attempted in a number of different ways to minimise the costs expended on this exercise, such as splitting the issues of liability

<sup>59</sup> *Re a Company (No 002567 of 1982)* [1983] 1 WLR 927, 937, per Vinelott J. See also *Re OC Transport Services Ltd* (1984) 1 BCC 99,068, 99,074, per Mervyn Davies J and the comments of Glidewell LJ in *Re Cumana Ltd* [1986] BCLC 430, 437-438; at first instance *sub nom Re a Company (No 002612 of 1984)*.

<sup>60</sup> Eg in *Re London School of Electronics Ltd* [1986] Ch 211, 225 the court considered that the conduct of the petitioner was such that he should not profit from the respondents' successful running of the company since his exclusion and fixed a valuation date accordingly.

<sup>61</sup> Eg *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 409; 22 May 1996 (unreported, CA). See also the comments of Vinelott J in *Re a Company (No 002612 of 1984)* (1986) 2 BCC 99,453, 99,492.

<sup>62</sup> *Re Bird Precision Bellows Ltd* [1986] Ch 658, 672, per Oliver LJ. See also *SCWS v Meyer* [1959] AC 324, 369, per Lord Denning and *Re Jermyn Street Turkish Baths Ltd* [1970] 1 WLR 1194, 1208, per Pennycuik J. However, the compensatory element in valuation should be distinguished from the ability to award compensatory damages in their own right: *Irish Press plc v Ingersoll Irish Publications Ltd* [1995] 2 ILRM 270; see para 10.27, n 72 below.

<sup>63</sup> See *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 411, per Arden J.

and valuation.<sup>64</sup> Commonly the parties agree that the court should rule on particular valuation issues so that the experts can carry out the valuation out of court on the basis of the principles determined by the court.<sup>65</sup>

#### *Type of order*

- 10.24 As is clear from the wording of the section itself, the scope of section 461(2)(d) is not limited to orders for the buy out of the petitioner by the majority shareholder(s). It is also possible for the court to order that the petitioner should purchase the shares of the respondent majority shareholders. Such orders have been requested by petitioners in a number of cases,<sup>66</sup> although they have only rarely been granted.<sup>67</sup>
- 10.25 The court will take the respondent's financial position into account in deciding what form of relief to give. However, the court is not bound to decline to make a purchase order which the petitioner seeks merely because it will cause the respondent financial difficulty. Nor is it bound to include in the order a provision which, for instance, requires the shares to be sold to a third party if the respondent is unable to raise the required sum within a given period.<sup>68</sup>

#### **Other orders**

- 10.26 Section 461(1) states: "If the court is satisfied that a petition under this Part<sup>69</sup> is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of". The types of order specified in section 461(2) are without prejudice to the generality of sub-section (1).<sup>70</sup>

<sup>64</sup> See *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280, 296, per Robert Walker J. Such an exercise can save unnecessary costs if the initial application under s 459 is unsuccessful.

<sup>65</sup> See, for example, *Re London School of Electronics Ltd* [1986] Ch 211 and *Re DR Chemicals Ltd* [1989] BCLC 383. See also *Re OC Transport Services Ltd* (1984) 1 BCC 99,068; *Harrison v Thompson* [1992] BCC 67 (Ch D), [1993] BCLC 784 (CA); and *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280.

<sup>66</sup> Eg *Re Jermyn Street Turkish Baths Ltd* [1970] 1 WLR 1194; *Re Ringtower Holdings plc* [1989] BCLC 427; *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354; and *Re Tottenham Hotspur plc* [1994] 1 BCLC 655.

<sup>67</sup> An order was made in *Re Nuneaton Borough Association Football Club Ltd* [1990] BCLC 384, where the court found that the company's financial difficulties had been caused by the conduct of the majority shareholder and that he had thereby shown himself to be unfit to exercise control of the company. See also the recent case of *Re Brenfield Squash Racquets Club Ltd* 8 December 1995 (unreported, Rattée J), which involved allegations of misappropriation of the company assets by the representatives of the majority shareholder (a company). See also the Irish case of *Irish Press plc v Ingersoll Irish Publications Ltd* [1995] 2 ILRM 270, although in that case the respondent and the petitioner were equal shareholders.

<sup>68</sup> See *Re Cumana Ltd* [1986] BCLC 430; at first instance *sub nom Re a Company (No 002612 of 1984)*.

<sup>69</sup> Part XVII of the Companies Act 1985.

<sup>70</sup> However, there is some question as to the interpretation of the section and whether the remedies available are limited by the purpose to which they are employed.

10.27 The power of the court to make orders under this section is wide.<sup>71</sup> However, doubt exists as to whether compensatory damages may be awarded,<sup>72</sup> and whether a respondent can be ordered to account to the company for losses attributable to the unfairly prejudicial conduct.<sup>73</sup>

10.28 The question of interest has also been raised in a number of cases in which a purchase order has been awarded. As with other judgment debts when they fall due, interest will be payable on the sum awarded if it is not paid on time.<sup>74</sup> However, it is extremely

<sup>71</sup> The court may make interim orders, such as those for injunctive relief; see para 10.7 above. It may also, in extremely limited situations, make an order for interim payment. See the Scottish case of *Ferguson v Maclellan Salmon Co Ltd* [1990] BCC 702.

<sup>72</sup> The matter has not been directly addressed in the English courts, although it is acknowledged that there can be a compensatory element to the valuation of a petitioner's shareholding for the purposes of a purchase order under s 461(2)(d); see paras 10.21-10.22 above. However, there has been a decision in the Irish courts on this point. In *Irish Press plc v Ingersoll Irish Publications Ltd* [1995] 2 ILRM 270 the Irish Supreme Court overturned the order for relief given by the High Court, whereby the respondent was ordered to pay I£2,750,000 to the petitioner, on the grounds that the object of such an order was to compensate the petitioner, not to bring an end to the oppression, and, as such, was beyond the powers awarded to the court under s 205 of the Companies Act 1963, which states, in sub-section (3), that orders should be made "... with a view to bringing to an end the matter complained of ...". The High Court had taken the oppression into account in determining the price at which the shares were to be transferred. The English provision, in s 461, is in slightly different terms, namely that the order be "... for giving relief in respect of the matters complained of". Although this would appear to give a wider discretion to the courts, the Irish wording is identical to that of s 210 of the Companies Act 1948, and it has been accepted by the courts that the approach in giving relief under s 75 (now ss 459-461) must be the same as that under s 210; see *Re Bird Precision Bellows Ltd* [1984] Ch 419, 427, *per* Nourse J. The approach in the English courts should, therefore, arguably be the same, although see the comments of Harman J in *Nuneaton Borough Association Football Club Ltd* [1990] BCLC 384, 394; Richard Sykes QC (sitting as a Deputy Judge of the High Court) in *Re Hailey Group Ltd* [1993] BCLC 459, 472; and Charles Aldous QC (sitting as a Deputy Judge of the High Court) in *Lowe v Fahey* [1996] 1 BCLC 262, 268.

<sup>73</sup> Whilst such a remedy is sought (eg *Re Hailey Group Ltd* [1993] BCLC 459 and see Appendix E, Table 1), we are unaware of any case where such an order has been made. In *Irish Press plc v Ingersoll Irish Publications Ltd* [1995] 2 ILRM 270 the Irish Supreme Court overturned the order of the High Court that the respondent should account to the companies, on the grounds that this was essentially a compensatory payment (see n 72 above). English courts would seem to take a different approach, differentiating between remedies to benefit the company, which can be obtained under a derivative action, and personal relief available under s 461; see *Re Chamley Davies Ltd (No 2)* [1990] BCLC 760 and *Re Little Olympian Each-Ways (No 3)* [1995] 1 BCLC 636. However, note the recent decision in *Lowe v Fahey* [1996] 1 BCLC 262, where the court rejected an argument raised in a striking out application that payment to the company could only be ordered in a derivative action and not under s 459. "[W]here ... the unfairly prejudicial conduct involves the diversion of company funds, a petitioner is entitled as a matter of jurisdiction to seek an order under s 461 for payment to the company itself...". *Ibid*, at p 268, *per* Charles Aldous QC (sitting as a Deputy Judge of the High Court). However, he differentiated between situations where a duty to account was only one of the remedies sought, where it would be costly and time-wasting to pursue two separate actions, and those where the only substantive relief being sought was a claim on behalf of the company against a third party, where a applicant might not always be able to proceed by petition instead of derivative action.

<sup>74</sup> Judgment Act 1838, s 17. The Scottish court has a common law power to award interest from date of decree (judgment).

unlikely that interest will be awarded in respect of the time elapsed before the date of the order.<sup>75</sup>

<sup>75</sup> Such an order was refused in *Re Bird Precision Bellows Ltd* [1986] Ch 658, where the argument was based on s 75(3) of the Companies Act 1981 (now s 461(1)), but the decision turned on the terms of a consent order.

# PART 11

## PROCEDURAL MATTERS

### Introduction

- 11.1 One of the major problems which has been highlighted, especially in recent years, when considering proceedings brought under section 459, is the length and cost of such cases. As Harman J observed in *Re Unisoft Group Ltd (No 3)*,<sup>1</sup> “[p]etitions under section 459 have become notorious to the judges of this court — and I think also to the Bar — for their length, their unpredictability of management,<sup>2</sup> and the enormous and appalling costs which are incurred upon them ...”.<sup>3</sup> In one of the most extreme examples, *Re Freudiana Music Co Ltd*,<sup>4</sup> the hearing lasted for a year and extended over some 165 court days. The judgment stretched to some 499 pages in length and the costs awarded in favour of the respondent alone were £2 million.<sup>5</sup> Although the length and costs of this case were exceptional, it is only an extreme example of what is characteristically a protracted procedure.<sup>6</sup>
- 11.2 The length and costs of such proceedings are not the only problems of which the courts and prospective parties to such proceedings need to be aware. As Vinelott J observed in *Re a Company, ex parte Burr*,<sup>7</sup> there is also “[t]he damaging effect which the presentation of the petition may have on the business of a company, even if it is not advertised ...”.<sup>8</sup> As one writer has observed, the costs “... are not just litigation costs

<sup>1</sup> [1994] 1 BCLC 609.

<sup>2</sup> He reinforced this point later in the same case, when dealing with the problem with time estimates in these proceedings. “On the second or third day of the hearing, I was informed by counsel on both sides that the estimate of 15 to 20 days was in their view a serious underestimate and that three months was a more likely period. Such a change of estimate can do nothing but depress a judge to whom it is made, and probably also the parties”. *Ibid*, at p 613. See also *Re Freudiana Music Co Ltd* 24 March 1993 (unreported, Jonathan Parker J), at p 496, where the court observed that the hearing had overrun the estimate by more than 500%.

<sup>3</sup> [1994] 1 BCLC 609, 611 (footnote added).

<sup>4</sup> 24 March 1993 (unreported, Jonathan Parker J).

<sup>5</sup> *Re Freudiana Holdings Ltd* 11 February 1994 (unreported, Jonathan Parker J).

<sup>6</sup> Eg *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, where the hearing of the petition lasted 27 days. In *Re Elgindata Ltd* [1991] BCLC 959, the hearing of the petition lasted 43 days, costs totalled £320,000 and the shares, originally purchased for £40,000, were finally valued at only £24,600. In the case of *Re Unisoft Group (No 2)* [1993] BCLC 532, 535, Sir Donald Nicholls V-C observed that, if the petition was to run its full course, the respondents’ estimate alone on costs was £250,000. This estimate was made before a further hearing in this case, *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, which lasted 19 days. The expenses of litigating in the Scottish courts, and in particular, the Court of Session, are generally significantly less than those in England.

<sup>7</sup> [1992] BCLC 724; on appeal *sub nom Saul D Harrison*.

<sup>8</sup> *Ibid*, at p 736. This point was echoed by Hoffmann LJ in the Court of Appeal, in the same case; [1995] BCLC 14, 22. Another example of this is that, at the conclusion of the mammoth *Freudiana* litigation, a previously viable company was effectively insolvent.

(particularly if the action is unsuccessful) but also the reputational costs of the company and the costs of management time expended in litigation”.<sup>9</sup> Proceedings may mean a company’s assets and business are effectively frozen, or at least severely restricted, for a long period of time, pending the outcome of any dispute.<sup>10</sup> In investment terms, the lack of any simple, cheap procedure may also cause investors to be more cautious before putting money into such companies.<sup>11</sup>

11.3 Hoffmann J had foreseen the potential difficulties that such petitions might present in the earlier case of *Re a Company (No 007623 of 1984)*,<sup>12</sup> where he said that section 75 [now section 459] was “... a valuable and overdue reform of the law which conferred on the court a wide and useful discretion. Nothing that I say ... is intended to (or could) reduce the ambit of that discretion. But the very width of the jurisdiction means that unless carefully controlled it can become a means of oppression”.<sup>13</sup>

11.4 In considering procedural aspects of petitions under section 459, one cannot ignore the more widespread complaints about the civil justice system.<sup>14</sup> The Lord Chancellor appointed Lord Woolf in March 1994 to review the current civil procedure, with a view to improving access to justice in the civil courts. The Woolf Report was published in July 1996,<sup>15</sup> and it is to be hoped that his proposals, along with other recent practice changes,<sup>16</sup> will go some way to addressing the problems that have arisen in this area.

<sup>9</sup> D D Prentice, “Protecting Minority Shareholders’ Interests: Recent Developments with respect to sections 459-461 of the Companies Act 1985” in *Corporate and Commercial Law: Modern Developments* (1996) p 79, at p 84.

<sup>10</sup> See *Re a Company (No 001363 of 1988)*, *ex parte S-P* [1989] BCLC 579, 586, *per* Warner J and *Re XYZ Ltd* [1987] 1 WLR 102, 110, *per* Hoffmann J.

<sup>11</sup> This view was reinforced in a radio interview in 1993, where Alastair Ross Goobey, Chief Executive of Postel, said that the failure to provide machinery by which grievances of shareholders in private companies could simply and fairly be resolved deters pension funds and other bodies from investing in small companies. See also the DTI consultation paper *Company Law Review: The Law Applicable to Private Companies* (November 1994).

<sup>12</sup> [1986] BCLC 362.

<sup>13</sup> *Ibid*, at p 367.

<sup>14</sup> See, for example, *Reform of the Civil Justice System, The Views of the UK Corporations, Research Report* (January 1995), prepared on behalf of Herbert Smith by Consensus Research International.

<sup>15</sup> Scottish procedure has recently been the subject of Lord Cullen’s *Review of Business of the Outer House of the Court of Session* (January 1996).

<sup>16</sup> In particular, Practice Direction (Civil Litigation: Case Management) [1995] 1 WLR 262; Practice Direction (Chancery Division: Procedure and Case Management) [1995] 1 WLR 785 and the Chancery Guide. See paras 11.29-11.33 below. No equivalent practice directions exist in Northern Ireland or Scotland. For the procedural rules applicable in Scotland, see n 24 below.



11.5 In this part we set out some of the procedural aspects which apply to petitions under section 459 and highlight a number of difficulties which have arisen.<sup>17</sup> We consider the following points in turn:

- (i) the petition and procedural rules;<sup>18</sup>
- (ii) parties to the proceedings;<sup>19</sup>
- (iii) advertisement of petitions;<sup>20</sup>
- (iv) strike out applications;<sup>21</sup>
- (v) costs;<sup>22</sup>
- (vi) recent developments.<sup>23</sup>

### **The petition and procedural rules**<sup>24</sup>

11.6 For the purposes of section 459,<sup>25</sup> “the court” means the court having jurisdiction to wind up the company.<sup>26</sup> Although practitioners seem to prefer to use the High Court when presenting a section 459 petition,<sup>27</sup> the County Court<sup>28</sup> also has jurisdiction, if the company’s paid-up (or credited as paid-up) share capital does not exceed £120,000.<sup>29</sup> The High Court has jurisdiction provided the company is registered in England and Wales. The procedure for petitions is governed by the Companies (Unfair

<sup>17</sup> This part also covers, to a lesser extent, s 122(1)(g) of the Insolvency Act 1986.

<sup>18</sup> See paras 11.6-11.11 below.

<sup>19</sup> See paras 11.12-11.20 below.

<sup>20</sup> See paras 11.21-11.22 below.

<sup>21</sup> See paras 11.23-11.25 below.

<sup>22</sup> See paras 11.26-11.28 below.

<sup>23</sup> See paras 11.29-11.33 below.

<sup>24</sup> There are no specific procedural rules for s 459 applications in Scottish procedure. The usual rules on petitions apply; see r 14 of the Court of Session Rules 1994. The present Rules, which are stated to apply to companies, do not deal expressly with s 459 applications. There is no Companies Court in the Court of Session. Some applications have been made in the local Sheriff Court, which has jurisdiction to wind up companies with an issued share capital not exceeding £120,000; see, for example, *Jesner v Farrad Properties Ltd* [1993] BCLC 1032. Section 459 applications cannot be heard as commercial causes.

<sup>25</sup> As well as the rest of the provisions in Part XVII of the Companies Act 1985.

<sup>26</sup> Section 744 of the Companies Act 1985.

<sup>27</sup> In 1994 and 1995, 166 s 459 petitions were presented in the High Court. See Appendix E. This can be compared, for example, with the Birmingham County Court, where there have only been 2 petitions presented in the last 5 years, both of which have settled. In the Manchester County Court, which handles the North and North Eastern Circuits, the situation is similar, although there were 3 petitions filed in the first 5 months of 1995, which was considered exceptional. Unfortunately what these figures are not able to tell us is how many times the threat of issuing such proceedings has brought about a settlement of the issues.

<sup>28</sup> Of the district in which the company’s registered office is situated.

<sup>29</sup> Insolvency Act 1986, s 117(2). In Northern Ireland the High Court alone has jurisdiction.

Prejudice Applications) Proceedings Rules 1986.<sup>30</sup> The RSC and the practice of the High Court also apply to proceedings brought under sections 459-461, save where they are inconsistent with the Companies Act 1985 and the 1986 Rules.<sup>31</sup>

- 11.7 The main body of a petition will set out the grounds on which the petition is presented. Although practice varies, this will often include a detailed account of the history of the affairs of the company, with every possible incident which is alleged to constitute unfairly prejudicial conduct. One reason for this<sup>32</sup> is that unless an allegation appears in the petition, it cannot properly be pleaded in any subsequent points of claim,<sup>33</sup> or, indeed, relied upon in evidence.<sup>34</sup> The prayer for relief in the petition may often ask for a winding up order on just and equitable grounds in the alternative.<sup>35</sup>
- 11.8 When the petition is issued, a “return date” will be fixed on which the petitioner and any respondent (including the company) must attend before a registrar in chambers for further directions.<sup>36</sup> The petitioner, in accordance with the 1986 Rules, must serve the petition on both the company and all the named respondents in the petition. The respondents do not have to acknowledge service of the petition, they simply have to appear at court on the return date.
- 11.9 On the return date, or any time after it, the court has the power to give such directions as it thinks fit on various points set out in rule 5 of the 1986 Rules. These matters include: service of the petition; whether or not points of claim are to be ordered; whether, and if so by what means, the petition is to be advertised; and any other matter affecting the procedure on the petition. In some cases the court gives only some of the requisite interlocutory directions on the first return date, and directions, for example for discovery, are adjourned to subsequent hearings.

<sup>30</sup> SI 1986 No 2000 (“the 1986 Rules”).

<sup>31</sup> Rule 2(2) of the 1986 Rules.

<sup>32</sup> For another reason, see para 11.10 below.

<sup>33</sup> *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 624, *per* Harman J, following *Re Lundie Bros Ltd* [1965] 1 WLR 1051, 1058, where Plowman J did not agree with counsel that it was the evidence, and not the allegations in the petition, which was of importance, and held it was wrong to travel outside the allegations in the petition.

<sup>34</sup> See *Re Tecnion Investments* [1985] BCLC 434, 441, *per* Dillon LJ, also relying on Plowman J’s judgment in *Re Lundie Bros Ltd* [1965] 1 WLR 1051.

<sup>35</sup> Of 156 petitions presented in the High Court during 1994-1995, 60.3% were under s 459 alone, and just under 40% were under s 459, with s 122(1)(g) pleaded in the alternative. See Appendix E, Table 1.

<sup>36</sup> Rule 3(3) of the 1986 Rules. In London this will be the Registrar of the Companies Court, outside London this will be the relevant District Judge.

- 11.10 We have already observed that the wording of section 459 is extremely wide<sup>37</sup> and that it allows conduct going back over many years to be raised in the proceedings.<sup>38</sup> We have also indicated that the prospects of success are greater if the petitioner can show that circumstances exist which satisfy the test in *Ebrahimi*.<sup>39</sup> This appears to encourage parties to produce detailed accounts of the history of the company and the understandings and agreements made between them. The result can often be petitions which are lengthy, vague and imprecise, and proceedings in which voluminous amounts of evidence are adduced.<sup>40</sup>
- 11.11 Although this is partly a substantive problem arising from the wording of section 459 itself, it is also a procedural matter. Pleadings are not ordered in all cases and directions are instead given for the service of affidavits. This means that the issues are not always clearly defined.<sup>41</sup> However, since the introduction of the Chancery Guide,<sup>42</sup> there has been greater court management of cases under section 459 which should in due course lead to significant improvements in the procedural aspects of these cases.

<sup>37</sup> See paras 9.17 and 11.3 above.

<sup>38</sup> As Harman J observed in *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, the "... words are, on the face of them, extraordinarily wide and general. They allow ... every sort and kind of conduct which has taken place over an almost unlimited — certainly upwards of 20 years — period of time in the management of a company's business to be dug up and gone over". *Ibid*, at p 611. For example, in the case of *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, the proceedings involved an examination of events spanning some 40 years and in *Re Sam Weller & Sons Ltd* [1990] Ch 682, events spanning some 38 years.

<sup>39</sup> [1973] AC 360, 379, *per* Lord Wilberforce. These could include: (i) an association based on a personal relationship, involving mutual confidence; (ii) an agreement that the shareholders shall participate in the conduct of business; or (iii) a restriction on the transfer of shares. See para 8.9 above. There are two aspects to this. First, it would appear that the term "interests" is often given a much wider definition if these types of circumstances are shown to exist, so that it is easier for the petitioner to show that his interests have been unfairly prejudiced. See paras 9.24-9.25 above. Secondly, where a purchase order is sought under section 461(2)(d) if such circumstances can be shown, the courts are inclined to give a more favourable valuation by valuing the shares on a pro rata basis instead of discounting them as a minority shareholding. See paras 10.14-10.15 above.

<sup>40</sup> Eg Harman J observed in *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, that on the petition before him there were "... upwards of 30 lever arch files of documents". In such circumstances, he said "... it befits the court ... to be extremely careful to ensure that oppression is not caused to parties, respondents ... or ... petitioners ..., by allowing the parties to trawl through facts which have given rise to grievances but which are not relevant conduct within even the very wide words of the section". *Ibid*, at p 611. A related problem concerning the duplication and irrelevance of bundles of documents was highlighted by Arden J in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 411. See further at para 11.31, n 87 below.

<sup>41</sup> Eg in *Re DR Chemicals Ltd* [1989] BCLC 383, 390, where Peter Gibson J said "I feel bound to observe that it would have been more helpful had pleadings been ordered to identify the particular issues between the parties". Also see *Re Elgindata Ltd* [1991] BCLC 959, 982-983, where Warner J criticised the vague and incomplete nature of the petition. Despite voluntary particulars having been filed, the judge observed that it still remained difficult to ascertain precisely what the petitioners' claim was. In Scottish procedure the application must also be made by petition rather than by an ordinary action in the form of a Summons (in the Court of Session) or an Initial Writ (in the Sheriff Court), but it does not appear that the standard of pleadings differs.

<sup>42</sup> See paras 11.30-11.32 below.

## Parties to the proceedings

### *Who may petition*

- 11.12 Section 459(1) provides simply that “a member of a company” may apply under the section.<sup>43</sup> It is clear that a petitioner must be a member at the time of bringing the petition, but the section is silent as to whether the petitioner must have been a member at the time of the unfairly prejudicial conduct. No case law exists on this point and it does not appear to create a problem in practice.<sup>44</sup>
- 11.13 Section 459 also omits any reference to former members of a company. At present, if a former member subsequently discovers that some unfairly prejudicial act had been committed at a time when he was a member, he is unable to bring an action under section 459 to recover any loss that he may have suffered.<sup>45</sup>
- 11.14 However, an earlier problem which existed regarding personal representatives<sup>46</sup> has now been resolved by section 459(2) of the Companies Act 1985. This extends the application of the section to “... a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law, as those provisions apply to a member of the company ...”.<sup>47</sup>

### *Who should be joined as a party*

- 11.15 The court has wide powers by virtue of both rule 5(a) of the 1986 Rules<sup>48</sup> and RSC, O 15, r 6 to join parties to proceedings, or order that a person should cease to be a party.<sup>49</sup> In section 459 cases, the question as to who should be joined as a party to the proceedings “... requires consideration to be given not only to the persons who were

<sup>43</sup> See Companies Act 1985, s 22 for the definition of “member”.

<sup>44</sup> For discussion of this point, see D D Prentice, “The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985” (1988) 8 OJLS 55; R Hollington, *Minority Shareholders’ Rights* (2nd ed 1994) para 4-003; and S H Goo, *Minority Shareholders’ Protection* (1994) p 19, n 12.

<sup>45</sup> Contrast this with the position of some former contributories who may bring proceedings under s 122(1)(g) of the Insolvency Act 1986. See para 8.3 above and see further at paras 20.32-20.38 below. For an illustration of the possible consequences of this omission, see A Marsden, “Prejudicial Relief?” (1994) 15 Co Law 178.

<sup>46</sup> It was unclear under s 210 of the Companies Act 1948 whether personal representatives of a bankrupt or deceased member would have locus standi. See the Jenkins Committee, Report of the Company Law Committee (1962) Cmnd 1749, para 209 and see H Rajak, “The Oppression of Minority Shareholders” (1972) 35 MLR 156.

<sup>47</sup> Note, however, that s 459(2) does not cover beneficial owners whose shares are held by nominees; see *Re Quickdome Ltd* [1988] BCLC 370. This paper does not deal with the position of nominees; see para 1.10 above.

<sup>48</sup> See para 11.9 above.

<sup>49</sup> As explained in para 11.6 above, the RSC apply save where they are inconsistent with the Companies Act 1985 and the 1986 Rules. Under both r 5(a) of the 1986 Rules and RSC, O 15, r 6 the court may join a party notwithstanding that the petitioner does not consent to such joinder. (With respect to r 5(a), see *Re Little Olympian Each-Ways Ltd (No 3)* 7 October 1994 (unreported, Evans-Lombe J) at p 13).

responsible for the unfair conduct complained of but those who might be affected by relief under section 461 rectifying that unfair conduct”.<sup>50</sup> Ultimately this is a question for the exercise of judicial discretion, but the cases do give some guidance.

- 11.16 The company will, and indeed should, always be joined as a party, not least because otherwise no orders will be enforceable against it.<sup>51</sup>
- 11.17 Other shareholders will be made parties where they are alleged to have been responsible for the unfairly prejudicial conduct or where they may be affected by the relief sought. However, where there are numerous shareholders, the court may direct that shareholders who are not directly affected by the relief sought and were not involved in the formation or management of the company should simply be given notice of the petition and the right to apply to the court to be joined as parties if they so wish.<sup>52</sup>
- 11.18 It has also been held that a former member of a company may be joined as a party if relief is sought against that person.<sup>53</sup>

#### *Third party proceedings*

- 11.19 It is interesting to note that in winding up proceedings in the Companies Court, third party claims and contribution claims between defendants<sup>54</sup> are not normally available in respect of claims which do not arise as a consequence of the winding up.<sup>55</sup> There is authority that such proceedings are also not available when a petition has been brought under section 459.<sup>56</sup>

<sup>50</sup> *Re BSB Holdings Ltd* [1993] BCLC 246, 253, per Vinelott J.

<sup>51</sup> Eg a buy out order. See the comments of Evans-Lombe J in *Re Little Olympian Each-Ways Ltd (No 3)* 7 October 1994 (unreported, Evans-Lombe J) at p 14. Having the company as a party will also be important for the discovery process.

<sup>52</sup> See *Re a Company (No 007281 of 1986)* (“the 3i case”) [1987] BCLC 593, 599, per Vinelott J.

<sup>53</sup> See *Re a Company* [1986] BCLC 68. In *Re Baltic Real Estate Ltd (No 1)* [1993] BCLC 498, Knox J struck out a petition against two former directors of a company who were the alleged wrongdoers, but see Lindsay J’s comments on this case in *Re Little Olympian Each-Ways Ltd* [1994] 2 BCLC 420, 428-429. See also *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636, where the court made a purchase order under s 461 against a company which, although a parent of the relevant company at the time of the alleged conduct, was no longer a member of it.

<sup>54</sup> Under RSC, O 16.

<sup>55</sup> *Re Shilena Hosiery Co Ltd* [1980] Ch 219. Third party proceedings are also unavailable in winding up proceedings under Scottish law.

<sup>56</sup> See *Aiden Shipping Ltd v Interbulk Ltd* [1986] AC 965, 981, per Lord Goff, which was applied in *Re Little Olympian Each-Ways Ltd (No 3)* 7 October 1994 (unreported, Evans-Lombe J) at p 16. However, in the light of r 2(2) of the 1986 Rules, it may well be that in other circumstances joinder under RSC, O 15 and third party and contribution notices under RSC, O 16 would be allowed in s 459 proceedings.

- 11.20 In the absence of contribution proceedings, the court may be unable to determine the basis on which respondents should, as between themselves, bear the burden of relief which is ordered in favour of the petitioners.<sup>57</sup>

### **Advertisement of petitions**

- 11.21 Dissemination of the information that a petition has been filed under either section 459 or section 122(1)(g), or both, is potentially very damaging to a company.<sup>58</sup> We have already seen that advertisement of the petition is one of the matters which the court will consider on the return date fixed for a section 459 petition.<sup>59</sup> A similar procedure applies to winding up petitions brought by contributories.<sup>60</sup>
- 11.22 It is now clear that, where the court directs that the petition should not be advertised, such a prohibition extends beyond advertising the petition in the Gazette, and includes any notification to an outsider of the existence of the petition.<sup>61</sup> It is also clear that, whilst there is no actual provision relating to the question of whether there should be advertisement prior to the return date, it is inherent in the rules that no advertisement should take place prior to that date.<sup>62</sup>

### **Strike out applications**

- 11.23 It is notable that a large number of the reported cases under section 459 are applications by the respondents to strike out the petition under RSC, O 18, r 19(1)

<sup>57</sup> See further at para 20.29 below.

<sup>58</sup> See paras 8.19-8.21 above on the effect of s 127 of the Insolvency Act 1986 where a winding up petition has been presented. Even where a petition seeks relief under s 459 alone, the company's customers and creditors are likely to be wary of doing business with the company, both because of the risk that the petition might be amended and a winding up order sought, and the disruption which is likely to be caused to the company as a result of the proceedings.

<sup>59</sup> See para 11.9 above. The Scottish courts have power to dispense with advertising the petition; see r 14.5 of the Court of Session Rules 1994. It is unheard of to order press advertisement of a s 459 petition. In Scotland there is no gap between the issuing of the petition and the return date, both are carried out at the same stage.

<sup>60</sup> Insolvency Rules 1986, rr 4.22(2) and 4.23(1). The detailed Scottish procedure for any winding up application is different; see rr 74.20-32 of the Court of Session Rules 1994. Under these rules the Scottish court has power to dispense with advertising the petition, and has done so in applications by contributories; see rr 74.20 and 74.32.

<sup>61</sup> *Re a Company (No 00687 of 1991)* [1992] BCLC 133; *Re Bill Hennessey Associates Ltd* [1992] BCC 386 and *Re Doreen Boards Ltd* [1996] 1 BCLC 501.

<sup>62</sup> See the comments of Laddie J in *Re Doreen Boards Ltd* [1996] 1 BCLC 501. Note, however, the different procedure which applies in Scotland; see n 59 above.

and/or under the inherent jurisdiction of the court.<sup>63</sup> RSC, O 18, r 19(1) provides that the court may:

... at any stage of the proceedings order to be struck out or amended any pleading ... or anything in any pleading ... on the ground that (a) it discloses no reasonable cause of action or defence, as the case may be; or (b) it is scandalous, frivolous or vexatious; or (c) it may prejudice, embarrass or delay the fair trial of the action; or it is otherwise an abuse of the process of the court; and may order the action to be stayed or dismissed or judgment to be entered, as the case may be.

- 11.24 Strike out applications are made on the basis that the factual allegations made by the petitioner are presumed to be true. However, the court will in an appropriate case examine the evidence with care to see whether the facts alleged, if proved, would constitute unfairly prejudicial conduct. Thus in *Saul D Harrison*,<sup>64</sup> the petition was struck out because the petitioner had failed to adduce any evidence which, if accepted at the trial, would support the allegations in the petition and justify the relief sought.<sup>65</sup>
- 11.25 There is no equivalent to section 125(2) of the Insolvency Act,<sup>66</sup> for petitions under section 459. However, a petition under section 459 may be struck out if the petitioner seeks a purchase order but has refused a fair and reasonable offer for his shares.<sup>67</sup>

<sup>63</sup> An identical rule applies in Northern Ireland. There is no direct equivalent under Scottish procedure of an application to strike out under RSC, O 18, r 19(1). The closest equivalent is to have the petition dismissed as irrelevant on the ground that the factual statements (even if correct) are insufficient to justify the order sought. The test is lower than that in an application for striking out.

<sup>64</sup> [1995] 1 BCLC 14.

<sup>65</sup> [1992] BCLC 724, 736 (Ch D); [1995] 1 BCLC 14, 26-27 and 33 (CA).

<sup>66</sup> Which requires the court to consider, in respect of winding up petitions under s 122(1)(g), whether the petitioner is acting unreasonably in refusing to pursue some other form of relief.

<sup>67</sup> See, for example, *Re a Company (No 003096 of 1987)* (1988) 4 BCC 80, and see generally paras 8.15-8.17 above.

## Costs<sup>68</sup>

### *No indemnity for costs*

- 11.26 The court has no jurisdiction in proceedings under section 459, unlike derivative actions,<sup>69</sup> to grant the petitioner an advance order requiring the company to indemnify him as to costs.<sup>70</sup> Petitioners under section 459, in contrast to shareholders who bring a derivative action,<sup>71</sup> are, however, eligible for legal aid.<sup>72</sup>

### *Costs of the respondents*

- 11.27 The court has considered the question of whether respondents (generally the majority shareholders and/or directors of the company) should be allowed to use company funds to finance the costs of their litigation in what is essentially an inter-shareholder dispute. In *Re Crossmore Electrical and Civil Engineering Ltd*<sup>73</sup> Hoffmann J said:

The company is a nominal party to the section 459 petition, but in substance the dispute is between the two shareholders. It is a general principle of company law that the company's money should not be expended on disputes between the shareholders ... .<sup>74</sup>

- 11.28 It has been suggested that such a use of resources could in itself be unfairly prejudicial conduct,<sup>75</sup> and the courts have held that there are only certain limited situations where company funds may be used to defray the costs in petitions brought under section 459.<sup>76</sup>

<sup>68</sup> In Scottish law the equivalent of “costs” is “expenses”; see para 6.10, n 29 above. The Scottish courts would follow the English cases on s 459 applications discussed at paras 11.26-11.28. Although the details of legal aid in Scotland are different (see Part III of the Legal Aid (Scotland) Act 1986), the availability of legal aid for s 459 applications is the same in both jurisdictions.

<sup>69</sup> See paras 6.11-6.14 above.

<sup>70</sup> *Re Sherborne Park Residents Co Ltd* [1987] BCLC 82.

<sup>71</sup> See para 6.11 above.

<sup>72</sup> Legal Aid Act 1988, s 14(1)(a). See *Mills v Mills* [1963] P 329 and *R v Legal Aid Committee No 1 (London) Legal Aid Area, ex parte Rondel* [1967] 2 QB 482 as to the width of the term “proceedings” and, in particular, the fact that it extends to matters commenced by petition.

<sup>73</sup> [1989] BCLC 137.

<sup>74</sup> *Ibid*, at p 138. See also *Re Milgate Developments Ltd* [1993] BCLC 291.

<sup>75</sup> See Harman J's comments in *Re Hydrosan Ltd* [1991] BCLC 418, 420.

<sup>76</sup> See *Re a Company (No 004502 of 1988), ex parte Johnson* [1992] BCLC 701. These exceptions were concerned with (i) discovery of documents against the company (ii) an application to obtain an order under s 127 of the Insolvency Act 1986 and (iii) the hearing where a judgment in the case is given (since an order could be made that the company purchase the petitioner's shares). For an analysis of the case law in this area generally, see the judgment of Lindsay J in *Re BSB (Holdings) Ltd* [1994] 2 BCLC 146.



### Recent developments<sup>77</sup>

- 11.29 Two recent practice directions<sup>78</sup> apply in the Chancery Division of the High Court, in which section 459 proceedings are frequently brought. The first practice direction<sup>79</sup> applies to civil proceedings in both the Chancery Division and the Queen’s Bench Division of the High Court. It emphasises the need for judges to assert greater control over the preparation for and conduct of hearings, and warns practitioners that failure to conduct cases economically may well result in cost penalties, including wasted costs orders.<sup>80</sup> The court will exercise its discretion to limit discovery and the other issues on which it wishes to be addressed.<sup>81</sup> Also, in cases estimated to last more than ten days, a pre-trial review should be applied for, or, in default, may be ordered by the court.<sup>82</sup> Skeleton arguments should be lodged with the court at least three days before the trial,<sup>83</sup> and a pre-trial check list lodged with the listing officer on behalf of each party no later than two months before the date of trial.<sup>84</sup> This check list must state whether the parties have been advised by their lawyers on the possibility of resolving the dispute by alternative dispute resolution (“ADR”).
- 11.30 The second practice direction, along with the publication of the new Chancery Guide,<sup>85</sup> specifically addresses proceedings in the Chancery Division of the High Court. The Guide identifies the measures proposed as being particularly relevant to proceedings under section 459.<sup>86</sup> It addresses both pre-trial procedural problems and problems arising in the conduct of proceedings themselves.

<sup>77</sup> The matters discussed in paras 11.29-11.33 do not apply to s 459 applications in Scotland or Northern Ireland. Lord Cullen’s *Review of the Business of the Outer House of the Court of Session* (January 1996) does not expressly refer to such applications.

<sup>78</sup> Practice Direction (Civil Litigation: Case Management) [1995] 1 WLR 262 and Practice Direction (Chancery Division: Procedure and Case Management) [1995] 1 WLR 785.

<sup>79</sup> Practice Direction (Civil Litigation: Case Management) [1995] 1 WLR 262.

<sup>80</sup> *Ibid*, at para 1.

<sup>81</sup> *Ibid*, at para 2.

<sup>82</sup> *Ibid*, at para 6.

<sup>83</sup> *Ibid*, at para 8.

<sup>84</sup> *Ibid*, at para 7. Note this rule is subject to the proviso, unless the court orders otherwise. It is hard to imagine situations where the court would so order.

<sup>85</sup> See *The Supreme Court Practice 1995, Third Cumulative Supplement* (1995) p 143.

<sup>86</sup> Chancery Guide, at p 50.

- 11.31 With respect to pre-trial matters, it gives guidance on: (i) bundles of documents;<sup>87</sup> (ii) skeleton arguments;<sup>88</sup> (iii) discovery;<sup>89</sup> (iv) witness statements;<sup>90</sup> (v) expert evidence;<sup>91</sup> (vi) pre-trial reviews and check lists;<sup>92</sup> (vii) filing of evidence on hearings before Masters;<sup>93</sup> and (viii) pleadings.<sup>94</sup>
- 11.32 With respect to the conduct of the proceedings, it focuses in particular on: (i) time estimates, provisional timetables and time limits imposed by the court;<sup>95</sup> (ii) opening and closing speeches;<sup>96</sup> (iii) documents and authorities;<sup>97</sup> (iv) adjournments;<sup>98</sup> (v) the hearing of evidence;<sup>99</sup> and (vi) costs.<sup>100</sup> The Guide not only gives guidance on court procedure, it also brings to the attention of parties the option of ADR.<sup>101</sup>
- 11.33 In addition to these practice directions, the Woolf Report proposals encourage further the role of judges in managing proceedings. They also include encouragement of early settlement and referral to alternative dispute procedures.<sup>102</sup>

<sup>87</sup> *Ibid*, at pp 3, 26-27 and 69-72. It is hoped that this will address the problems noted by Arden J in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 411. See para 11.10, n 40 above.

<sup>88</sup> *Ibid*, at pp 4, 27-29 and 73.

<sup>89</sup> *Ibid*, at pp 4 and 11-12. Eg one suggestion is that it may be helpful for parties to draw up (and if possible agree) a list of the essential issues in the case before any application for discovery is made to assist the court in deciding to which issues discovery should relate.

<sup>90</sup> *Ibid*, at pp 5, 13-15 and 33-34.

<sup>91</sup> *Ibid*, at pp 5, 15-16 and 34-35. Eg one suggestion is that the experts should meet either before or after they have written their reports, on a without prejudice basis if necessary. The court can then direct the experts to exchange lists of issues and prepare a report for the court stating the matters on which they agree or disagree.

<sup>92</sup> *Ibid*, at pp 5, 16-17 and 79-80.

<sup>93</sup> *Ibid*, at pp 5-6 and 9-10.

<sup>94</sup> *Ibid*, at p 10.

<sup>95</sup> *Ibid*, at pp 6, 25 and 29-30. Some examples of these proposals are that at the beginning of a substantial application, the court may fix a provisional timetable for the completion of the various stages in the hearing, and that the court may at any time fix time limits for oral submissions, speeches and the examination and cross-examination of witnesses. *Ibid*, at p 29.

<sup>96</sup> *Ibid*, at pp 6-7, 33 and 35.

<sup>97</sup> *Ibid*, at pp 7 and 30.

<sup>98</sup> *Ibid*, at pp 7 and 30-31.

<sup>99</sup> *Ibid*, at pp 33-34.

<sup>100</sup> *Ibid*, at pp 39-41.

<sup>101</sup> *Ibid*, at p 61. For further discussion on this point see paras 19.12-19.15 below.

<sup>102</sup> See further paras 17.3-17.4 below.

# SECTION D OUTLINE OF OTHER STATUTORY REMEDIES

## PART 12 THE COMPANIES ACT 1985

### Introduction

- 12.1 In this section we set out briefly a number of other statutory remedies which are available to a shareholder, either directly or indirectly. In this part we consider such remedies available under the Companies Act 1985.<sup>1</sup> These include both substantive remedies to challenge certain decisions of the company, or to require the company to carry out certain obligations, and rights to information. In the next part (Part 13) we examine a number of provisions of the Insolvency Act 1986, and in particular those which enable a shareholder to apply to wind up the company<sup>2</sup> and those enabling a liquidator appointed to the company to recover assets on the company's behalf.<sup>3</sup>

### Substantive remedies

- 12.2 Although the principal remedy against unfairly prejudicial conduct has already been considered,<sup>4</sup> the Secretary of State may bring a similar action<sup>5</sup> and this will be considered here. Other rights and remedies of shareholders are also important. For example, shareholders have the right to call meetings and table resolutions<sup>6</sup> and the right to challenge resolutions.<sup>7</sup> There are, in addition, a number of miscellaneous remedies which are available to the shareholder.<sup>8</sup>

### *Application by Secretary of State for unfair prejudice remedy*<sup>9</sup>

- 12.3 Section 460 provides an unfair prejudice remedy similar to that provided by section 459. The petitioner, however, will be the Secretary of State. This may provide a dissatisfied member with an indirect remedy. Such a member may apply formally for

<sup>1</sup> All references to sections are to provisions in the Companies Act 1985 unless otherwise specified, or to the equivalent provisions in the Companies (Northern Ireland) Order 1986 (SI 1986 No 1032).

<sup>2</sup> See paras 13.2-13.7 below.

<sup>3</sup> See paras 13.8-13.15 below.

<sup>4</sup> See Parts 7-11 above.

<sup>5</sup> Section 460. In Northern Ireland the Department of Economic Development has similar powers; see art 453 of the Companies (Northern Ireland) Order 1986.

<sup>6</sup> See paras 12.9-12.10 below.

<sup>7</sup> See paras 12.11-12.18 below.

<sup>8</sup> See paras 12.19-12.23 below.

<sup>9</sup> For other remedies which make use of the "unfair prejudice" concept, see n 50 below.

the appointment of inspectors under section 431,<sup>10</sup> who may produce a report under section 437, which would give the Secretary of State grounds to act.

12.4 Section 460 (as amended)<sup>11</sup> provides that:

- (1) If in the case of any company—
  - (a) The Secretary of State has received a report under section 437,<sup>12</sup> or exercised his powers under section 447<sup>13</sup> or 448<sup>14</sup> of this Act or section 44(2) to (6) of the Insurance Companies Act 1982,<sup>15</sup> and
  - (b) it appears to him that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members, or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial,he may himself (in addition to or instead of presenting a petition for the winding up of the company) apply to the court by petition for an order under this Part.<sup>16</sup>

(2) In this section (and, so far as applicable for its purposes, in the section next following) “company” means any body corporate which is liable to be wound up under this Act<sup>17, 18</sup>.

12.5 This power is one of a number of powers which the Secretary of State possesses which enable the bringing of proceedings in relation to the conduct of the affairs of a company where the shareholders of that company are unable or unwilling to do so. Other powers available to the Secretary of State are:

<sup>10</sup> Which requires application by at least 200 members, or a member or members representing 10% of the shares issued.

<sup>11</sup> By Companies Act 1989, s 145 (Sched 19, para 11) and s 212 (Sched 24).

<sup>12</sup> Ie an inspectors' report.

<sup>13</sup> Secretary of State's power to require production of documents.

<sup>14</sup> Secretary of State's power to request a warrant for premises to be entered and searched.

<sup>15</sup> Secretary of State's power to require an insurance company to provide him with specified information, books and/or papers.

<sup>16</sup> Ie Part XVII of the Companies Act 1985. See Part 10 above for a discussion of the remedies available.

<sup>17</sup> The reference to “this Act” refers not only to the Companies Act 1985 but also to Parts I to VII (and certain sections of Part XV) of the Insolvency Act 1986 and the Company Directors Disqualification Act 1986; see s 735A(1) of the Companies Act 1985.

<sup>18</sup> It is worth noting the narrower category of companies which can be the subject of a s 459 petition. Section 459 applies to “... any company within the meaning of this Act or any company which is not such a company but is a statutory water company within the meaning of the Statutory Water Companies Act 1991”: Companies Act 1985, s 459(3).

- (i) a power under section 438 to bring proceedings on behalf of the company; and
- (ii) a power under section 124A of the Insolvency Act 1986 to petition for the company to be wound up.

One critical difference between section 460 and these other provisions is that the section 460 power is exercisable irrespective of whether it is in the public interest for the proceedings to be brought.<sup>19</sup> The only preconditions for the exercise of the Secretary of State's power under section 460 are as set out above.

- 12.6 Section 460(1) expressly provides that the Secretary of State may present a petition under section 460 either instead of *or in addition to* presenting a petition to wind up the company.
- 12.7 In fact, there is no judicial guidance<sup>20</sup> on the circumstances in which it is appropriate for the Secretary of State to exercise this power<sup>21</sup> and what (if any) impact the fact that the petition was brought by the Secretary of State should have on the form of the relief.
- 12.8 The Secretary of State also has wide powers to appoint inspectors, which shareholders may call upon him to exercise.<sup>22</sup>

#### *Requisition of meetings and resolutions*

- 12.9 In private companies (which may elect not to hold annual general meetings ("AGM"s) by elective resolution in accordance with section 379A)<sup>23</sup> a member can require the

<sup>19</sup> In contrast proceedings can only be brought by the Secretary of State under s 438 if "... it appears to the Secretary of State that any civil proceedings ought in the public interest to be brought ...": s 438(1), and the Secretary of State can only bring a petition to have a company wound up if "... it appears to the Secretary of State ... that it is expedient in the public interest that [the] company should be wound up ...": Insolvency Act 1986, s 124A.

<sup>20</sup> No applications have yet been made by the Secretary of State to bring proceedings under s 460.

<sup>21</sup> Eg whether the Secretary of State can bring a petition on the basis of evidence other than from an inspectors' report or information obtained as a result of the exercise of powers under ss 447 and 448 or s 44(2)-(6) of the Insurance Companies Act 1982.

<sup>22</sup> Section 431 (investigation of a company on its own application or that of its members) and s 442 (investigation of company ownership). For the powers exercisable by inspectors, see s 447 (power to order production of documents) and s 448 (power to apply for search warrant). Their report may be sent to members of the company under inspection: s 437. In 1994-1995, the DTI considered 1,024 cases for investigation which resulted in 323 statutory investigations, mostly under s 447 (DTI, *Companies in 1994-95* (1995)). Statistics for the first quarter of 1995 show an increase, with 274 complaints (cf 226 in 1994), of which 78 were approved for investigation.

<sup>23</sup> Ie by unanimous agreement. The elective regime under s 379A applies to decisions under s 80A (election as to duration of authority to allot shares), s 252 (election to dispense with laying of accounts before a general meeting; see para 12.33 below), ss 366A, 369(4) and 378(3) (election as to majority required to authorise short notice of meeting) and s 386 (election to dispense with annual appointment of auditors; see para 12.21). 21 days notice must be given in writing of a proposal for an elective resolution and the resolution must be

holding of such a meeting and in the event of default the Secretary of State may direct the calling of such a meeting.<sup>24</sup> In addition, members representing not less than 10 per cent of the total voting rights of all the members may require the company directors to convene an EGM and if the directors do not do so the members may do it themselves.<sup>25</sup> If it is impracticable to call the meeting in any other way, an application may be made to the court by any voting member for an order that a meeting be called, held and conducted in any manner that the court thinks fit.<sup>26</sup>

12.10 Section 376<sup>27</sup> provides that members may require the company to distribute notice of any resolution intended to be moved at the next AGM. There is no restriction on the nature of the resolution (except that it must not seek to achieve anything beyond the powers of the company). They may also require the company to circulate to members entitled to notice of a general meeting a statement with respect to a resolution or the business to be dealt with at any such meeting. The cost of this must be met by the requisitioning members.<sup>28</sup> The number of members required for this requisition is: any number representing not less than one twentieth of the total voting rights of all the members who have at the date of the requisition the right to vote at the meeting to which the requisition relates; or not less than 100 members holding shares in the company on which there has been paid up an average sum, per member, of not less than £100.<sup>29</sup>

agreed to at the meeting by all members entitled to attend and vote. Such a resolution may be revoked by ordinary resolution. However, if all members agree, less than 21 days notice may be given; see s 379(2A) (as inserted by the Deregulation (Resolutions of Private Companies) Order 1996 (SI 1996 No 1471)).

<sup>24</sup> Sections 366A(3) and 367. In Northern Ireland, art 375 of the Companies (Northern Ireland) Order 1986 confers a similar power on the Department of Economic Development.

<sup>25</sup> Section 368(1). The court has additional powers to order meetings under s 425. It may order a meeting of the members or any class of members on the application of any member in the event of a compromise or arrangement being proposed between the company and its members or a class of them. A similar remedy is available to the members of a transferee company during a merger or division of a public company prior to a sanction by the court of any compromise or arrangement under s 425(2); see s 427A(3).

<sup>26</sup> Section 371. For an interesting example of this provision in use see *Re British Union for the Abolition of Vivisection* [1995] 2 BCLC 1, where Rimer J granted an order under the section to hold a meeting at which votes could only be cast by post, following a meeting which had ended in violent clashes between rival members of the company. The order was granted even though it overrode the right of personal attendance granted under the company's constitution. Note also the court's power to order a meeting under s 461; see para 10.4 above.

<sup>27</sup> Article 384 of the Companies (Northern Ireland) Order 1986.

<sup>28</sup> The DTI recently published a consultative document, *Shareholder Communications at the Annual General Meeting* (April 1996) on possible changes to the statutory rules relating to the tabling and publication of resolutions, including the possibility that companies should be required, where certain criteria are met, to circulate such resolutions without charge.

<sup>29</sup> Section 376(2).

*Challenges to resolutions*<sup>30</sup>

- 12.11 The statement of the company's objects in the memorandum of association may be altered by special resolution,<sup>31</sup> but under section 5<sup>32</sup> shareholders who have dissented from such an alteration may apply to the court to cancel the resolution. Section 5 also applies to alterations by special resolution of conditions which could have been contained in the articles.<sup>33</sup>
- 12.12 To exercise this right of cancellation the holders of not less than 15 per cent in nominal value of the issued share capital (or a class of it), who must not have consented to or voted in favour of the resolution, have to apply to the court within 21 days after the passing of the resolution.<sup>34</sup> The court has a wide discretion as to the order it can make on such an application, in that it can order that there be no alteration, or confirm the alteration in whole or in part and impose terms and conditions. There is also a power to adjourn the application to allow the parties to reach an agreement as to the purchase of the shares of the dissenting members, and the power to order the purchase of the shares of any members<sup>35</sup> and the consequent reduction of the company's capital.<sup>36</sup>
- 12.13 Another situation in which the court has similar powers to those under section 5 is when a shareholder challenges a special resolution passed by a public company to be re-registered as a private company.<sup>37</sup> The holders of not less than 5 per cent of the company's issued share capital have 28 days from the passing of the resolution to apply for its cancellation. The shareholders may appoint one of their number to make the application on their behalf. The court can either confirm the resolution or order that it be cancelled and may, additionally, adjourn proceedings for the parties to come to an arrangement for the purchase of the dissenting members' shares or order the purchase of the shares by the company.<sup>38</sup>

<sup>30</sup> On voting rights and the right to challenge resolutions other than on Companies Act grounds, see paras 2.31-2.38 above.

<sup>31</sup> Section 4; art 15 of the Companies (Northern Ireland) Order 1986.

<sup>32</sup> Article 16 of the Companies (Northern Ireland) Order 1986.

<sup>33</sup> Section 17(3); art 28(3) of the Companies (Northern Ireland) Order 1986.

<sup>34</sup> Section 5(3); art 16(3) of the Companies (Northern Ireland) Order 1986.

<sup>35</sup> We have been unable to find any reported case in which the power to order a sale under s 5(5) has been exercised.

<sup>36</sup> Alteration of the articles may also lead to a petition under s 459 of the Companies Act 1985 (see para 9.39 above) if it amounts to conduct in the affairs of the company. See paras 9.5-9.7 above for consideration of the phrase "company's affairs" with respect to s 459 and see generally paras 20.20-20.22 below.

<sup>37</sup> Section 54; art 65 of the Companies (Northern Ireland) Order 1986. This was one of the grounds relied upon by the petitioners in *Re Ringtower Holdings plc* [1989] BCLC 427. See also para 9.39, n 94 above and paras 12.14-12.15 below.

<sup>38</sup> Section 54(5)-(6). Sections 5 (see paras 12.11-12.12 above) and 177 of the Companies Act 1985 (objection to payment out of capital for redemption or purchase of a private company's own shares; see para 12.18 below) and s 111 of the Insolvency Act 1986 (see para 13.2

- 12.14 No guidance is given in the section as to how the shares should be valued. However, in the case of *Re Ringtower Holdings plc*,<sup>39</sup> the petitioners relied on section 54 in the alternative to their petition under section 459,<sup>40</sup> and sought<sup>41</sup> a cancellation of the resolution passed. Peter Gibson J observed that there was little guidance given to the court by the statutory provisions as to the exercise of the wide discretion conferred by the section. He said of the discretion to order a purchase of the petitioner's shares that "... where a fair offer to purchase the dissentient's shares has not been made, the court might exercise its power to procure a sale".<sup>42</sup>
- 12.15 Peter Gibson J also held that the court could, on a striking out application, consider "... the appropriateness of the remedy sought and the reasonableness of the conduct of the petitioner in the light of offers made to the petitioner to purchase his shares".<sup>43</sup>
- 12.16 The Companies Act 1985 also provides a procedure whereby resolutions varying the rights attached to any class of shares may be challenged.<sup>44</sup> Such rights may be attached by the memorandum, the articles, the terms of issue or the resolution authorising the

below) similarly provides the court with power to order the company (or liquidator in the case of s 111) to buy the dissenting member's shares and reduce its capital accordingly. In addition, s 111 makes provision for arbitration for the purposes of valuation. See generally Part 19 below.

<sup>39</sup> [1989] BCLC 427.

<sup>40</sup> As well as seeking a just and equitable winding up under s 122(1)(g) of the Insolvency Act 1986.

<sup>41</sup> Under s 54.

<sup>42</sup> [1989] BCLC 427, 437-438. He also said that one circumstance in which it might be appropriate to invoke the jurisdiction was where the dissentient shareholder found himself locked into a company, whereas previously, when the company was a public one, he had been able to transfer his shares more freely.

<sup>43</sup> *Ibid*, at p 438. In this case, the judge held that no ground had been shown for cancelling the special resolution for re-registration. He further held that even if there was a hearing of the petition under s 54, there was no scope for the court to impose any terms in view of the fact that the respondents had made a fair offer for the petitioner's shares. *Ibid*, at p 452.

<sup>44</sup> In appropriate cases shareholders may be able to challenge such resolutions as a matter of common law (see paras 2.31-2.38 above) or seek a remedy under s 459 (see para 9.39 above).



issue of shares,<sup>45</sup> and may be varied in accordance with section 125.<sup>46</sup> However, under section 127 any such variation or abrogation can be challenged in court by the holders of not less than 15 per cent of the shares of the class in question if they did not consent or vote in favour of the change.<sup>47</sup> The application must be made within 21 days after the resolution passing the variation, and the court "... may, if satisfied having regard to all the circumstances of the case, that the variation would unfairly prejudice the shareholders of the class ..." <sup>48</sup> either disallow or confirm the variation, but there is no provision for the purchase of the dissentient shareholders' shares.

<sup>45</sup> It is also suggested that basic rights of all the classes as to dividends, capital and voting should be treated as class rights. See *Gore-Browne on Companies* (44th ed 1986) paragraph 14.7.1. The decision in *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd* [1987] Ch 1 suggests that rights conferred by name on a shareholder as such by the company's constitution can be class rights even though not attached to any particular class of shares. Also see the commentary on this case in *Gowder's Principles of Modern Company Law*, (5th ed 1992) pp 536-538. Note, however, *Re Blue Arrow plc* [1987] BCLC 585, where argument by the petitioner that her right to remain president of the company amounted to a class right, following *Cumbrian Newspapers*, was rejected by Vinelott J, who emphasised at p 590 that class rights must attach in some way to a category of shares of the company. (See also Vinelott J's comments in this case at para 9.53 above.) The right to remain president was unrelated to the petitioner's shareholding. Another right protected by this remedy is insistence upon compliance with a variation of rights clause.

<sup>46</sup> Article 135 of the Companies (Northern Ireland) Order 1986.

<sup>47</sup> Where a class consists of a single shareholder this right would be open to that particular member. Note that once the application is made the variation is of no effect until the court confirms it; see s 127(2).

<sup>48</sup> Section 127(4).

12.17 There is little reported authority<sup>49</sup> on section 127 or its predecessors.<sup>50</sup> In its original form<sup>51</sup> shareholders had only seven days to make the application and the two cases on that section deal with technical points.<sup>52</sup> This absence of authority may be explained, in part, by the difficulties that faced a dissentient shareholder in trying to gather together 15 per cent of the other members of his class within seven days.<sup>53</sup>

12.18 Shareholders may also apply to the court for the cancellation of a special resolution passed by a private company which approves the giving of financial assistance for the purchase of the company's shares. The applicants must hold not less than 10 per cent of the nominal value of the company's issued share capital and they must not have consented to or voted in favour of the resolution.<sup>54</sup> The court has the same wide powers in dealing with this application as those under sections 5 and 54.<sup>55</sup> In addition,

<sup>49</sup> Although note the reference made to the section by Scott J in *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd* [1987] Ch 1, 19-22 in determining whether class rights could be created by rights which attached not to specific shares, but to specific members.

<sup>50</sup> However, there are other sections which refer to unfair prejudice, and some guidance as to the interpretation of unfair prejudice may be gleaned from these. Thus, s 262 of the Insolvency Act 1986 refers to unfair prejudice to the interests of creditors in the context of a voluntary arrangement. The meaning of unfair prejudice in this context was considered recently in the case of *Doorbar v Alltime Securities Ltd (No 2)* [1995] BCC 728 (Ch D) affirmed at [1996] 1 WLR 456, 467-468, per Peter Gibson LJ. Section 432 of the Companies Act 1985 provides that the Secretary of State may appoint inspectors where there are circumstances suggesting unfairly prejudicial conduct of the company's affairs, but we are not aware of any cases considering the interpretation of unfair prejudice in relation to that section. Section 27 of the Insolvency Act 1986, providing protection to members while a company is in administration, also includes reference to unfair prejudice in wording similar to that of s 459 of the Companies Act 1985. In *Re Charnley Davies Ltd (No 2)* [1990] BCLC 760, Millett J considered the effect of the phrase "in a manner which is unfairly prejudicial" in s 127, and referred to its obvious derivation from s 459; *ibid*, at p 782. It is clear that he considered that s 27 should follow the case law decided under s 459. (However, as is apparent above (see paras 9.21-9.30 above), whilst some guidelines are possible as to the meaning of the phrase "unfairly prejudicial", the words should be applied flexibly (see para 9.25 above)). Cf *Doorbar v Alltime Securities Ltd (No 2)* [1996] 1 WLR 456, 467). However, s 27 reflects the wording of s 459 more closely than s 127 of the Companies Act 1985 (save that s 27 substitutes "creditors or members" for "members", and reference to the management by the administrator of the company's affairs, business and property for reference to conduct of the company's affairs). It is therefore unclear whether the courts will adopt the same approach in applications under those sections.

<sup>51</sup> Companies Act 1929, s 61.

<sup>52</sup> As to whether the requirements of the section had been complied with within the statutory time limits, see *Re Suburban and Provincial Stores Ltd* [1943] Ch 156 and *Re Sound City (Films) Ltd* [1947] Ch 169.

<sup>53</sup> Evershed J said in *Re Sound City (Films) Ltd* [1947] Ch 169, 173, "I cannot help feeling some sympathy for a man who, by the terms of the section ... has but seven days in which to collect the necessary forces to support his application". Section 127 now allows applications within 21 days.

<sup>54</sup> Section 157(2).

<sup>55</sup> Section 157(3). See paras 12.12-12.13 above. The DTI has issued a consultative document, *Proposals for Reform of Sections 151-158 Companies Act 1985* (October 1993). The scheme envisaged is of a two-tier nature. At the first level, art 23 of the Second EC Company Law Directive (77/91/EEC) would be implemented (preventing specific types of assistance). This

in a private company a special resolution approving a payment out of capital for the purchase or redemption of its shares may be cancelled upon application to a court by a member other than one who has consented to, or who voted in favour of, the resolution. Such application must be made within five weeks of the date on which the resolution was passed. The court has a similar power to adjourn proceedings, cancel or confirm the resolution, or order the purchase of shares as it has under sections 5, 54 and 157(2).<sup>56</sup>

*Miscellaneous shareholder remedies*

- 12.19 Under section 303,<sup>57</sup> shareholders may by ordinary resolution remove any director before the expiration of his term of office, notwithstanding anything in the company's articles or any agreement between the company and the director.<sup>58</sup>
- 12.20 Application may be made to a court for an order that the company's register of members be rectified pursuant to section 359,<sup>59</sup> on the grounds that a person is, without sufficient cause,<sup>60</sup> entered or omitted from the register<sup>61</sup> or default or delay takes place in removing a person from the register. Application may be made by the aggrieved person, a member, or the company. On making an order for rectification,<sup>62</sup> the payment of damages may be ordered.<sup>63</sup> Questions relating to the title of a person

would apply only to public companies. At the next level, all financial assistance would be prevented, with the current procedure under s 155 available to both public and private companies. The proposals include, at p 24, increasing to 15% the proportion of shareholders required to raise a challenge.

<sup>56</sup> Section 177.

<sup>57</sup> Article 311 of the Companies (Northern Ireland) Order 1986.

<sup>58</sup> Note, however, that a resolution to dismiss a director may give rise to an application under s 459 if unfairly prejudicial (see para 9.34 above). See also *Bushell v Faith* [1970] AC 1099.

<sup>59</sup> Article 367 of the Companies (Northern Ireland) Order 1986.

<sup>60</sup> It is sufficient to show that an error has been made. As Harman J said, "there is no question of fault being necessary" and the company need not have committed any wrong. The jurisdiction arises "whenever any name is omitted from the register and somebody claims that the omission is erroneous"; see *Re Fagin's Bookshop plc* [1992] BCLC 118, 123. Regard must be had to the justice of the case; see *Trevor v Whitworth* (1887) 12 App Cas 409, 440, *per* Lord Macnaughten (a case on Companies Act 1862, s 35, a forerunner of the current section).

<sup>61</sup> Applications have even been made on the grounds of misrepresentation in the prospectus, the same principles being employed as in an action for misrepresentation, although such application must be made within reasonable time and before the company becomes the subject of winding up proceedings. If the shares are fully paid up the court may refuse relief, requiring the applicant to bring an action.

<sup>62</sup> Which order may, where appropriate, be retrospective; eg *Re Sussex Brick Co* [1904] 1 Ch 598, 605, *per* Vaughan-Williams LJ, considering Companies Act 1862, s 35.

<sup>63</sup> Section 359(2).

to be entered on the register may be considered on such an application, as may “... any question necessary or expedient to be decided for rectification ...”<sup>64</sup>

- 12.21 Where a private company has passed an elective resolution to dispense with the annual appointment of the auditors,<sup>65</sup> any member may deposit written notice with the company proposing to bring the appointment of the auditors to an end. Following such a deposit the directors must convene a general meeting and if they fail to do so the member himself may call the meeting.<sup>66</sup>
- 12.22 Where, following a takeover offer, the bidder holds 90 per cent in value of all the shares in the company,<sup>67</sup> a non-assenting shareholder may, by written notice under section 430A, require the offeror to acquire his shares. The acquisition is on the terms of the offer unless the court orders otherwise.<sup>68</sup> Within one month of the end of the period of the offer, notice of rights under section 430A must be given to all shareholders who have not accepted the offer.<sup>69</sup>
- 12.23 The allotment of shares for cash without giving existing shareholders the right to take them up first, in breach of section 89,<sup>70</sup> may lead to an award of damages under section 92.<sup>71</sup>

### **Access to information**

<sup>64</sup> Section 359(3). However, only relatively straightforward cases may be decided on a motion under s 359. More complicated cases must be brought by action; see *Re Greater Britain Products Development Corpn Ltd* (1924) 40 TLR 488 (on Companies (Consolidation) Act 1908, s 32).

<sup>65</sup> Section 386. As to elective resolutions, see n 23 above.

<sup>66</sup> Section 393; art 401 of the Companies (Northern Ireland) Order 1986.

<sup>67</sup> Or, if the offer relates to a class of shares, 90% in value of the shares of that class: s 430A(2). See art 423 of the Companies (Northern Ireland) Order 1986. See also para 4.13, n 36 above.

<sup>68</sup> Section 430C(3).

<sup>69</sup> Section 430A(3). After the offeror has acquired or contracted to acquire 90% of the shares, he may give notice under s 429 entitling and binding him to acquire remaining shares on the terms of the offer: s 430(2). The recipient of such a notice may apply to the court within 6 weeks for an order preventing the acquisition or to obtain different terms of acquisition: s 430C.

<sup>70</sup> Article 99 of the Companies (Northern Ireland) Order 1986.

<sup>71</sup> Article 102 of the Companies (Northern Ireland) Order 1986. There are also criminal sanctions available in respect of allotments of shares. Financial Services Act 1986, s 47 provides such a sanction against misleading statements. Misleading statements in listing particulars or a prospectus of a public company may also lead to civil liability. See Financial Services Act 1986, s 150 and reg 14 of the Public Offers of Securities Regulations 1995 (SI 1995 No 1537).

12.24 The information available to shareholders may assist in determining whether or not a remedy should be sought and ascertaining the likely success of an action.<sup>72</sup> Failure to provide information may itself be a ground for complaint.<sup>73</sup> Moreover, thorough provision of information, and communication between a company's officers and its shareholders, may be sufficient in many cases to avert any conflict.<sup>74</sup>

*Constitution and registers*

12.25 A member may obtain a copy of the memorandum and articles on request to the company after payment of the relevant fee.<sup>75</sup> Members are also entitled to free inspection of the register of members and index of members' names and on payment of a fee to require a copy of the register, and these rights may also be enforced by the court.<sup>76</sup>

12.26 Members of all companies may inspect:

- (i) the register of directors and secretaries;<sup>77</sup>
- (ii) the register of charges and copies of those instruments creating charges which must be registered;<sup>78</sup>
- (iii) the register of debenture holders;<sup>79</sup>

<sup>72</sup> This is emphasised by the Listing Rules, para 9.24, which provides that "... a company must ensure that ... all the necessary facilities and information are available to enable holders of such securities to exercise their rights". In particular, such information must include notice of meetings, dividends, new issues and information on redemption or repayment.

<sup>73</sup> It has been one of several allegations in a number of cases under s 459 of the Companies Act 1985, eg *Re RA Noble* [1983] BCLC 273 and *Re Elgindata Ltd* [1991] BCLC 959; see para 9.35 above. 41.7% of the petitions filed in 1994-1995 contained such an allegation; see Appendix E, Table 1.

<sup>74</sup> While in public companies the risk of public censure will often be enough to dissuade companies from courses of conduct with adverse effects on shareholders, this is unlikely in private companies.

<sup>75</sup> Section 19(1); art 30 of the Companies (Northern Ireland) Order 1986. A company and any officer in default is liable to a fine.

<sup>76</sup> Section 356; art 364 of the Companies (Northern Ireland) Order 1986. Failure to observe these provisions renders the company and its officers liable to a fine.

<sup>77</sup> Section 288; art 296 of the Companies (Northern Ireland) Order 1986. This can also be enforced by the court. Failure to afford this right renders the company and any officer in default liable to a fine.

<sup>78</sup> Sections 401(3), 408(1), 417(4), 423(1); arts 409(3), 416(1) and 409 of the Companies (Northern Ireland) Order 1986. If inspection is refused, every officer who is in default is liable to a fine and the court may compel immediate inspection: ss 408 and 423.

<sup>79</sup> Section 191; art 200 of the Companies (Northern Ireland) Order 1986. The members are also entitled to request a copy of the register on payment of a prescribed fee. If inspection or copies are refused, the company and every officer in default is liable to a fine. Such inspection or copies may be compelled by the court.

- (iv) the books containing the minutes of any general meeting;<sup>80</sup> and
- (v) any records kept by the registrar for the purposes of the Companies Act.<sup>81</sup>

Under section 713(1) a member can apply to the court for an order requiring the company to make good a default in complying with any provision of the Act which requires it to deliver a document to the registrar or to give him notice of any matter.<sup>82</sup>

- 12.27 Section 212<sup>83</sup> provides certain powers to a public company to obtain information<sup>84</sup> with respect to interests in its shares.<sup>85</sup> Holders of not less than 10 per cent of the paid-up capital may require the company to exercise this power, provided they specify the manner in which the power is to be exercised and give reasonable grounds for their request.<sup>86</sup> Any report prepared in response to such a request and any register of interests in shares must be open to inspection by all persons without charge. Such persons may require a copy of the register or report on payment of such fee as may be prescribed.<sup>87</sup>

#### *Accounts*

- 12.28 Section 238(1) provides that a company is under a duty to send to shareholders copies of its annual accounts (which must comply with Schedule 4 to the Companies Act

<sup>80</sup> Section 383; art 391 of the Companies (Northern Ireland) Order 1986. Copies may be required. In default, the company and defaulting officers are liable to a fine. The court may compel inspection or production of copies.

<sup>81</sup> Section 709(1); art 648 of the Companies (Northern Ireland) Order 1986. Members may require copies of the information. No process for compelling the production of a record kept by the registrar shall issue from any court without the leave of the court: s 709(5).

<sup>82</sup> Particular rights to copies of a periodical statement are granted to members of insurance companies, deposit, provident and benefit societies by s 720(3); art 669 of the Companies (Northern Ireland) Order.

<sup>83</sup> Article 220 of the Companies (Northern Ireland) Order 1986.

<sup>84</sup> Relating to the identity of holders of the shares or those with a beneficial interest.

<sup>85</sup> In April 1995, the DTI issued a consultative document, *Proposals for Reform of Part VI of the Companies Act 1985* (April 1995). Under the proposals, ss 198-220 would apply only to listed companies and companies whose shares are publicly traded, although it is possible that s 212 would continue to be available to all public companies. In future, the disclosure required would relate only to the voting rights held in relation to the company, rather than the wider "interests" as at present. Further limitations proposed in relation to s 212 are that information may only be required retrospectively up to 1 year and companies will no longer be able to require from offerors in takeover situations the identity of shareholders accepting the offeror's bid.

<sup>86</sup> Section 214. On default, the company and every officer in default is liable to a fine.

<sup>87</sup> Section 219. Failure to comply renders the company and any officer in default liable to a fine. The court may also order immediate compliance with the section.

1985),<sup>88</sup> together with the directors' report<sup>89</sup> and the auditor's report on the accounts.<sup>90</sup> Additional requirements apply to listed companies.<sup>91</sup> Further, section 239 provides that a shareholder may at any time demand, without charge, one (further) copy of these documents. Section 241 requires that the documents be laid before the general meeting,<sup>92</sup> within a fixed period after the accounting year. If revisions are made to the accounts, these must be notified to members, pursuant to the Companies (Revision of Defective Accounts and Report) Regulations 1990.<sup>93</sup> Where a company would be exempt from producing group accounts by virtue of the fact that it is a subsidiary (under section 228), shareholders holding more than half of the remaining shares or 5 per cent of the total shares may require group accounts to be prepared. Auditors are under a duty, pursuant to section 235, to report to members on all annual accounts which are laid before the general meeting.

<sup>88</sup> Schedule 4 requires, inter alia, that the company declare its accounts to have been prepared in accordance with accounting standards (para 36A), such accounting standards to be laid down by the Accounting Standards Board: s 256(1) and Accounting Standards (Prescribed Body) Regulations 1990 (SI 1990 No 1667).

<sup>89</sup> Which must comply with s 234 and Sched 7. In the case of listed companies, the Cadbury Report recommended it should carry details of any outside interests of directors, in order to establish whether a majority of non-executive directors are totally independent as recommended by the Committee (para 4.12). The directors should also report on the effectiveness of the company's system of internal control, including a statement that the business is a going concern. This is effected by the Listing Rules for accounting periods beginning on or after 31 October 1995.

<sup>90</sup> The Cadbury Committee recommended that, in the case of listed companies, performance information in the report and accounts (to be summarised in the chairman's report) should present a balanced view and factors likely to affect future performance should be included (para 4.50). They also recommended that the directors include a statement of their responsibilities in preparing the accounts, adjacent to an equivalent notice from the auditors (*Code of Best Practice*, para 4.4). Wording for this statement has been suggested by the Accounting Practices Board (SAS 600, Appendix 3) and the Law Society ((1993) 90/40 LSG 33).

<sup>91</sup> See the Listing Rules paras 12.41 ff. Notably, such a company must state whether it has complied with the Cadbury Committee's *Code of Best Practice* (except paras 3.1-3.3 and 4.6) and give reasons for non-compliance (Listing Rules, para 12.43(j)). Half-yearly reports on activities and profit and loss must be published (para 12.46). Publication may be achieved either by sending copies to all members or by publication in the national press. However, listed companies may issue shareholders with summary financial statements in place of the documents referred to in s 238(1). This requires the consent of the members involved, and members may require that they receive the documents in s 238(1). See the Companies Act 1985 (Summary of Financial Statement) Regulations 1995 (SI 1995 No 2092) which came into force on 1 September 1995, implementing the proposals of the DTI consultation paper, *Simpler Procedures for Summary Financial Statements* (March 1995). These provide that a shareholder with notice may receive by default a summary statement (unless he otherwise indicates) and to assist this decision, the company should send advance notice of what the summary statement will contain rather than sending both a full report and summary statements to enable the shareholder to make his decision. The statement must give clear notice of how to obtain a free copy of the last full accounts and how they can elect to receive the full accounts in the future.

<sup>92</sup> Although this requirement may be waived in private companies; see para 12.33 below.

<sup>93</sup> SI 1990 No 2570; SI 1996 No 315

12.29 Small and medium-sized companies are exempted from certain of the requirements, as laid out in the schedules to the Act.<sup>94</sup> “Small” and “medium” are defined in section 247(3).<sup>95</sup> A small company is one which satisfies two or more of the following criteria in two consecutive accounting years:

- (i) turnover of £2.8 million or less;
- (ii) balance sheet total of £1.4 million or less;
- (iii) 50 employees or less.

A medium-sized company must satisfy two or more of the following criteria:

- (i) turnover of £11.2 million or less;
- (ii) balance sheet total of £5.6 million or less;
- (iii) 250 employees or less.

12.30 The exceptions relate to requirements that the company declare the accounts to have been made in accordance with accounting standards (paragraph 36A, Schedule 4) and various other accounting details designed to abbreviate the accounts (Schedule 8).

12.31 The DTI have proposed<sup>96</sup> increasing the financial ceilings for qualification as a small or medium-sized company. The DTI proposals also suggested that the disclosure requirements for small companies could be reduced still further or the requirement of publication abolished altogether.

12.32 Companies which are particularly small may dispense altogether with the annual audit.<sup>97</sup> Small companies (as defined in section 247) with a turnover of not more than £90,000 and a balance sheet total of £1.4 million in a given year need not have that year’s accounts audited. Small companies with a turnover of between £90,000 and £350,000 and a balance sheet of not more than £1.4 million need not undertake a full audit, but must present an accountant’s report in accordance with section 249C. These exemptions do not apply to public companies, parent or subsidiary companies,<sup>98</sup> banking or insurance companies, or if a shareholder or shareholders holding at least

<sup>94</sup> Section 246.

<sup>95</sup> As amended by the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Publication of Accounts in ECUs) Regulations 1992 (SI 1992 No 2452).

<sup>96</sup> In *Accounting Simplifications* (May 1995). No change is currently proposed; see DTI, *Accounting Simplifications and Tackling Late Payment: Consultation on Draft Regulations* (1995) p 12.

<sup>97</sup> Sections 249A-249E, as inserted by the Companies Act 1985 (Audit Exemption) Regulations 1994 (SI 1994 No 1935).

<sup>98</sup> Unless the company is a dormant subsidiary: s 249B(1A), as inserted by the Companies Act 1985 (Miscellaneous Accounting Amendments) Regulations 1996 (SI 1996 No 189).



10 per cent of the shares, or a class of shares, gives written notice requiring an audit.<sup>99</sup> The Auditing Practices Board, formed by the six major accounting regulatory bodies, produced guidelines in 1994 on the detailed format to be complied with by the accountant's report above.<sup>100</sup> These guidelines have no statutory force, but all six accounting bodies are committed to their implementation.

- 12.33 Private companies may by elective resolution (which requires unanimity of the general meeting)<sup>101</sup> dispense with the requirement of laying the accounts before a general meeting for the present and future years.<sup>102</sup> However, any single shareholder may require that a general meeting be held for the purpose of laying the accounts before the company.<sup>103</sup>

*Directors' remuneration*

- 12.34 Regulation 82 of Table A<sup>104</sup> provides that it is for the company by ordinary resolution to determine the remuneration for the directors. However, under regulation 84 of Table A the remuneration of executive directors is a matter for the board.<sup>105</sup>
- 12.35 Section 318<sup>106</sup> provides that a company shall keep copies of all directors' service contracts or (if they are not in writing) memoranda of their terms, and that such copies and memoranda shall be open to inspection by any member of the company without charge.<sup>107</sup> Failure to comply may involve a criminal offence on the part of the company and any officers involved. Where inspection by a member is refused, the court may compel compliance.<sup>108</sup> However, none of the above is applicable in relation to a director with less than 12 months of his service contract remaining or where his contract can be terminated in the next 12 months without payment of compensation.

<sup>99</sup> Section 249B.

<sup>100</sup> Auditing Practices Board, *Statement of Standards for Reporting Accountants "Audit Exemption Reports"* (October 1995).

<sup>101</sup> Section 379A. See n 23 above for more details on the elective regime.

<sup>102</sup> Section 252. However, the accounts must still be distributed pursuant to s 238.

<sup>103</sup> Section 253.

<sup>104</sup> There is an equivalent provision in the Northern Ireland Table A; see the Companies (Tables A to F) Regulations (Northern Ireland) 1986 (SR 1986 No 264).

<sup>105</sup> With reference to listed companies, see the recommendations of the Greenbury Report, as implemented by the Stock Exchange; see para 12.39 below.

<sup>106</sup> Article 326 of the Companies (Northern Ireland) Order 1986.

<sup>107</sup> Section 318(7). The Listing Rules require that directors' service contracts be open to inspection at the AGM; para 16.9.

<sup>108</sup> Section 318(9).

12.36 Section 319<sup>109</sup> provides that service contracts for longer than five years must be approved in advance by ordinary resolution of a general meeting. The terms of the contract must be available for inspection at the meeting and for at least 15 days before at the company's office. In default, a term entitling the company to dismiss with reasonable notice is deemed.<sup>110</sup>

12.37 Section 232<sup>111</sup> requires that certain specified information<sup>112</sup> shall be given in the notes to the company's accounts. This includes:

- (i) the aggregate amount of directors' emoluments (including fees, expenses, pension contributions<sup>113</sup> and other non-cash benefits);<sup>114</sup>
- (ii) the aggregate amount of directors' or past directors' pensions (not including those paid from a pension scheme adequately funded by contributions).

Additionally, where the company is a parent or subsidiary or the amount in (i) is £60,000<sup>115</sup> or more, this includes:

- (iii) the emoluments of the chairman;<sup>116</sup>

<sup>109</sup> Article 327 of the Companies (Northern Ireland) Order 1986.

<sup>110</sup> The period of 5 years has been criticised as being too long. For listed companies, the Cadbury Report suggested that 3 years would be more appropriate and the Greenbury Report identified a "strong case" for setting notice periods of 12 months or less. It recommended that service contracts exceeding this limit should have to be disclosed in the annual report, with an explanation of why the limit was exceeded. These recommendations have been included in the Listing Rules; see para 12.39 below. In practice, the rollover contract is often used to circumvent these limitations. There has, for some time, been much pressure from institutional investors for reduction in the length of such rollovers.

<sup>111</sup> Article 240 of the Companies (Northern Ireland) Order 1986.

<sup>112</sup> See Sched 6. Following the Greenbury Report, the DTI published a consultative document, *The Company Accounts (Disclosure of Directors' Emoluments) Regulations 1996: Draft Statutory Instrument under the Companies Act 1985* (January 1996) ("the Draft Disclosure Rules"), commenting on proposed changes to the rules relating to disclosure.

<sup>113</sup> Under the Draft Disclosure Rules the inclusion of pension entitlements would cease and would be replaced by a separate disclosure of the aggregate value of directors' pension entitlements accrued during the year.

<sup>114</sup> This does not, however, appear to include bonuses, which are contingent in nature. The Draft Disclosure Rules would introduce a new requirement for disclosure of the aggregate of directors' gains made on the exercise of share options and under long-term incentive schemes.

<sup>115</sup> The Draft Disclosure Rules raise this figure to £100,000, and remove the need for companies to comply with the additional requirements simply by reason of being part of a group.

<sup>116</sup> This requirement would be removed under the Draft Disclosure Rules, which require only the disclosure of the emoluments of the highest paid director.

- (iv) the number of directors falling within each band of emolument, the bands being defined in £5,000 increments;<sup>117</sup>
- (v) the greatest amount of emoluments of any director, if this exceeds that of the chairman;

(but these emoluments do not include pension contributions). Any transactions in which a director is interested entered into by the company must be disclosed.<sup>118</sup>

12.38 Under section 246,<sup>119</sup> small and medium-sized companies<sup>120</sup> are entitled to the accounting exemptions contained in Schedule 8 with respect to the annual accounts. For a small company this means the information required by the schedule relating to disclosure of directors' remuneration<sup>121</sup> need not be included in the notes to the accounts.<sup>122</sup>

12.39 Listed companies<sup>123</sup> are required<sup>124</sup> (unless the Stock Exchange otherwise agrees) to include in the annual report and accounts a statement as to whether or not they have complied with the best practice provisions annexed to the Listing Rules relating to remuneration committees.<sup>125</sup> These provisions embrace the setting up of a committee of non-executive directors, the disclosure of its composition to the shareholders and their attendance at general meetings. The annual report must also include a report by that committee<sup>126</sup> (or the board if no such committee exists) containing: a statement

<sup>117</sup> This requirement would be removed under the Draft Disclosure Rules.

<sup>118</sup> Schedule 6, para 16(c). The Accounting Standards Board has recently published a new mandatory code, *Financial Reporting Standard 8 — Related Party Disclosures* (25 October 1995), which widens some of the requirements of the Companies Act. It applies to all companies for accounting periods commencing on or after 23 December 1995.

<sup>119</sup> Article 254 of the Companies (Northern Ireland) Order 1986.

<sup>120</sup> As defined in s 247; see para 12.29 above.

<sup>121</sup> Schedule 6, Part I.

<sup>122</sup> Schedule 8, para 19(3).

<sup>123</sup> On remuneration for directors of privatised utilities, see the Third Report of the Employment Committee of Session 1994-95, *The Remuneration of Directors and Chief Executives of Privatised Utilities* (1994-95) HC 159, and the reply by the DTL, (1995-96) HC 38.

<sup>124</sup> The requirements follow the recommendations of the Greenbury Report. Although the report recommended that only listed companies should be required to comply, all other companies were strongly encouraged to consider the recommendations.

<sup>125</sup> The Listing Rules, para 12.43(w). The Listing Rules also require a statement as to whether the company has complied with the Cadbury Committee's *Code of Best Practice*, giving reasons for any non-compliance (para 12.43(j)). These rules came into effect on 31 December 1995. The Cadbury Committee recommendations included non-executive remuneration committees and more detailed disclosure of remuneration. Note that the effects of the Cadbury and Greenbury codes are being reviewed by the Hampel Committee; see *Financial Times* 23 November 1995. See para 1.5 above.

<sup>126</sup> Paragraph 12.43(x).

of policy (the framing of which must give consideration to best practice provisions);<sup>127</sup> specific details of each director's remuneration,<sup>128</sup> including share options and other long-term incentive schemes,<sup>129</sup> and justification for each element of remuneration other than basic salary; details of any service contracts with over one year remaining (or an entitlement to more than one year's salary), with reasons for exceeding one year; and the unexpired term of any director's contract whose election is proposed at the next AGM. The auditors are required to report on the disclosure of details of remuneration and state whether the company has complied with those disclosure requirements.

<sup>127</sup> Such as the need to attract directors of an appropriate quality while remaining sensitive to the wider scene, encouraging long-term incentive schemes, which should not be excessive and should be approved by shareholders, and making all incentive schemes subject to challenging criteria.

<sup>128</sup> The issue of pension contributions remains to be addressed. In its consultative document, *Proposed Changes to the Listing Rules: Amendment 6 — Directors' Remuneration* (July 1995), the Stock Exchange indicated that pension entitlements would have to be disclosed on a basis to be recommended by the Faculty of Actuaries and the Institute of Actuaries (in accordance with the Greenbury Report, *Code of Best Practice*, para B7). This will be included in the Listing Rules once these bodies have reported. The Greenbury Report recommended that the information to be disclosed should reflect the value of the pension entitlements to the director, rather than the pension contributions made by the company (Greenbury Report, paras 5.17 ff). It has been commented that the eventual rules on disclosure may have a considerable impact on the values disclosed; see *Financial Times* 28/29 October 1995.

<sup>129</sup> Some of which may now require approval by shareholders in accordance with the Listing Rules, para 13.13.

## **PART 13**

# **THE INSOLVENCY ACT 1986<sup>1</sup>**

13.1 In the event of deadlock or serious disagreement in a company, it may be impossible for the company to be carried on in its current form and the members may agree, or some may apply, to have it wound up. A solvent winding up will enable the assets of the company to be returned to its members after creditors are paid. Even an insolvent winding up may ultimately provide returns to members if there are assets which can be retrieved from parties involved in any unlawful transactions or other misfeasance. We consider in turn voluntary winding up,<sup>2</sup> compulsory winding up<sup>3</sup> and the powers of a liquidator to recover company assets.<sup>4</sup>

### **Voluntary winding up**

13.2 If there is agreement among the shareholders, they may cause the company to wind up voluntarily.<sup>5</sup> If, during the liquidation, or when the company is proposed to be wound up, the whole or part of the company's business or property is to be sold to another company in consideration for shares or like interests in the transferee company,<sup>6</sup> a member who does not vote in favour of the special resolution for the transaction may object under section 111 of the Insolvency Act 1986. Dissent must be expressed in writing to the liquidator within seven days of the resolution, and the liquidator must either cancel the sale or buy the objector's shares at a price to be determined "... by agreement or by arbitration".<sup>7</sup> Section 111(4) provides that for the purposes of arbitration under this section the provisions of the Companies Clauses Consolidation Act 1845 apply. Both parties must appoint an arbitrator.<sup>8</sup> If there are two arbitrators, they must appoint an umpire to decide matters on which they differ.<sup>9</sup> Arbitrators or

<sup>1</sup> All references to sections are to provisions in the Insolvency Act 1986, unless otherwise specified, or to the equivalent provisions in the Insolvency (Northern Ireland) Order 1989 (SI 1989 No 2405).

<sup>2</sup> See para 13.2 below.

<sup>3</sup> See paras 13.3-13.7 below.

<sup>4</sup> See paras 13.8-13.15 below.

<sup>5</sup> Section 84(b) provides that members may, by special resolution, resolve that the company be wound up; art 70 of the Insolvency (Northern Ireland) Order 1989. If the directors are able to make a declaration, in accordance with s 89, that the company is solvent, the winding up is a members' voluntary winding up, governed by ss 91-96. Otherwise it is a creditors' voluntary winding up, and governed by ss 97-106.

<sup>6</sup> Section 110; art 96 of the Insolvency (Northern Ireland) Order 1989.

<sup>7</sup> Section 111(2); art 97(2) of the Insolvency (Northern Ireland) Order 1989.

<sup>8</sup> If either party fails to do so within 14 days of the dispute arising, the other party may give notice and if the defaulting party still does not appoint, the other party may then appoint his arbitrator to act for both: s 128 Company Clauses Consolidation Act 1845 ("CCCA"). No guidance is given as to how long the defaulter has to respond to such notice.

<sup>9</sup> Section 130 of the CCCA. Under the Arbitration Act 1996 the appointment of an umpire shall be "... before any substantive hearing or forthwith if [the arbitrators] cannot agree on a matter relating to the arbitration": s 16(6)(b). If the arbitrators fail to do so, either party may

their umpire may call for "... the production of any documents in the possession or power of either party which they may think necessary for determining the question in dispute".<sup>10</sup> Costs of the arbitration are at the discretion of the arbitrators and their umpire.<sup>11</sup>

### **Compulsory winding up**

13.3 If, however, the members of the company do not agree in sufficient number for the company voluntarily to wind itself up, then it may be necessary for those disaffected to petition for a compulsory winding up.

13.4 Any contributory<sup>12</sup> has the right to petition the court to wind up the company on one of the grounds set out in section 122(1) of the Insolvency Act 1986, namely:

- (a) the company has by special resolution resolved that the company be wound up by the court,
- (b) being a public company which was registered as such on its original incorporation, the company has not been issued with a certificate under section 117 of the Companies Act [1985] ... and more than a year has expired since it was so registered,
- (c) it is an old public company, within the meaning of the [Companies Consolidation] Consequential Provisions Act [1985],
- (d) the company does not commence its business within a year from its incorporation or suspends its business for a whole year,
- (e) except in the case of a private company limited by shares or by guarantee, the number of members is reduced below 2,
- (f) the company is unable to pay its debts,
- (g) the court is of the opinion that it is just and equitable that the company should be wound up.<sup>13</sup>

13.5 Shareholders who are contributories may also apply to the court at any time after a winding up petition has been presented, but before the winding up order has been

apply (on notice) to the court (s 18(2)) for an order under s 18(3) including an order for the appointment of an umpire: s 18(3)(d).

<sup>10</sup> Section 132 of the CCCA.

<sup>11</sup> Section 133 of the CCCA. It is thought that the basis upon which the purchase price has to be agreed for the shares will be the purchase price before reconstruction and that any enhanced value as a result of the reconstruction must not be taken into account. See *Palmer's Company Law* (25th ed 1992) para 12.108.

<sup>12</sup> See para 8.3 above for a consideration of contributories. We are only here concerned with shareholders who are contributories. Note that former contributories may also petition.

<sup>13</sup> Note that if shareholders petition to have the company wound up on the ground that it is just and equitable to do so, the application may not succeed if the court considers that another remedy is available to them and that they are acting unreasonably in seeking to have the company wound up rather than pursuing that other remedy: s 125(2). See paras 8.13-8.17 above.

made, for an order staying or restraining any proceedings against the company.<sup>14</sup> The rights of contributories to choose the identity of the liquidator in a compulsory winding up are the same as those of members in a creditors' voluntary winding up.<sup>15</sup>

13.6 During the winding up there are several applications which contributories may make. Principally, they may apply to the court to stay or stop the winding up,<sup>16</sup> require the Official Receiver to apply for a public examination of certain persons,<sup>17</sup> and apply for an order that they be allowed to inspect company documents.<sup>18</sup> Application may be made to the Secretary of State for direction as to the date of dissolution.<sup>19</sup>

13.7 Contributories also have rights under the Insolvency Act 1986 which allow them to complain to the court about the exercise of powers by a liquidator under certain sections<sup>20</sup> and generally regarding any decision of the liquidator.<sup>21</sup> They may also require the liquidator to hold a meeting to ascertain their wishes.<sup>22</sup>

### **Right of liquidator to recover company assets**

13.8 Clearly it is of the utmost importance to shareholders that on liquidation the company's assets are realised to the fullest extent possible and that any wrongdoing by directors is penalised. The Insolvency Act 1986 provides a liquidator with various powers designed to ensure that all assets properly belonging to the company can be traced.

#### *Power of investigation*

13.9 As already considered,<sup>23</sup> a shareholder will require information upon which to found a claim and the Insolvency Act 1986 provides a very important power in this respect.

<sup>14</sup> Section 126; art 106 of the Insolvency (Northern Ireland) Order 1989.

<sup>15</sup> For the provisions applicable in a creditor's winding up, see ss 139 and 100 (provision in creditors' winding up); arts 118 and 94 of the Insolvency (Northern Ireland) Order 1989. The liquidator will be whoever the creditors on meeting nominate, or, otherwise, whoever the contributories nominate. If the creditors and contributories nominate different people then any of them may apply (within 7 days of the creditors' nomination) to the court for the appointment of a different liquidator or joint liquidators.

<sup>16</sup> Section 147; art 125 of the Insolvency (Northern Ireland) Order 1989.

<sup>17</sup> Section 133; art 113 of the Insolvency (Northern Ireland) Order 1989.

<sup>18</sup> Section 155; art 133 of the Insolvency (Northern Ireland) Order 1989.

<sup>19</sup> Sections 203 and 205; arts 168-169 of the Insolvency (Northern Ireland) Order 1989.

<sup>20</sup> Eg ss 167 and 188; arts 142 and 159 of the Insolvency (Northern Ireland) Order 1989. He may also be forced to comply with his obligations to file documents and give notices: s 170; art 144 of the Insolvency (Northern Ireland) Order 1989.

<sup>21</sup> Section 168(5); art 143 of the Insolvency (Northern Ireland) Order 1989.

<sup>22</sup> Section 168(2); art 143 of the Insolvency (Northern Ireland) Order 1989. The liquidator is not obliged to comply with their wishes.

<sup>23</sup> See paras 12.24-12.39 above.

Section 236 confers a power of investigation upon liquidators, who may apply to the court to summon before the court any officer of the company, person in possession of company property or indebted to it, or person capable of giving information concerning the company.

*Summary remedy for misfeasance*

- 13.10 Section 212 provides a summary remedy against company officers and others who are guilty of “misfeasance”.<sup>24</sup> In addition to the liquidator, this remedy is available to any creditor or contributory (with the leave of the court). The wrongs to which this section applies include the misapplication or retention of company assets, and “any misfeasance or breach of any fiduciary or other duty in relation to the company”. If the court makes a finding under this section it may order the person to restore the assets, or part thereof, to the company, with interest as appropriate, or to make compensation to the company for their misfeasance or breach of duty.

*Wrongful or fraudulent trading*

- 13.11 Sections 213 and 214,<sup>25</sup> respectively, provide that a liquidator may petition the court for a declaration that the business has been trading fraudulently or wrongfully.<sup>26</sup>
- 13.12 To prove fraudulent trading, elements of an intent to “defraud” creditors or a “fraudulent purpose” need to be shown. These words were described by Maugham J in *Re Patrick and Lyon Ltd*<sup>27</sup> as requiring “... actual dishonesty, according to current notions of fair trading among commercial men at the present day, real moral blame”.<sup>28</sup> Contributions which may be ordered by the court are to the company’s assets (and not individual creditors).
- 13.13 Section 214, which deals with wrongful trading, provides in sub-section (2), that the court may order contribution against a person when:

- (i) the company is in insolvent liquidation;
- (ii) before the winding up the person knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation; and

<sup>24</sup> See also art 176 of the Insolvency (Northern Ireland) Order 1989.

<sup>25</sup> Articles 177-178 of the Insolvency (Northern Ireland) Order 1989.

<sup>26</sup> The limitation period for an action is six years; see *Re Farmizer (Products) Ltd* [1995] BCC 926.

<sup>27</sup> [1933] Ch 786.

<sup>28</sup> *Ibid*, at p 790.



(iii) the person was a director (or shadow director)<sup>29</sup> at the time.

However, if the director took every possible step with a view to minimising the potential loss to creditors, he will not be liable to contribute. For the purposes of assessing the director's knowledge and the steps he ought to have taken, the standard against which he will be measured is that of:

... a reasonably diligent person having both—

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
- (b) the general knowledge, skill and experience that that director has.<sup>30</sup>

Recent cases seem to suggest a trend towards narrowing the application of the section,<sup>31</sup> already little utilised by liquidators.<sup>32</sup>

#### *Transactions at an undervalue*

13.14 Section 238<sup>33</sup> allows a liquidator (or administrator) to apply to the court for an order<sup>34</sup> restoring the position to what it would have been had the company not entered into a transaction at an undervalue. A transaction at an undervalue is one which amounts to a gift or where the company receives no consideration, or a transaction where the monetary value of the consideration received by the company is “significantly less than” the value of the consideration provided by the company. The transaction will only be set aside if the company was unable to pay its debts at the time the transaction

<sup>29</sup> Defined in s 251; and see *Re PFTZM Ltd* [1995] 2 BCLC 354, 367 and *Re Unisoft Group (No 3)* [1994] 1 BCLC 609.

<sup>30</sup> Section 214(4); art 178(4) of the Insolvency (Northern Ireland) Order 1989. See also comments by Hoffmann J in *Norman v Theodore Goddard* [1991] BCLC 1028 and *Re D'Jan of London Ltd* [1994] 1 BCLC 561, equating the duty of care required of directors with the test in s 214. See also paras 9.44-9.48 above.

<sup>31</sup> See *Re Sherborne Associates Ltd* [1995] BCC 40, where Judge Jack QC refused to grant an order under s 214, holding that on the facts before him the directors had not acted in an irresponsible manner, thus distinguishing it from the successful applications in the reported cases which had gone before (*Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520; *Re Purpoint Ltd* [1991] BCLC 491; and *Re DKG Contractors Ltd* [1990] BCC 903). The decision has been received as signalling an assimilation of the wrongful trading provision (s 214) to the fraudulent trading provision (s 213), with the assertion that the directors involved were honest, hard working, well respected businessmen saving the respondents from an order. Implicit in this is the perception that an order under s 214 involves an assertion of blameworthiness, previously only associated with s 213. See P Godfrey and S Nield, “The Wrongful Trading Provisions — All Bark and No Bite?” (1995) 11 ILP 139.

<sup>32</sup> See D Milman in *Palmer's in Company* (Issue 8/95, 20 September 1995) p 1.

<sup>33</sup> Article 202 of the Insolvency (Northern Ireland) Order 1989.

<sup>34</sup> An order may validly be sought even against someone outside the jurisdiction: *Re Paramount Airways Ltd (In Administration)* [1993] Ch 223.

was entered into, or if it became unable to pay its debts as a result of the transaction.<sup>35</sup> Further, the transaction must have been entered into within two years before the onset of insolvency (effectively the commencement of the winding up). The court shall make an order unless it is satisfied that the company entered into the transaction in good faith for the purpose of carrying on business and there were reasonable grounds to believe that the transaction would benefit the company.<sup>36</sup> Similar provisions apply with respect to preferences (preferential treatment of creditors)<sup>37</sup> in section 239. A range of possible orders is illustrated in section 241. These are, however, without prejudice to the court's power to make such order as it thinks fit.

*Transactions defrauding creditors*

- 13.15 If the liquidator is unable to come within the requirements of section 238, he may still have a remedy under section 423 which deals with transactions defrauding creditors. Under this section the liquidator, or a person prejudiced by a transaction (with leave where the company is in liquidation) may apply for an order for restoring the pre-transaction position or for protecting the interests of the victims.<sup>38</sup> The intention of such a transaction must have been to put assets beyond the reach of, or in some other way to prejudice the interest of, a claimant or potential claimant.<sup>39</sup>

<sup>35</sup> In the case of a transaction which was entered into with a person "connected" with the company (which includes a director) this requirement will be deemed to have been complied with unless the contrary is shown.

<sup>36</sup> Section 238(5); art 202(5) of the Insolvency (Northern Ireland) Order 1989.

<sup>37</sup> Although a different time period applies; see s 240(1). Section 239(4) (art 203 of the Insolvency (Northern Ireland) Order 1989) provides that a preference is given to a person if:

- (a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and
- (b) the company does anything or suffers anything to be done which ... has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done.

<sup>38</sup> Section 424; art 368 of the Insolvency (Northern Ireland) Order 1989.

<sup>39</sup> Section 423(3); art 367 of the Insolvency (Northern Ireland) Order 1989.

## SECTION E REFORM

### PART 14 DEFICIENCIES IN THE PRESENT LAW AND THE APPROACH TO REFORM

#### Problems in the current law

##### *Problems in actions on behalf of the company*

- 14.1 A member who wishes to bring an action on behalf of his company (a derivative action) can only bring it if the situation falls within the exceptions to the rule in *Foss v Harbottle*.<sup>1</sup> We have formed the provisional view that, in certain respects, the rule and its exceptions are inflexible and outmoded. We perceive four major problems that should be addressed.
- 14.2 First, the rule cannot be found in rules of court, but only in case law, much of it decided many years ago. Second, the effect of the exceptions is that an action to recover damages suffered by a company by reason of a director's breach of fiduciary duty cannot be brought unless the wrongdoers have control of the company. The law as to the meaning of "control" in these circumstances is unclear. It is not restricted to situations where wrongdoers have voting control, but its applicability outside these circumstances is in doubt.<sup>2</sup> This is problematic, in particular, in larger companies where, in practice, directors exercise control with less than a majority of the votes.<sup>3</sup>
- 14.3 Third, a further effect of the exceptions is that an action to recover damages suffered by a company by reason of the negligence of a director cannot be brought by a minority shareholder unless it is possible to prove that the negligence confers a benefit on the controlling shareholders,<sup>4</sup> or that the failure of the other directors to bring an action constitutes a fraud on the minority.
- 14.4 The fourth problem is that the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on

<sup>1</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>2</sup> See paras 4.12-4.16 above.

<sup>3</sup> It could be argued, however, that the requirement to prove control by the wrongdoers is a valuable check on undue interference by shareholders in the running of the company. As can be seen from para 14.11(v) below, we consider that undue interference should be avoided. In Part 16 we set out provisional proposals for a leave stage which are intended to allow judicial control of derivative actions so as to avoid interference by shareholders who, for example, are not acting in good faith or in the interests of the company; see paras 16.18 and 16.20-16.44 below, and see also para 15.4 below. At para 16.45 below we raise the possibility of requiring applicants to have held their shares for a minimum period of time.

<sup>4</sup> See paras 4.10-4.11 above. See para 16.9 below for further detail as to the nature of this problem.

the merits.<sup>5</sup> Without effective case management this can result in a mini trial which increases the length and cost of the litigation.

**Do consultees agree that the operation of the rule in *Foss v Harbottle* and its exceptions is unsatisfactory or would they like to see it retained without change?**

**If they consider it to be unsatisfactory, do they agree with our provisional identification of the four major problems which it presents to a member who wishes to take action on behalf of a company, namely:**

- (i) that the rule can only be found in case law, much of which is many years old;**
- (ii) that an action to recover damages suffered by a company by reason of a director's breach of fiduciary duty cannot be brought unless the wrongdoers have control;**
- (iii) that unless the negligence benefits the controlling shareholders a minority cannot bring an action for damages suffered by the company by reason of the negligence of a director;**
- (iv) that standing to bring a claim has to be determined as a preliminary issue and this results in a mini trial which increases the length and cost of litigation?**

*Problems in the remedy for unfairly prejudicial conduct, sections 459-461*

- 14.5 The main problem in respect of the remedy for unfairly prejudicial conduct arises out of the generality of the wording, as this permits applicants<sup>6</sup> to put in issue anything that may be remotely relevant. This results in complex, often historical, factual investigations and, therefore, in costly, cumbersome litigation. For two reasons it is particularly small owner-managed companies that are affected by these problems.<sup>7</sup> First, because case law on sections 459-461 enables members of those types of companies to resort to this remedy more easily than members of other types of companies; and secondly, because the consequent delays and lost management time are particularly detrimental in such companies.<sup>8</sup>

<sup>5</sup> See para 6.6 above.

<sup>6</sup> We have used the term "applicant" throughout this section to denote the person who is seeking to pursue a particular remedy; see para 1.14, n 25 above. However, where we refer directly to the terms of existing procedural rules, we have adopted the terminology used in the relevant rule.

<sup>7</sup> See Appendix E, Table 1.

<sup>8</sup> See paras 11.1-11.2 above.

- 14.6 There may be another problem that arises out of the generality of the wording, which is that those who are not experts in company law may have difficulty predicting whether or not a court is likely to find that there has been unfairly prejudicial conduct,<sup>9</sup> and a shareholder may not have access to the advice of an expert in company law.

**Do consultees agree with our provisional views that:**

- (i) **proceedings under section 459 are often costly and cumbersome; and**
- (ii) **small owner-managed companies are particularly affected by this problem?**

**Do those who are not experts in company law have difficulty predicting whether or not a court is likely to find that there has been unfairly prejudicial conduct? If so, does this cause hardship?**

*Remedies for breaches of contract in the articles of association*

- 14.7 There are two legal difficulties that arise in this connection. The first is that it is probably<sup>10</sup> not possible under section 14 of the Companies Act 1985 to enforce rights which a member has in some other capacity, for example as a director. It is beyond our terms of reference to consider this particular problem<sup>11</sup> and, in any event, there will normally be a separate contract between the company and the member in his other capacity.<sup>12</sup>
- 14.8 The second problem is that of identifying which rights conferred by the articles are personal membership rights. If they are such rights, breach of the relevant article cannot be ratified. We have discussed this with numerous interested parties during our preliminary consultation but these discussions have not produced evidence that this is causing problems today. Moreover, we have expressed the view above<sup>13</sup> that there can never be a comprehensive definition of what constitutes a personal membership right under section 14 of the Companies Act 1985, since regard has to be had to the terms of the particular articles in question and to the circumstances of the alleged breach.<sup>14</sup>

<sup>9</sup> Experts are not troubled by the generality of the wording because of the volume of case law with which they are familiar and which provides guidance as to the likely outcome of the case. Non experts, such as Citizens' Advice Bureaux and smaller firms of solicitors, may not have the specialist reports in which the cases appear and may not have any of the books in which the law is summarised.

<sup>10</sup> See paras 2.15-2.20 above.

<sup>11</sup> See para 1.9 above.

<sup>12</sup> See para 2.20, n 41 above.

<sup>13</sup> See para 2.39 above.

<sup>14</sup> See paras 20.2-20.4 below for consideration of law reform in relation to this issue.

14.9 It has also been suggested to us that the fact that section 14 does not expressly state that the company is bound by its own articles may cause problems. However, it seems to us clear on the wording of the section that the company is bound, although it is not deemed to have executed the articles under seal. The latter point affects the limitation period for actions against the company,<sup>15</sup> but we are not aware of any reason to change this period.<sup>16</sup>

**Do consultees agree with our provisional findings that no hardship is being caused by:**

- (i) any difficulty in identifying personal rights conferred by the articles; and**
- (ii) the fact that section 14 does not state that the company is bound by the articles as if it had executed them under seal?**

**Guiding principles for resolving the problems identified**

14.10 We do not wish to damage the legal skeleton on which the flesh of company affairs is hung,<sup>17</sup> nor do we wish to disturb unduly the balance of power between directors and shareholders.

14.11 The above approach has led us provisionally to identify the following guiding principles for the law on shareholder remedies:

*(i) Proper plaintiff*

The “proper plaintiff” rule entails, rightly it is submitted, that normally the company should be the only party entitled to enforce a cause of action belonging to it. Accordingly, a member should be able to maintain proceedings about wrongs done to the company only in exceptional circumstances.

*(ii) Internal management*

An individual member should not be able to pursue proceedings on behalf of a company about matters of internal management, that is, matters which the majority are entitled to regulate by ordinary resolution.

<sup>15</sup> This is 6 years. If the articles were deemed to be sealed by the company, the limitation period for claims against it would be 12 years; see *Re Compania de Electricidad de la Provincia de Buenos Aires Ltd* [1980] Ch 146.

<sup>16</sup> Under the Listing Rules, ch 13, Appendix 1, para 17, where power is taken to forfeit unclaimed dividends, the power must not be exercisable until 12 years or more after the date the dividend to be forfeited was declared or became due for payment. Likewise, there are restrictions on selling the shares of a member who cannot be traced within 12 years (para 15). Thus a member of a listed company can in practice bring a claim against his company for, eg, unclaimed dividends after the period of 6 years has expired.

<sup>17</sup> Indeed this was not within the terms of reference which do not encompass consideration of alteration of underlying rights and duties but only their enforcement; see paras 1.5 and 1.9 above.

*(iii) Commercial decisions*

The court should continue to have regard to the decision of the directors on commercial matters if the decision was made in good faith, on proper information and in the light of the relevant considerations, and appears to be a reasonable decision for the directors to have taken.<sup>18</sup> In those circumstances the court should not substitute its own judgment for that of the directors.

*(iv) Sanctity of contract*

A member is taken to have agreed to the terms of the memorandum and articles of association when he became a member, whether or not he appreciated what they meant at the time. The law should continue to treat him as so bound unless he shows that the parties have come to some other agreement or understanding which is not reflected in the articles or memorandum.<sup>19</sup> Failure to do so will create unacceptable commercial uncertainty. The corollary of this is that the best protection for a shareholder is appropriate protection in the articles themselves.

*(v) Freedom from unnecessary shareholder interference*

Shareholders should not be able to involve the company in litigation without good cause, or where they intend to cause the company or the other shareholders embarrassment or harm rather than genuinely pursue the relief claimed. Otherwise the company may be “killed by kindness”,<sup>20</sup> or waste money and management time in dealing with unwarranted proceedings. The importance of this principle increases if the circumstances in which individual shareholders can bring derivative actions are enlarged. Nuisance or other litigation of this nature has to be identified on a case by case basis. This means that the requisite control has to be exercised by the courts, with increased powers if necessary.

*(vi) Efficiency and cost effectiveness*

All shareholder remedies should be made as efficient and cost effective as can be achieved in the circumstances. This is largely a matter for the courts and the Woolf

<sup>18</sup> See generally *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821 (PC) at pp 832-835. The requirement that directors should have acted reasonably can be seen, for example, in the judgment of Slade J in *Re Burton & Deakin Ltd* [1977] 1 WLR 390, 397; in *Smith v Croft (No 2)* [1988] Ch 114, 189, *per* Knox J and in *Re D’Jan of London Ltd* [1994] 1 BCLC 561, 563, *per* Hoffmann LJ (sitting as an Additional Judge of the High Court). Section 727 of the Companies Act 1985 provides a defence for directors who are sued for breach of duty as follows:

If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company ... it appears to the court hearing the case that that officer ... is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, he ought fairly to be excused ... that court may relieve him, either wholly or partly, from his liability ... .

<sup>19</sup> In some situations this principle may have to give way to the jurisdiction under s 459.

<sup>20</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221.

Report, but it has to be considered whether any additional powers are needed in the case of shareholder litigation.

- 14.12 We provisionally consider that all save the first two of these principles are applicable to all kinds of shareholder remedies. The first two are relevant only to derivative actions.<sup>21</sup> The fifth has only limited relevance to proceedings under section 459, since, in general, such proceedings do not require the company to take an active role (although, in small owner-managed companies, section 459 proceedings may well result in lost management time). However, if a member seeks a winding up order as an alternative to relief under section 459 in circumstances in which this is unjustified, then the relevance of the fifth principle is increased.
- 14.13 Applying these principles, we reach three basic provisional conclusions. The first of these is that, within proper bounds, the rule in *Foss v Harbottle*<sup>22</sup> should be replaced by a simpler and more modern procedure if a satisfactory procedure can be devised. The second is that the court must have all necessary powers to streamline minority shareholder litigation so that it is less costly and complicated. The third is that we should provide a “self-help” remedy (or range of remedies) to avoid the need for shareholders to resort to the court to resolve disputes.

**Do consultees agree with the six guiding principles for our provisional proposals in relation to the reform of the law and procedure relating to shareholder remedies, namely:**

- (i) the proper plaintiff rule;**
- (ii) the internal management rule;**
- (iii) the court’s respect for the commercial decisions of directors;**
- (iv) sanctity of contract;**
- (v) freedom from unnecessary shareholder interference;**
- (vi) efficiency and cost effectiveness?**

**Are there any which have been excluded that should have been included, and are there any which we have included with which consultees do not agree?**

- 14.14 In Part 15 we set out a summary of our provisional proposals for reform. The detail is to be found in Parts 16-19. Part 16 deals with the new derivative action and Part 17 with our views as to case management in shareholder proceedings. In Part 18 we deal with the provisions of a new unfair prejudice remedy. Although we are of the

<sup>21</sup> However, there may be some overlap between the second principle and the approach of the court under s 459 to trivial or technical infringements of the articles; see *Saul D Harrison* [1995] 1 BCLC 14, 18, *per* Hoffmann LJ.

<sup>22</sup> As restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204; see para 15.2, n 2 below.



provisional view that a new remedy would be useful, we are not recommending this one but merely using the draft to, hopefully, prompt further ideas from consultees. In Part 19 we cover three new regulations for insertion into Table A, and their text is to be seen at Appendix H. Part 20 deals with other reform issues which do not form an essential part of our proposals, but which have been raised with us in the course of our preliminary consultations. Part 21 consists of a summary of our provisional views and the questions on which we seek responses.

# PART 15

## SUMMARY OF PROVISIONAL RECOMMENDATIONS

### Introduction

- 15.1 This part sets out a summary of a package of three types of reforms which could be used to achieve the three aims set out in Part 14 above.<sup>1</sup>

### Summary of possible reform package

- 15.2 First, we provisionally suggest a partial abrogation of the rule in *Foss v Harbottle*<sup>2</sup> and its replacement with a new derivative action. This would, subject to the matters discussed in Part 16, be available to any member if the case fell within the following situation:

that, if the company were the applicant, it would be entitled to any remedy against any person<sup>3</sup> as a result of any breach or threatened breach by any director of the company of any of his duties to the company.<sup>4</sup>

The action would be subject to tight judicial control at all stages.

<sup>1</sup> See para 14.13 above.

<sup>2</sup> (1843) 2 Hare 461; 67 ER 189. The rule would be abrogated to the extent necessary to ensure that all derivative proceedings are brought under the new procedure. The classic definition of the rule in *Foss v Harbottle* was restated by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210 as follows:

- (1) The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation.
- (2) Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, no individual member of the corporation is allowed to maintain an action in respect of that matter because, if the majority confirms the transaction, *cadit quaestio* [the question is at an end]; or, if the majority challenges the transaction, there is no valid reason why the company should not sue.
- (3) There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction.
- (4) There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority.
- (5) There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.

<sup>3</sup> Including claims against third parties for the recovery of property or damages in consequence of an ultra vires transaction.

<sup>4</sup> If the breach or threatened breach were of a duty of an officer other than a director, or of a duty of an employee, we provisionally recommend, at paras 16.10-16.11 below, that the applicant should have to show that the circumstances fell within the fifth limb of the rule in *Foss v Harbottle*.

15.3 Since the reform will, in most respects,<sup>5</sup> involve questions of procedure, the new derivative action should be governed by rules of court which (among other matters) partially replace the rule in *Foss v Harbottle* as restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*.<sup>6</sup> The advantage of this course is that the new procedure could more easily be amended in the light of changing circumstances. The Supreme Court Rule Committee has power to make rules of court for the High Court with respect to matters of procedure.<sup>7</sup> If a new rule-making power were required simply for derivative actions, it might be located in a group of sections in the Companies Act 1985, headed “shareholder remedies”, which would also contain the unfair prejudice remedy.

15.4 Our provisional views as to the further features of this reform are:

- (i) the applicant would, unless the court gives leave to start proceedings without notice to the company, be required to give the company 28 days notice of the grounds on which he wishes to bring a derivative action;<sup>8</sup>
- (ii) leave of the court to continue the action would have to be sought by close of pleadings at the latest;<sup>9</sup>
- (iii) in considering whether to grant leave, the court should take into account all the circumstances;<sup>10</sup>
- (iv) leave of the court would be required for compromise or discontinuance;<sup>11</sup>

<sup>5</sup> But not if, for example, personal remedies were to be available in the new derivative action; see paras 16.48-16.50 below.

<sup>6</sup> [1982] Ch 204, 210; see n 2 above.

<sup>7</sup> Sections 84 and 85 of the Supreme Court Act 1981. Section 75 of the County Courts Act 1984 gives similar powers to the County Court Rule Committee. The Draft Civil Proceedings Rules published with the Woolf Report are intended to replace both the RSC and the CCR; see ch 20, para 1 of the Woolf Report.

<sup>8</sup> See paras 16.15-16.17 below.

<sup>9</sup> And earlier if the court so directed. The court’s leave should be required for the continuation of the action thereafter. Moreover, the court should be able to revoke the leave if at any stage it considers that there has been a material adverse change in circumstances, and to dismiss the action if at any stage it considers that there is no realistic prospect of success. The court would be able to grant leave subject to conditions, and it could limit leave to the completion of certain stages in the litigation. See para 16.18 below.

<sup>10</sup> See, generally, paras 16.20 and 16.25 below. Five criteria would be specifically mentioned in the rules of court; see paras 16.20 and 16.27-16.44 below.

<sup>11</sup> See para 17.10 below.

(v) the court would continue to be able to indemnify the applicant against some or all of his costs;<sup>12</sup> and

(vi) the court should have power to give directions for a meeting of the company to be held.<sup>13</sup>

15.5 The second aim, to streamline litigation, can be achieved by a number of means. First, reforms recommended in the Woolf Report will go a long way to meeting the problem. Second, if the circumstances in which a derivative action can be brought are made more transparent, members may be encouraged to bring this claim rather than the wide-ranging proceedings under section 459.<sup>14</sup> Third, we propose for consideration the introduction of a new remedy available to small owner-managed companies, which are the ones particularly badly affected by the prolixity and costs of section 459 proceedings. The new remedy is focused on the situation where a shareholder, entitled to management participation, is wrongly excluded, which our statistical analysis<sup>15</sup> shows to be the most common allegation in unfair prejudice cases. The new remedy should reduce the number of issues currently being raised, with consequent reductions in the cost and length of proceedings. We set out a wording for consideration, but we are not making any provisional recommendation in advance of consultation. Its presence is intended to stimulate other views as to the nature of such a remedy.<sup>16</sup>

15.6 To achieve our third aim of providing a self-help remedy, we seek consultees' views on a range of articles to be added to Table A. They would form part of the articles of association only if adopted by a special resolution. They are:

- (i) a standard form article referring disputes to arbitration;
- (ii) a procedure for valuing shares; and
- (iii) an exit article for smaller private companies.

<sup>12</sup> See para 17.8 below.

<sup>13</sup> See para 17.7 below.

<sup>14</sup> See the views of the Chancery Working Group discussed at para 17.1, n 2 below.

<sup>15</sup> See Appendix E, Table 1.

<sup>16</sup> See, generally, Part 18 below.

# PART 16

## A NEW DERIVATIVE ACTION

### Introduction

- 16.1 In Part 15 we expressed the view that a member should, subject as mentioned below, be able to bring and thereafter maintain a derivative action to enforce any cause of action vested in the company against any person arising out of any breach or threatened breach of duty by any director.<sup>1</sup> The effect of this reform would be to abrogate the fraud on the minority limb of the rule in *Foss v Harbottle* and to replace it with consideration by the court of all the circumstances. Our aim is to create a more flexible and modern criterion for leave to bring a derivative action than fraud on the minority.
- 16.2 We now turn to examine these proposals in greater detail. We consider the need for a derivative action;<sup>2</sup> the circumstances in which it should be available;<sup>3</sup> the partial abrogation of the rule in *Foss v Harbottle*;<sup>4</sup> notice to the company;<sup>5</sup> the stage at which the court should consider granting leave to continue the proceedings;<sup>6</sup> the matters to be taken into account by the court in exercising its discretion to grant leave;<sup>7</sup> whether there should be an additional qualifying requirement that the applicant should have been a shareholder for a minimum period of time;<sup>8</sup> whether the court should have power to appoint an independent person to investigate whether there is a good cause of action;<sup>9</sup> whether, and if so when, the court should be able to grant personal remedies in a derivative action;<sup>10</sup> and whether provision should be made for multiple derivative actions.<sup>11</sup>

### The need for a derivative action

- 16.3 As highlighted in Part 7 above,<sup>12</sup> the wording of what is now section 461(2)(c) was introduced following the recommendations of the Jenkins Committee. We consider

<sup>1</sup> It is intended that this should include any servant or agent of the director.

<sup>2</sup> See paras 16.3-16.6 below.

<sup>3</sup> See paras 16.7-16.11 below.

<sup>4</sup> See paras 16.12-16.14 below.

<sup>5</sup> See paras 16.15-16.17 below.

<sup>6</sup> See paras 16.18-16.19 below.

<sup>7</sup> See paras 16.20-16.44 below.

<sup>8</sup> See para 16.45 below.

<sup>9</sup> See paras 16.46-16.47 below.

<sup>10</sup> See paras 16.48-16.50 below.

<sup>11</sup> See para 16.51 below.

<sup>12</sup> See paras 7.11-7.12 above.

that the Jenkins Committee saw this provision as enabling the court to authorise a minority shareholder to bring a derivative action without satisfying the rule in *Foss v Harbottle*.<sup>13</sup> However, this provision is little used because it requires two full sets of proceedings.<sup>14</sup> There is evidence that shareholders are bringing claims under section 459 directly against third parties for a personal remedy (and not an order under section 461(2)(c)) in circumstances where the ground for complaint could have given rise to a derivative action.<sup>15</sup>

**Consultees are asked whether they agree with our views:**

- (i) that section 461(2)(c) is not being used because it requires two full sets of proceedings; and**
- (ii) that section 459 proceedings are being brought against third parties in circumstances where the ground for complaint could have given rise to a derivative action.**

16.4 It can be argued that derivative actions should be channelled into section 459 proceedings, that is, brought only as claims under that section. We do not, however, think that this can or should be the case. Our reasons for this are as follows:

- (i) Under section 459 the applicant must show unfairly prejudicial conduct. In a derivative action, apart from the preliminary issue as to standing, the issue is whether the company has a cause of action against (say) a director. If the main complaint in section 459 proceedings is that a party to the proceedings has committed a wrong against the company, the applicant, in order to succeed in his proceedings, must show not only that the company has a good cause of action in respect of this wrong, but also that the company's failure to pursue this cause of action is unfairly prejudicial conduct. In order to bolster his case the applicant will probably include a number of other allegations of unfairly prejudicial conduct. In

<sup>13</sup> See para 7.11 above.

<sup>14</sup> See, further, para 10.9, n 25 above. One of the members of the judiciary with whom we discussed this project has used this power in the following circumstances. In a family company a former director had misappropriated the company's property. His brother, a current director, took proceedings under s 459 and proved unfairly prejudicial conduct. The remedy sought was a purchase order. The value of the shares had been affected by the loss of the misappropriated property. An order was made which authorised the bringing of proceedings on the company's behalf to recover the property. Following such recovery the shares were to be valued for the purposes of the purchase order. It seems that the case may have settled before any proceedings were in fact brought on behalf of the company.

<sup>15</sup> *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636, 665-6, *per* Evans-Lombe J and *Lowe v Fahey* [1996] 1 BCLC 262, 267-268, *per* Charles Aldous QC (sitting as a Deputy Judge of the High Court). In this situation, the shareholder does not have to bring his claim within the exceptions to the rule in *Foss v Harbottle*, nor does he have to obtain leave under RSC, O 15, r 12A, nor will his claim be liable to be affected by ratification or release. He will not be able to obtain a costs indemnity order but he may be eligible for legal aid which is not available for derivative actions.

this way the issues in section 459 proceedings, from a case management point of view, are less focused and, moreover, tend to proliferate. From the point of view of limiting costs and making economical use of court time, it may be better if the issues are confined to the wrong to the company if this is the substantial complaint, and the issues would be so confined at trial if the proceedings were a derivative action.

- (ii) As the law presently stands, if a shareholder decides to apply for a personal remedy (for example a buyout) under section 459, then, even though the complaints which he has proved could have led to relief in favour of the company, the court cannot on that ground alone refuse him personal relief. This means that the cause of action vested in the company is not affected by the judgment. Moreover, so long as the directors remain unwilling to enforce it, it will not be enforced unless a liquidator is appointed.<sup>16</sup> The advantage of a derivative action is that it offers the possibility that, in appropriate circumstances, the company's cause of action may be enforced without a liquidation. Moreover, creditors are likely to be better off and treated equally if wrongs to the company are remedied by relief for the company, rather than its shareholders personally under section 459.
- (iii) There may be circumstances where a derivative action can be brought but unfair prejudice proceedings cannot. A breach by a director of his duty of skill and care involves a wrong to his company<sup>17</sup> but it will not amount to unfairly prejudicial conduct unless there is serious mismanagement.<sup>18</sup> An applicant under section 459 may be able to obtain an order under section 461(2)(c) if he can show that the company's failure to sue the director is unfairly prejudicial conduct. However, we consider that an applicant should not have to expend time and money in going through two sets of proceedings where, if a derivative action exists, only one is required.

16.5 As indicated above,<sup>19</sup> the court cannot refuse relief under section 459 simply because it considers that the company should receive the benefit of the relief rather than the applicant. If the court gives relief at all, it is limited to the type of relief sought by the applicant.<sup>20</sup> The same would apply if the applicant brought section 459 proceedings

<sup>16</sup> Or another minority shareholder brings a derivative action.

<sup>17</sup> Under the rule in *Foss v Harbottle* as it presently stands, a derivative action can only be brought if the majority obtain a benefit from the wrong: *Daniels v Daniels* [1978] Ch 406. However, this restriction would be replaced by a requirement to obtain the leave of the court under the proposed new derivative procedure.

<sup>18</sup> See paras 9.44-9.48 above.

<sup>19</sup> See para 16.4(ii) above.

<sup>20</sup> See para 10.1, n 7 above.

where the court considered that a derivative action should have been brought. The court could not stay the section 459 proceedings.

- 16.6 We are provisionally against altering these rules. It seems to us consonant with principle that the applicant should have the right to choose which mode of proceeding to take and which remedy to seek. For the same reason we do not, provisionally, favour a rule requiring all claims which can be brought by or on behalf of the company to be so brought. That might also involve amending section 459. As we see it, a shareholder should be able to bring alternative or cumulative claims under section 459 and derivatively, and the court has already adequate powers to order issues to be tried separately and, in the case of duplication of remedies, to require election between them.<sup>21</sup>

**Do consultees agree with our views that:**

- (i) an applicant should have the right to choose whether to bring a derivative action or proceedings under section 459, or cumulative claims under both; and**
- (ii) where the applicant is seeking personal relief under section 459 (eg a buy out order) in circumstances where the facts of the case would also justify relief for the company (eg the return of company property), the court should not have the power to make an order in favour of the company where such an order is not in fact sought by the applicant?**

**Availability of the new derivative action**

- 16.7 In considering the circumstances in which this action should be available a number of issues arise. The first issue is whether the new procedure should circumscribe the wrongs in respect of which the derivative action is available.<sup>22</sup> If the answer to that is in the affirmative, the following points arise: whether it should be available in respect of breach of a director's duty of skill and care;<sup>23</sup> whether it should be available in respect of breaches of duty by officers (other than directors) and employees;<sup>24</sup> whether it should apply to actions to restrain the company from acting in breach of its articles or the Companies Acts;<sup>25</sup> and whether it should be available in relation to a wholly or partly-owned subsidiary or associated company (the multiple derivative action).<sup>26</sup>

<sup>21</sup> *Slough Estates Ltd v Slough Borough Council* [1968] Ch 299.

<sup>22</sup> See para 16.8 below.

<sup>23</sup> See para 16.9 below.

<sup>24</sup> See paras 16.10-16.11 below.

<sup>25</sup> See para 16.14 below.

<sup>26</sup> See para 16.51 below.



*Should the new procedure prescribe the wrongs in respect of which the action is available?*

- 16.8 It is our view that, in general, if there is no breach of duty by a director the shareholder should not be bringing the action.<sup>27</sup> Where there is no breach of duty by a director it is difficult to see why the company should not be left to bring proceedings itself. It is for that reason that we are of the provisional view<sup>28</sup> that the new procedure should be limited to the situation where, if the company were bringing the proceedings, it would be entitled to any remedy against any person as a result of any breach or threatened breach by any director of the company of any of his duties to the company. In this context “director” would include “shadow director” to cover de facto as well as de jure directors.<sup>29</sup> It would also include directors who were in office at the time of the alleged wrong but who are no longer directors at the date of the proceedings. In the Ghanaian Companies Code 1963, which was drafted by Professor Gower, the statutory derivative action<sup>30</sup> is available only in respect of breach of duties which are set out in the statute.<sup>31</sup> In South Africa the statutory derivative action is available in respect of breaches of duty only.<sup>32</sup> By contrast, in Canada under the Canadian Business Corporations Act (“the CBCA”), in New Zealand and under the draft Australian legislation there is no statutory circumscription of the availability of the derivative action.<sup>33</sup>

**Do consultees agree with our provisional view that the new procedure should only be available for claims in respect of breaches of duty (including claims against third parties as a result of such breaches)?**

*Type of duty*

- 16.9 Another issue which arises is whether or not breach of duty should include breach of the director’s duty to exercise skill and care. There are deficiencies in the means available for shareholders to enforce directors’ duties of skill and care, in that section

<sup>27</sup> The relief sought may not be against the director personally but against a third party, eg to set aside an allotment of shares made by directors for an improper purpose. In relation to such an allotment the shareholder may be able to bring a personal action instead of a derivative action, see generally para 5.16, n 33 above.

<sup>28</sup> See para 15.2 above.

<sup>29</sup> One statutory definition of such an individual is to be found in s 741(2) of the Companies Act 1985: “... a person in accordance with whose directions or instructions the directors of the company are accustomed to act. However a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity”. See also s 251 of the Insolvency Act 1986; s 22(4) and (5) of the Company Directors Disqualification Act 1986; and s 207 of the Financial Services Act 1986. See also *Shadow Directorships* (1993), a paper issued by the Financial Law Panel.

<sup>30</sup> See Appendix G.

<sup>31</sup> This may mean that the availability is easier to determine than it would be in this country. For example, this restriction could raise arguments as to whether the conduct was a breach of duty or whether the director was only under a disability or whether the effect of ratification was such as to cure the breach so that there is no right to a derivative action.

<sup>32</sup> Shareholders can also bring a derivative action under the common law.

<sup>33</sup> See Appendix F. For the position in the USA, see Appendix F, paras 6.2-6.3.

459 cannot be used in respect of negligence as such, but only for serious mismanagement,<sup>34</sup> and a derivative action based on negligence may only be brought if it can be shown that the majority have profited by the negligence.<sup>35</sup> We are of the view that the Jenkins Committee intended section 461(2)(c) to be available in the case of negligence<sup>36</sup> and we provisionally recommend that the new derivative action should be available in respect of negligence in order to remedy the deficiencies identified above.<sup>37</sup>

**Consultees views are sought on our provisional view that this action should be available for breach of directors' duties of skill and care.**

*Should the new procedure be available for breaches of duty by others apart from directors?*

16.10 This issue concerns whether this action should be available in respect of breaches of duty by other officers<sup>38</sup> or employees. Examples could be an employee accepting a bribe and committing a wrong against the company or a branch manager of a single branch bank misappropriating company assets and passing them to the majority shareholder. The unusual situation where there is a breach of duty by an officer or employee (other than a director) could be left to the common law governing derivative actions. That, however, could result in the development of diverging principles between the new procedure and the procedure at common law.<sup>39</sup> On the other hand, to extend the new procedure to claims in respect of breaches of duty by officers and employees other than directors might result in excessive shareholder interference in company management.

16.11 We provisionally recommend a method of resolving these conflicting considerations. In the event of breaches of duty by officers other than directors, or by employees, the new derivative procedure should be used, but the applicant should have to show that the claim could have been brought under the fifth limb of the rule in *Foss v Harbottle*

<sup>34</sup> See paras 9.44-9.48 above.

<sup>35</sup> See paras 4.10-4.11 above.

<sup>36</sup> See the Report of the Company Law Committee (1962) Cmnd 1749, paras 206-207; see paras 7.10-7.11 above.

<sup>37</sup> It should be remembered that we are not creating new causes of action against directors; the company could bring this claim itself.

<sup>38</sup> Section 744 of the Companies Act 1985 defines "officer" as including "a director, manager or secretary". A "manager" does not include every branch manager of a multiple branch business, but is a person who is managing the affairs of the company as a whole; see *Registrar of Restrictive Trading Agreements v WH Smith & Son Ltd* [1969] 1 WLR 1460, 1467. Auditors are officers for a number of purposes, eg when they are appointed as the company's auditor for the purposes of s 384 of the Companies Act 1985; see *R v Shacter* [1960] 2 QB 252, applying *Re Western Counties Steam Bakeries and Milling Co* [1897] 1 Ch 617; and for the purpose of misfeasance summonses in liquidations under s 212 of the Insolvency Act 1986; see *Re London and General Bank* [1895] 2 Ch 166 and *Re Kingston Cotton Mill Co* [1896] 1 Ch 6.

<sup>39</sup> Which we state in para 16.13 below to be an undesirable state of affairs.

as restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*.<sup>40</sup> We anticipate that it would only be in very rare circumstances that advantage would have to be taken of this provision, since in most situations there would also be a breach of duty by the directors.

**Do consultees consider that the new procedure should also be available for breach of duty by officers and employees other than directors, but only where there has been a fraud on the minority?**

**Partial abrogation of the rule in *Foss v Harbottle***

16.12 The first issue is whether it is desirable to abrogate any part of the rule. In South Africa the statutory derivative action supplements a member's right to bring a derivative action at common law.<sup>41</sup> It has been argued there that the statutory derivative action is subject to the same restrictions as the common law right.<sup>42</sup> In New Zealand the legislation expressly provides that no derivative action can be brought except as provided in the section creating the statutory derivative action.<sup>43</sup> The draft Australian provision abolishes the common law right to bring a derivative action.<sup>44</sup>

16.13 In relation to the Canadian legislation it was said:

It would only lead to confusion to allow both common law and statutory actions. A more orderly development of the law would result from one point of access to a derivative action and would allow for a body of experience and precedent to be built up to guide shareholders.<sup>45</sup>

The same arguments appear to us to hold good in this jurisdiction. It is possible that diverging principles could develop between the new procedure and the procedure at common law and this would add to the current confusion.<sup>46</sup> As our objective is that the law should be simpler than at present, steps have to be taken to avoid these dangers.

<sup>40</sup> [1982] Ch 204. See para 15.2, n 2 above.

<sup>41</sup> See Appendix F, para 5.3.

<sup>42</sup> *Henechberg on the Companies Act* (5th ed 1994) p 511.

<sup>43</sup> See Appendix F, para 4.3.

<sup>44</sup> See Appendix F, para 1.4.

<sup>45</sup> S Beck, "The Shareholders' Derivative Action" (1974) 52 Can Bar Rev 159. In Canada this objective is met, however, not by express abrogation of the rule but by requiring that no derivative action be brought without the leave of the court and by laying down conditions for the granting of leave.

<sup>46</sup> See, for example, the Australian Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 4.

**Consultees are asked whether an action which can be brought under the new procedure should only be capable of being so brought, and not also under the exceptions to the rule in *Foss v Harbottle*.**

- 16.14 We saw in Part 4<sup>47</sup> that the so-called exceptions to the rule in *Foss v Harbottle*, apart from that stated in paragraph (5) of the restatement of the rule in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>48</sup> and the exception for a claim for the recovery of damages arising out of, or property transferred as part of, an ultra vires transaction, are really situations in which the rule does not operate. The rule does not apply to actions for infringement of personal rights or to personal actions for rescission of an improper allotment of shares or to actions to restrain ultra vires acts, none of which are affected by the new derivative procedure. A claim to establish the invalidity of a transaction for which a special majority is required is also outside the operation of the rule in *Foss v Harbottle*.<sup>49</sup> Since both the company and the applicant member are parties to the statutory contract constituted by the memorandum and articles, the action may either be in personal or derivative form.<sup>50</sup> It is not proposed that the creation of the new derivative action and the abrogation of the exceptions to the rule in *Foss v Harbottle*, so far as necessary to ensure that all claims that can be brought under the new procedure are so brought, should affect these claims. As these claims are outside the rule in *Foss v Harbottle*, different considerations apply and we see no reason why they should not be treated as ordinary actions.

**Consultees are asked for their views on whether actions within paragraph (4) of the definition of the rule in *Foss v Harbottle* given in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*, namely actions in respect of transactions requiring approval by special majority, should be governed by specific rules of court requiring the court's leave for continuation of the action. If so, which of the matters set out in paragraph 16.20 (or other matters) should apply to such actions?**

#### **Notice to the company**

- 16.15 The object of this requirement is to allow a company sufficient time to decide what to do about the action, including whether or not to bring proceedings itself. Under the CBCA in Canada reasonable notice to the directors is a requirement. One month's notice is required prior to the commencement of the statutory action in South Africa. The Australian draft legislation requires fourteen days notice.<sup>51</sup>

<sup>47</sup> See para 4.5, n 13 above.

<sup>48</sup> [1982] Ch 204, 210. See also para 15.1, n 2 above.

<sup>49</sup> *Edwards v Halliwell* [1950] 2 All ER 1064.

<sup>50</sup> As in *Quin & Axtens Ltd v Salmon* [1909] AC 442.

<sup>51</sup> Unless, despite its absence, leave is appropriate. This is intended to allow for an ex parte hearing where there is need for urgent litigation. The notice also has to contain the reasons for applying for leave so as to allow the company time to address the applicant's concerns

- 16.16 Notice allows the company time to take, or at least commence, remedial action or, if such action is not to be taken, it gives officers time to prepare a response to the application.<sup>52</sup> Furthermore, it is in accordance with principle that the company should have the opportunity to bring the action itself, since the cause is the company's.
- 16.17 We provisionally recommend that shareholders should be required to serve a notice on the company calling on it to institute proceedings within one month, specifying the grounds of the proposed derivative action, and stating that, if the company fails to do so, the shareholder will commence a derivative action. An exception to this requirement for notice should be made where the applicant shows that urgent relief is needed or the court dispenses with the requirement. If the company commences an action, but fails diligently to prosecute it, it should be open to a shareholder to apply to the court for leave to take over the action. In these circumstances the court would have to consider the criteria for leave.<sup>53</sup> If it granted leave, the court would have the same powers in relation to the proceedings as in any other derivative action.<sup>54</sup>

**Do consultees agree with our provisional recommendations that:**

- (i) notice to the company should be a precondition to the grant of leave to a shareholder to maintain a derivative action;**
- (ii) the requirement for notice should be waived if the shareholder can show that urgent relief is required and/or if the court dispenses with the requirement;**
- (iii) the notice period should be 28 days;**
- (iv) the notice should specify the grounds of the proposed derivative action?**

**Consideration by the court**

- 16.18 As stated above,<sup>55</sup> the court's leave should be required for the maintenance of a derivative action. A convenient stage for the court to consider the grant of leave might

prior to the hearing. See the Australian Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 6.

<sup>52</sup> Australian Companies and Securities Law Review Committee ("CSLRC"), *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action, Report No 12* (1990) p 19.

<sup>53</sup> As set out in paras 16.20 and 16.27-16.44 below.

<sup>54</sup> See *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, where the company had applied to discontinue the action. As can be seen from Appendix G, the draft legislation in Australia, the CBCA in Canada and the statutory provisions in New Zealand provide for intervention in proceedings to which a company is party.

<sup>55</sup> See para 15.4(ii) above.

be at the close of pleadings,<sup>56</sup> but we consider that the court should have power to require leave to be sought at an earlier stage if it felt fit. When considering whether to grant leave, the court would take into account all the relevant circumstances including certain specified matters. It must be recognised that the leave stage may be complex and lengthy and that it will require case management in itself. In those circumstances, we consider that the application for leave should be heard by a judge rather than a Master.<sup>57</sup> The judge may, in a particularly complex case, direct that pleadings be served on the issue of whether leave should be given. The court would be able to grant leave subject to conditions, and it could limit leave to the completion of certain stages in the litigation.

**Do consultees agree with our provisional view that the court should normally consider leave at close of pleadings, but should be able to do so earlier, and that the application should normally be heard by a judge rather than a Master?**

- 16.19 The question arises whether all the parties to the action should be parties to the application for leave. On an indemnity costs order application, the defendants other than the company would not normally be present, and the application would be heard by a judge or Master who was not concerned with the rest of the case. However, RSC, O 15, r 12A contemplates that all the parties to the action would be parties to the application for leave and they would thus all be entitled to receive the affidavits and other documents used on the application. Such an application, however, would turn on whether the applicant had shown a prima facie case that his claim was within the exceptions to the rule in *Foss v Harbottle*, and would not involve argument as to whether the derivative action was in the interests of the company. Our provisional view is that all the parties to the action should be parties to the application for leave<sup>58</sup> and be entitled to receive evidence filed on it and to be present at the hearing unless the court otherwise directs.<sup>59</sup>

**Our provisional view is that all the parties to the proceedings should:**

- (i) be parties to the application for leave; and**
- (ii) be entitled to receive evidence filed on it; and**

<sup>56</sup> Chapter 5 of the Woolf Report recommends that there should be case management conferences in appropriate cases; see paras 5 and 6. The timing is to be flexible (para 13) but where it takes place before disclosure of documents it might be a convenient stage at which leave could be considered.

<sup>57</sup> See also the Woolf Report, ch 1, para 4 on performance of the task of procedural judge by Circuit and High Court judges in more complex cases.

<sup>58</sup> Save where the circumstances are such that an ex parte application is appropriate.

<sup>59</sup> Cf *Smith v Croft* [1986] 1 WLR 580.

**(iii) be present at the hearing unless the court otherwise directs.**

**Do consultees agree?**

**Issues relevant to the grant of leave**

16.20 Our provisional view is that the court, when considering whether or not to grant leave, must have regard to all the relevant circumstances and, without prejudice to the generality of that requirement, should in particular consider the following matters: whether the applicant is acting in good faith;<sup>60</sup> whether the proceedings are in the interests of the company;<sup>61</sup> ratification;<sup>62</sup> views of an independent organ;<sup>63</sup> and the availability of alternative remedies.<sup>64</sup> The issues that arise under this head are: whether leave should be subject to a threshold test on the merits; which matters the courts should take into account in the exercise of their discretion; and whether such matters should be laid down. Below we first deal with the threshold test,<sup>65</sup> then we summarise different approaches to the exercise of the discretion in foreign jurisdictions,<sup>66</sup> then we consider each of the matters in turn together with more detailed consideration of the foreign provisions<sup>67</sup> and finally we look at the issue of whether it is necessary expressly to lay down the matters which the court should take into account.<sup>68</sup>

*Threshold test on the merits*

16.21 The current law in the United Kingdom is that a shareholder seeking to bring a derivative action has to prove fraud and control on a prima facie basis. Under the CBCA in Canada there is no express threshold test,<sup>69</sup> whereas in New Zealand the court must have regard to the likelihood of the proceedings succeeding,<sup>70</sup> and the

<sup>60</sup> See paras 16.27-16.31 below.

<sup>61</sup> See paras 16.32-16.34 below.

<sup>62</sup> See paras 16.35-16.37 below.

<sup>63</sup> See para 16.38 below.

<sup>64</sup> See paras 16.39-16.40 below.

<sup>65</sup> See paras 16.21-16.22 below.

<sup>66</sup> See paras 16.23-16.24 below.

<sup>67</sup> See paras 16.27-16.40 below.

<sup>68</sup> See paras 16.42-16.44 below.

<sup>69</sup> Although the Dickerson Committee, *Proposals for a New Business Corporations Law for Canada* (1971) recommended that the complainant should have to show that the action was "... prima facie in the interests of the corporation". They said that this would "... block actions to recover small amounts, particularly actions really instituted to harass or to embarrass directors or officers who have committed an act which, although unwise, is not material". *Ibid*, at para 482.

<sup>70</sup> See Appendix F, para 4.3. In the first case on the legislation, *Vrij v Boyle* [1995] 3 NZLR 763, the judge adopted the test suggested in *Smith v Croft* as follows: "It is not for me to conduct an interim trial on the merits. The appropriate test is that which would be exercised by a prudent business person in the conduct of his or her own affairs when deciding whether to bring a claim. Such a decision requires one to consider such matters as the amount at

Australian draft legislation provides that there should be a serious question to be tried.<sup>71</sup>

- 16.22 We do not consider that it is appropriate to have a threshold test on the merits of the action. The case will necessarily be one which the court decides or has decided has a realistic prospect of success.<sup>72</sup> The court will have power to grant or refuse leave to maintain the action, and if, for instance, it has doubts about the wisdom of the action, it may grant leave for limited stages in the proceedings at any one time to allow the position to be clarified. Moreover, a requirement to consider the interests of the company<sup>73</sup> may, where the directors have not expressed a view on this question or the court is not persuaded by their view, involve some assessment of the legal merits. It is important to avoid a mini-trial or detailed investigation of the merits at the leave stage, which would be time consuming and expensive. The risk of a mini-trial is reduced if there is no specific threshold test. Parties should not, in our provisional view, go into the legal merits in detail on the application for leave unless it is clear that there is a high degree of probability of success or failure.<sup>74</sup>

**We provisionally recommend that there should be no threshold test on the merits of the case and seek consultees' views on this issue.**

stake, the apparent strength of the claim, likely costs and the prospect of executing any judgment". *Ibid*, at p 765.

<sup>71</sup> See Appendix F, para 1.5. This test was said to be preferable to the prima facie test as it was felt to be undesirable to turn the leave application into a trial of the substantive issues without the applicant having had discovery of the opponent's documents. The test was also said to be familiar and accepted in the context of interim injunction applications; see Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 6.

<sup>72</sup> See paras 17.4 and 17.16 below for the new power to dismiss a case or part of it on the grounds that it has no realistic prospect of success. The power will enable the court to strike out hopelessly optimistic or unrealistic claims by reference not merely to the pleadings but also (within limits) to the available evidence.

<sup>73</sup> See paras 16.32-16.34 below.

<sup>74</sup> Cf the approach in *Porzelack KG v Porzelack (UK) Ltd* [1987] 1 WLR 420, 423.



*Summary of approach to derivative actions in foreign jurisdictions*

- 16.23 Under the CBCA in Canada,<sup>75</sup> in New Zealand<sup>76</sup> and in the proposed Australian legislation<sup>77</sup> there are no express provisions as to the causes of action for which the derivative action is to be available. In each of these jurisdictions the member has to seek leave to bring the action and statute sets out the conditions which the court must find to be satisfied before leave can be given.<sup>78</sup> In South Africa the common law derivative action has not been repealed but members are given an additional remedy and the statute sets out the causes of action and circumstances in which they can bring action on behalf of a company.<sup>79</sup> The court, on being satisfied on a prima facie basis that there are grounds for such proceedings and that the company has not itself brought proceedings, appoints an independent person to investigate and report on the desirability of the proceedings. Following the report the court can then appoint that person to pursue the proceedings on behalf of the company.<sup>80</sup>
- 16.24 Under the Ghanaian Companies Code 1963 the causes of action for which the proceedings can be brought are expressly laid down.<sup>81</sup> Upon a defendant's application for a stay the court may stop the action proceeding on the grounds that it is inequitable that the plaintiff should have its conduct. The statute requires that on such an application the court is to take all the circumstances into account and two are specifically mentioned in the legislation.<sup>82</sup>
- 16.25 We are of the provisional view that in considering the issue of leave the court should take into account all the relevant circumstances.

**Do consultees agree that in considering the issue of leave the court should take into account all the relevant circumstances without limit?**

<sup>75</sup> See Appendix F, paras 2.3-2.6; and see Appendix G.

<sup>76</sup> See Appendix F, paras 4.2-4.8; and see Appendix G.

<sup>77</sup> See Appendix F, paras 1.2-1.8; and see Appendix G.

<sup>78</sup> Welling in *Corporate Law in Canada: the Governing Principles* (2nd ed 1991) states at p 537 that in some cases, even where all the prerequisites have been satisfied, leave has been refused.

<sup>79</sup> See Appendix F, paras 5.1-5.8; and see Appendix G.

<sup>80</sup> In Australia, the court would have similar powers under proposed legislation. See Appendix F, para 1.7; and see Appendix G.

<sup>81</sup> See Appendix F, para 3.2.

<sup>82</sup> Namely the member's participation in the transaction complained of and the circumstances in which he became a member of the company. See Appendix F, para 3.5, and para 16.28 below.

16.26 We now turn to examine the specific matters which we have suggested<sup>83</sup> should be taken into account by the court in considering whether to grant leave.

*Applicant's good faith*

16.27 Under the current law shareholders are denied the conduct of derivative actions if they have acted in such a way as to render it unjust for them to bring such a claim.<sup>84</sup> In Canada, under the CBCA,<sup>85</sup> and in the Australian draft legislation<sup>86</sup> the good faith of the applicant is a prerequisite for the grant of leave. In Canada the Dickerson Committee considered that it would prevent “private vendettas”.<sup>87</sup> In Australia the CSLRC<sup>88</sup> put forward a number of reasons for the inclusion of good faith. These include the need to determine whether the applicant has been complicit in the matters complained of and the prevention of strike suits<sup>89</sup> brought, for example, to further the interests of a business competitor or someone making a proposed takeover offer.

16.28 In Ghana, Professor Gower put the current law into statute form by providing that the court can stay the proceedings in the event that it finds it inequitable that the member should have the conduct of them. The court is to take into account all the circumstances but participation in the transaction complained of and the circumstances of acquisition of the shares are specifically mentioned.<sup>90</sup> These are intended<sup>91</sup> to protect against complicity<sup>92</sup> and against the purchase of shares for the purpose of litigation by vexatious litigants.<sup>93</sup>

16.29 Our provisional suggestion is that, in this context, good faith should be a separate consideration from the interests of the company.<sup>94</sup> We would tend to favour the test

<sup>83</sup> See para 16.20 above.

<sup>84</sup> See para 5.18 above.

<sup>85</sup> See Appendix F, para 2.3.

<sup>86</sup> See Appendix F, para 1.5.

<sup>87</sup> *Proposals for a New Business Corporations Law for Canada* (1971) para 482.

<sup>88</sup> *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action, Report No 12* (1990) pp 20-21.

<sup>89</sup> A phrase used in North America to describe applications made in order to further the interests of someone other than the company.

<sup>90</sup> See Appendix F, para 3.5.

<sup>91</sup> See *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana* (1961) pp 152-153.

<sup>92</sup> As is the requirement of good faith in Australia, see para 16.27 above.

<sup>93</sup> There is no requirement that the applicant should be acting in good faith in New Zealand, South Africa or under the Federal Rules of Civil Procedure in the USA.

<sup>94</sup> So that it would not necessarily have the same meaning as the phrase “bona fide in the interests of the company” applied in relation to voting by shareholders on resolutions amending the articles of association. See paras 2.32-2.38 above.

for good faith applied<sup>95</sup> by Lord Denning MR in *Central Estates (Belgravia) Ltd v Woolgar*<sup>96</sup> and by Plowman J in *Smith v Morrison*<sup>97</sup> which is “honestly and with no ulterior motive”.<sup>98</sup>

16.30 Depending on the meaning of good faith in this context, a court would generally refuse leave to an applicant whom it considered to be acting in bad faith so that it may not be necessary to state this factor specifically.<sup>99</sup> Furthermore, since the meaning of the phrase is unclear its express presence could encourage litigation as to its meaning in this context.

16.31 On the other hand, it is a relevant criterion for granting leave and we provisionally consider that it is of sufficient importance to be mentioned expressly. Furthermore, although we make no provisional recommendation on this issue, we invite views as to whether good faith should be defined. We are also of the provisional view that the good faith of the applicant should not be a prerequisite to the grant of leave. If its absence amounted to a bar to leave, it would encourage mini-trials on the issue.<sup>100</sup>

**We provisionally recommend that, in considering the issue of leave, the good faith of the applicant is one of the circumstances which the court should take into account. Do consultees agree? If so:**

- (i) do they consider that “good faith” should be defined for these purposes; and**
  
- (ii) if so, what do they consider would be the appropriate definition;**

<sup>95</sup> Although not in this context.

<sup>96</sup> [1972] 1 QB 48, 55, construing the Leasehold Reform Act 1967, Sched 3 para 4(1):  
Where a tenant makes a claim to acquire the freehold or an extended lease of any property, then during the currency of the claim no proceedings to enforce any right of re-entry or forfeiture terminating the tenancy shall be brought in any court without the leave of that court, and leave shall not be granted unless the court is satisfied that the claim was not made in good faith; but where leave is granted, the claim shall cease to have effect.

<sup>97</sup> [1974] 1 WLR 659, 676 construing The Land Registration (Official Searches) Rules 1969 (SI 1969 No 1179), r 2(2):  
... “purchaser” means any person (including a lessee or chargee) who in good faith and for valuable consideration acquires or intends to acquire a legal estate in land ... .

<sup>98</sup> [1972] 1 QB 48, 55. If it is a requirement of good faith that the action would, if successful, benefit all shareholders apart from the wrongdoers, there may be some doubt whether this criterion would have been satisfied in *Trusthouse Forte plc v The Savoy Hotel plc*, see para 6.6 above.

<sup>99</sup> If the court found or suspected the applicant to be acting in bad faith it could exercise its power to substitute another applicant; see para 17.9 below.

<sup>100</sup> See also para 16.22 above.

**(iii) do consultees agree with our provisional view that the good faith of the applicant should be relevant, but not a prerequisite to the grant of leave?**

*Interests of the company*

- 16.32 In Canada under the CBCA<sup>101</sup> and in the Australian draft legislation<sup>102</sup> it is an express prerequisite to a grant of leave that the action should be in the interests of the company. In New Zealand, the position is different in that, whilst the court has to take the interests of the company into account in considering whether to grant leave, satisfaction on this point is not expressed to be a prerequisite to the grant of leave. There is a prerequisite that it be in the interests of the company that the conduct of proceedings should not be left to the directors or shareholders as a whole. This is, however, an alternative to a requirement that the company does not intend to bring proceedings.<sup>103</sup>
- 16.33 There is a debate as to the meaning of the words “in the interests of the company” which might be repeatedly contested in the courts in such actions, thereby producing the undesirable result of mini-trials. The requirement that the action should be in the interests of the company is not stated in the South African legislation or in Ghana. Given, however, the essential nature of this action it could be strongly argued that courts in any jurisdiction would not permit such actions to proceed unless they were satisfied on this point, whether or not it appears in the statute. This raises the question of whether the court should be bound to refuse leave if the action is not in the interests of the company. Our provisional view is that it should not for the reason stated (in relation to the issue of good faith) above.<sup>104</sup>
- 16.34 As the Australian CSLRC said,<sup>105</sup> in some cases it would be relatively straight forward to satisfy this test. They suggest that the clearest case would be where directors had no legitimate reason for refusing to take action for loss caused by breach of duty. They go on to point out that there could be good commercial reasons for not taking action. These could include, for example, the board’s reluctance to disturb a long standing profitable relationship with a customer, or their conviction that the recovery by the company will be much less than the costs of the proceedings.<sup>106</sup> It is our provisional view that the court should have regard to the views of the directors in accordance with

<sup>101</sup> See Appendix F, para 2.3.

<sup>102</sup> See Appendix F, para 1.5.

<sup>103</sup> See Appendix F, para 4.3.

<sup>104</sup> See para 16.31 above.

<sup>105</sup> *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action, Report No 12 (1990) p 22.*

<sup>106</sup> *Ibid*, at p 22.

the approach mentioned in our third principle set out in Part 14 above.<sup>107</sup> This means that, in general, the court will not substitute its judgment on such matters.

**We provisionally recommend that in considering the issue of leave:**

- (i) the court should take account of the interests of the company; and**
- (ii) in doing so, the court should have regard to the views of directors on commercial matters;**
- (iii) the court should not be bound to refuse leave if the proceedings are not in the interests of the company.**

**Do consultees agree?**

*That the wrong has been, or may be, approved by the company in general meeting*

16.35 The state of current law gives rise to a number of issues. What should be the effect of an ordinary resolution which has ratified a breach of duty? Should it bar the action, or should it merely be something which the court takes into account?<sup>108</sup> Should the court take into account the fact that it is likely that a wrong will be ratified? Our provisional view is that the fact that a wrong has been or may be ratified is relevant to the court's decision whether to grant leave and, if so, on what terms, and that it should be included in the list of matters to be taken into account. However, we provisionally do not consider that the new rules should go on to provide that the court must refuse leave in these circumstances.

16.36 In Canada, the Dickerson Report,<sup>109</sup> on which the CBCA was based, treated ratification as an issue which the court should take into account. The legislation reflects this approach in expressly providing that ratification shall not result in the action being stayed but that the court can take it into account. The draft Australian legislation is to the same effect.<sup>110</sup> In Ghana, where the duties are set out in statute, detailed provision is made for ratification of conduct which is in breach of the various duties.<sup>111</sup> In South Africa ratification will not bar the initiation of proceedings by a member. The court is given express power, after the investigation by the provisional *curator ad litem*, to declare ratification or approval of the conduct to be of no effect.<sup>112</sup>

<sup>107</sup> See para 14.11 above.

<sup>108</sup> See paras 5.2-5.17 above for the current law.

<sup>109</sup> See Appendix F, paras 2.3-2.4.

<sup>110</sup> See Appendix F, para 1.6.

<sup>111</sup> See Appendix F, paras 3.2 and 3.4.

<sup>112</sup> See Appendix F, para 5.6.

16.37 As we have said above,<sup>113</sup> our provisional view is that the court should not be bound to stay an action where there has been ratification. The ratification may have been procured by the wrongdoers. Moreover, the court may entertain doubts about the influence of the wrongdoers, or the information placed before the company in general meeting may have been deficient, sometimes simply because information which had subsequently come to light was not then available. On the other hand, the court would have to consider the extent to which the ratification was effective. If it was effective in law to cure the breach of duty of which the applicant complained, the court would have to dismiss any claims based on that breach of duty.

**We provisionally recommend that in considering the issue of leave:**

- (i) the court should take account of the fact that the wrong has been, or may be, approved by the company in general meeting; and**
- (ii) the court should not be bound to refuse leave where there has been ratification.**

**Do consultees agree?**

*The views of an independent organ*

16.38 This item differs from ratification, which involves approval of the wrong. The court may, in the absence of ratification, be informed of commercial reasons why the directors or the shareholders as a body<sup>114</sup> consider that the action should or should not be pursued. Consistent with the guiding principle identified in Part 14 above,<sup>115</sup> we provisionally consider that the court should take these views into account in determining whether to grant leave. We envisage that the court would take these views into account in accordance with the approach adopted in the authorities we have noted in Part 14 above.<sup>116</sup>

**We provisionally recommend that, in considering the issue of leave, the court should take account of the views of an independent organ that for commercial reasons the action should or should not be pursued, but that its views should not necessarily be conclusive on the issue of whether or not leave should be granted. Do consultees agree?**

<sup>113</sup> See para 16.35 above.

<sup>114</sup> See paras 4.27-4.29 above for detailed consideration of the nature of an independent organ.

<sup>115</sup> See para 14.11(iii) above.

<sup>116</sup> See para 14.11, n 18 above.

*The availability of alternative remedies*

- 16.39 An issue prompted in part by the case of *Barrett v Duckett*<sup>117</sup> is whether the court should take into account the existence of an alternative remedy. It could be a bar to a derivative action that there was another adequate remedy that could be sought.
- 16.40 We consider that the court will take into account the availability of alternative remedies (such as seeking liquidation) in considering the derivative action. Thus our provisional view is that it might be useful if this matter was included in the list of criteria.

**We provisionally recommend that, in considering the issue of leave, the court should take account of the availability of alternative remedies, but that their availability should not necessarily be conclusive on the issue of whether or not leave should be granted. Do consultees agree?**

- 16.41 In the absence of circumstances justifying the grant of leave the proper plaintiff principle should apply since, in the words of the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>118</sup> it "... is fundamental to any rational system of jurisprudence".<sup>119</sup>

**Do consultees agree that in the absence of circumstances justifying the grant of leave the proper plaintiff principle should apply?**

*Advantages and disadvantages of express list of criteria*

- 16.42 There are five criteria mentioned above. They are: applicant's good faith, interests of the company, ratification, views of an independent organ, and the availability of alternative remedies. We consider that the court should take them all into account, together with any other relevant circumstances.
- 16.43 There are a number of arguments against their inclusion in a list. The first is that a list may appear to be a set of hurdles which applicants have to overcome and which would deter them. Second, it could be seen as maintaining the policy of not favouring derivative actions and as a signal to adopt an over-restrictive approach to them. Third, it could be seen as constraining the flexible exercise of discretion which we are anxious to encourage, in that inclusion of these and omission of others may suggest that these are the only relevant criteria or the most important. The fourth argument against such a list is that it is not truly helpful by way of guidance to advisers or shareholders in relation to "good faith" and "the interests of the company" because they are such open textured phrases which have been given numerous meanings by different courts.

<sup>117</sup> [1995] 1 BCLC 243; see para 5.19 above. See also *Re Blue Arrow plc* [1987] BCLC 585, 591, cf *Re a Company (No 005287 of 1985)* [1986] 1 WLR 281.

<sup>118</sup> [1982] Ch 204.

<sup>119</sup> *Ibid*, at p 210.

16.44 In answer to such criticism, we intend that the wording should make it plain that the discretion is wide and that the matters set out are only some examples of the circumstances to which the courts should have regard. This should overcome the first three points made in the last paragraph.<sup>120</sup> As for the last, although advisers will have to carry out further research, express reference to these factors will be of some assistance. The most important advantage of listing them is that they should assist in building up a body of reported cases which will guide shareholders and advisers.<sup>121</sup> For example, in New Zealand, in the first reported case on the new statutory derivative action<sup>122</sup> the court, although pointing out the breadth of the discretion, reviewed the considerations listed in the statute together with the facts relevant to them. Our provisional view is that this is a desirable result and outweighs the arguments against laying down such criteria.

**Our provisional view is that there should be an express statement in the rules of court that regard should be had to all relevant circumstances, and that they include the five criteria mentioned above, namely: whether the applicant is acting in good faith; whether the proceedings are in the interests of the company; ratification; views of an independent organ; and the availability of alternative remedies. Do consultees agree?**

#### **Additional qualifying requirement**

16.45 We have considered and provisionally rejected a requirement that the applicant should have been a shareholder for a minimum period of time. The foreign legal systems which we have examined have not adopted this approach. Any time period would be arbitrary and may, therefore, result in derivative actions being unavailable in some situations where they are needed. The application of the criteria of good faith and the company's interests should ensure that people who buy shares just to engage in such litigation will not be permitted to do so.<sup>123</sup>

<sup>120</sup> However, the proper plaintiff rule would be maintained.

<sup>121</sup> Although it could be argued that because the factors are not weighted and the discretion is so open the case law will provide little guidance because each case will turn on its own facts.

<sup>122</sup> *Vrij v Boyle* [1995] 3 NZLR 763.

<sup>123</sup> An alternative approach to the derivative action is to require a minimum shareholding which would be similar to the approach to be found in the EC Draft Fifth Directive for the Harmonisation of Company Law in relation to shareholders' ability to cause proceedings to be brought on behalf of the company. For the 1988 text, see J Dine, *EC Company Law* (1st ed 1991) paras A8.20-A8.93. Under this provision proceedings are to be commenced on behalf of a public company in respect of directors' liabilities for breach of duty if "... so requested by one or more shareholders who hold shares of a nominal value or in the absence of a nominal value, an accounting par value which the Member States may not require to be greater than 10% of the subscribed capital" (art 16). Work by the European Commission on that directive appears to be concentrated on Worker Information and Consultation (see *Communication from the Commission* (14 November 1995) COM (95) 547 final) and the ultimate fate of this draft procedure for a derivative action is uncertain.



**Do consultees agree with our provisional rejection of a requirement that the applicant should have been a shareholder for a minimum period of time?**

**Court's power to appoint an independent expert**

- 16.46 The Australian draft statutory derivative action<sup>124</sup> provides that the court may appoint an independent person to investigate and report to the court on the company's financial affairs, or facts underlying the complaint, or the costs of the proceedings.<sup>125</sup>
- 16.47 Our provisional view is that the question whether a derivative action should proceed should be dealt with by the court in the usual way, that is, on the evidence placed before it by the parties.<sup>126</sup>

**We provisionally recommend against creating a special power to allow the court to appoint an independent expert to investigate and advise on the action. Do consultees agree?**

**Remedy**

- 16.48 The question arises whether it should be open to the court to make an order granting a personal benefit to the shareholder bringing the derivative action, such as an order that the defendant wrongdoers buy the applicant's shares. It can be argued that the very nature of the derivative action is that it seeks a benefit for the company and that it is contrary to principle to permit an applicant a personal benefit. It can also be argued that it is unnecessary to allow it because the company, with the leave of the court (and provided no question of breach of duty or ultra vires arose), could settle the proceedings by providing the applicant with such a benefit. It may also be said that permitting such a benefit would encourage strike suits.

<sup>124</sup> In South Africa, the whole derivative action turns on provision for a *curator ad litem* to be appointed by the court to investigate the merits of the action and then to control it on behalf of the applicant. See para 16.23 above and Appendix F, para 5.5.

<sup>125</sup> See Appendix F, para 1.7. J Kluver, Executive Director, CSLRC in "Derivative Actions and the Rule in Foss v Harbottle: Do We Need a Statutory Derivative Remedy?" (1993) 11 Co & Sec LJ 7 explains this provision. He refers to the need to ensure that the action is in the company's best interests and to the fact that there may be good reasons for not pursuing the action (of the type referred to in para 16.34 above). He points out that, by contrast with the USA's independent directors or litigation committee approach, the Canadian CBCA, the New Zealand legislation and the Australian CSLRC have given the task of making this decision to the courts. He considers that this avoids the danger that is prevalent in American litigation committees of "self interest considerations or managerial bias" but that it still leaves a problem of informing the court of the merits of the application. *Ibid*, at p 21. The appointment of an independent expert is seen as one way of dealing with this task.

<sup>126</sup> See ch 13, paras 16-24 of the Woolf Report for consideration of the cases in which it would be appropriate to use a single expert.

- 16.49 However, in New Zealand,<sup>127</sup> under the CBCA in Canada<sup>128</sup> and in Ghana<sup>129</sup> compensation may be paid to members rather than to the company.<sup>130</sup> Professor Gower<sup>131</sup> considered this to be necessary to avoid someone who has bought shares obtaining effectively an unjustified reduction in the price paid and he cited *Regal (Hastings) Ltd v Gulliver*<sup>132</sup> as an example of such a case.<sup>133</sup> As a matter of policy we are trying to facilitate shareholder remedies. To maintain a distinction in available relief based solely on the cause of action pleaded may perpetuate the current problems facing litigants in deciding whether to bring a personal or derivative action.
- 16.50 Turning to the practical needs of members, the case law on section 459<sup>134</sup> shows that in many cases shareholders do want an exit route, even when their primary allegation is one of breach of duty to the company. However, particularly now that it has been established that a third party<sup>135</sup> can be joined to a claim under s 459,<sup>136</sup> a shareholder can obtain a personal remedy under that section for a wrong done to the company.<sup>137</sup> In these circumstances, it may be felt that to give the court power to grant personal relief in a derivative action is unnecessary. It may also be undesirable because, as we point out in our proposal that a derivative action should not be abandoned or compromised without the leave of the court,<sup>138</sup> a derivative action concerns shareholders not before the court, and creditors may also be adversely affected. In the circumstances we provisionally consider that there should not be the power to grant a personal benefit.

**Do consultees agree with our provisional view that the court should not have power to grant a personal benefit in a derivative action? If consultees do not agree with this view, what types of order do they consider that the court should be able to grant? In particular, do they consider that the court's power should**

<sup>127</sup> See Appendix F, para 4.7.

<sup>128</sup> See Appendix F, para 2.5.

<sup>129</sup> See Appendix F, para 3.7.

<sup>130</sup> These powers would not appear to extend to granting a buy-out order. It should be noted that in the UK it is open to doubt whether the courts have the power to grant compensation to an individual shareholder, whether the claim is brought under an exception to the rule in *Foss v Harbottle* or under s 459; see para 10.27, n 72 above.

<sup>131</sup> *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana* (1961) p 153.

<sup>132</sup> [1967] 2 AC 134n. For the facts, see para 5.11 above.

<sup>133</sup> He also points out that in the USA, such payment is allowed in the interests of justice.

<sup>134</sup> See para 9.32 above.

<sup>135</sup> Ie a person other than a current member or director of the company.

<sup>136</sup> See para 16.3 above.

<sup>137</sup> If he can show that the conduct is unfairly prejudicial; see para 16.4(i) above.

<sup>138</sup> See para 17.10 below.

**be limited to the grant of orders for compensation or should it extend to orders for the purchase of shareholdings?**<sup>139</sup>

### **Multiple derivative actions**

- 16.51 The modern tendency, as observed in Part 1, is for companies to have subsidiaries and associated undertakings. This tendency gives rise to the issue of whether a shareholder in a parent company may bring a derivative action on behalf of a subsidiary or associated company within the group. Logically an action by a shareholder of a parent company on behalf of a subsidiary is called a “double” derivative action and, if on behalf of a “second tier” subsidiary, it would be called a “triple” derivative action. It is therefore easier to refer to all these actions as “multiple” derivative actions.<sup>140</sup> Such an action may be appropriate where a shareholder in one company (A) can show that the directors of company A and of a subsidiary (B) or related company (C), (which may not be a direct subsidiary or a direct investment of company A), have wrongly prevented the enforcement of a cause of action vested in subsidiary B or related company C.<sup>141</sup> Derivative actions are permitted in these circumstances in the United States of America.<sup>142</sup> If actions were permitted in similar circumstances in the United Kingdom, the court would have to be satisfied that the refusal of company A and subsidiary B or related company C was unjustified. It would probably attach weight to the view of any intermediate wholly or partly owned subsidiary. The company whose cause of action was being enforced would have to be joined as a party to the derivative action and no doubt it would be liable to costs indemnity applications.

**We are not making any provisional recommendation on this issue, but would be grateful if consultees could inform us whether they consider that provision should be made for multiple derivative actions. If so, do they envisage any particular difficulties with such actions, or do they consider that they should be treated in the same way as any other derivative action?**<sup>143</sup>

<sup>139</sup> See para 16.49, n 130 above.

<sup>140</sup> Philip I Blumberg, *The Law of Corporate Groups: Procedural Law* (1st ed 1983) p 350, n 3.

<sup>141</sup> For the reverse situation, where a shareholder complains about the conduct of a parent company, see the cases set out in paras 9.9-9.13 above.

<sup>142</sup> See Appendix F, para 6.4 for some of the difficulties encountered in that jurisdiction. Double derivative actions are available in Canada under the CBCA (see Appendix F, para 2.6) and multiple derivative actions are available in New Zealand (see Appendix F, para 4.3).

<sup>143</sup> In other words should they be subject to the 6 features listed in para 15.4 above and the same powers of case management as are set out in Part 17 below.

# PART 17

## CASE MANAGEMENT BY THE COURTS OF SHAREHOLDER PROCEEDINGS

### Introduction

- 17.1 The current position in relation to case management of the remedy under section 459 and the problems to which it gives rise is set out in Part 11 above.<sup>1</sup> The relevant coverage of the common law derivative action is to be found in Section B. The powers set out below are modelled on the case management techniques to be found in the Woolf Report.<sup>2</sup> Most, if not all, of these suggestions could be achieved by rules of procedure or a practice guide. Most of the matters mentioned are merely applications of general powers which the court has to control procedure.
- 17.2 Our intention is that the following system of case management should operate in respect of the new derivative action, section 459 and any additional unfair prejudice remedy enacted as a result of our proposals. Any new rules of procedure setting out the proposed powers would supplement the 1986 Rules and replace RSC, O 15, r 12A.<sup>3</sup> The Companies Acts govern the United Kingdom. However, as there are differences in Scottish procedure<sup>4</sup> it would be desirable for the court's powers set out below to be dealt with in procedural rules rather than in statute.

### Proposals in the Woolf Report

- 17.3 The process of case management will begin following receipt of a defence. At this point decisions will be taken as to whether a case management conference is necessary or whether written directions are all that is required, and whether a pre-trial review should be fixed.<sup>5</sup> The issue of whether a case management conference is held before or after

<sup>1</sup> See, in particular, paras 11.1-11.3 and 11.10-11.11 above. On applications to strike out, see paras 11.23-11.25 above.

<sup>2</sup> In December 1995 a specialist Chancery Working Group considered some of the implications of Lord Woolf's work (published in *Access to Justice: an Interim Report to the Lord Chancellor on the Civil Justice System in England and Wales* (June 1995)) on Chancery proceedings; see R Clark, "Changes at Chancery" (1996) 93/23 LSG 30. The Working Group considered that there would be no need for RSC, O 15, r 12A to be retained in most part if the new powers of case management proposed by Lord Woolf were adopted. The Working Group did not consider whether the rule in *Foss v Harbottle* should be retained but it expressed the view that proceedings under s 459 were now instituted where formerly a derivative action would have been brought, and that this had a number of undesirable consequences, including a longer, less certain and more costly trial.

<sup>3</sup> Which govern s 459 proceedings and the common law derivative action respectively. RSC, O 15, r 12A provides that the court may grant leave to continue the action for such period and on such terms as the court may think fit, may dismiss the action or the part claiming relief on behalf of the company, or adjourn and give such directions as it may consider expedient: r 12A(8). On an application to dismiss the action the rule expressly provides that the court may make such order as may in the circumstances be appropriate.

<sup>4</sup> This is additional to the reason given in para 15.3 above.

<sup>5</sup> Chapter 5, paras 5-8 and Recommendation 32. Chapter 5, para 26 suggests that pre-trial reviews should take place about 8-10 weeks before the hearing.

disclosure of documents will depend on the nature of the case.<sup>6</sup> The lay clients, or someone authorised to act on their behalf, should be present at hearings with their legal representatives where they have instructed any.<sup>7</sup> At the case management conference there will be a full review of the action and directions will be given as to its future conduct. Any issues that can be disposed of at such hearings will be dealt with and directions given for others to be dealt with before trial where appropriate. The court will also have information as to the costs of the case to date and future costs so that these may be taken into account. The judge is to draw alternative means of dispute resolution to the parties' attention and explore the possibility of settlement of issues and the case as a whole.<sup>8</sup>

- 17.4 It is Lord Woolf's intention that issues that can be dealt with at an early stage should be eliminated as soon as possible. He therefore recommends a new summary procedure<sup>9</sup> to take the place of the provisions for summary judgment<sup>10</sup> and striking out.<sup>11</sup> Under this procedure a party will be able to apply for judgment on the ground that the other party's case, or part of it, has no realistic prospect of success at trial. The resisting party would have to show more than a merely arguable case, it would have to be one which he had a real prospect of winning.<sup>12</sup> The court will itself be able to consider this issue, without an application by the parties, and if it forms the view that this is the case then it can call the parties in and determine the issue at an early stage. The Woolf Report envisages that the court should be able to do this at any stage in the proceedings and could require oral evidence and written statements if it considered that it could dispose of the case in this way more economically than at full trial.

#### **Introduction to our provisional recommendations for case management**

- 17.5 Some of the powers discussed below are relevant only to derivative actions, others relate to all shareholder proceedings. The former, so far as they are considered necessary and do not form part of the court's general powers, could be contained in the proposed new rules of court dealing with the derivative action. They would be in addition to the court's other powers. If it is thought desirable to introduce some new powers for all shareholder proceedings, not solely for derivative actions, it may also be necessary to create new rules which would deal with all such proceedings.

<sup>6</sup> Chapter 5, para 13.

<sup>7</sup> Chapter 5, para 15. Also note that a body corporate cannot conduct proceedings save through legal representatives; see RSC, O 5, r 6. The Woolf Report recommends that this rule be repealed; see Recommendations 152-155.

<sup>8</sup> Chapter 5, paras 11, 15-18 and Recommendations 32, 33, 35, 36 and 41.

<sup>9</sup> The Woolf Report, ch 12, paras 31-36 and Recommendations 132-133; the Draft Civil Proceedings Rules, Part 14.

<sup>10</sup> RSC, Ords 14, 14A and 86; CCR O 9, r 14.

<sup>11</sup> RSC, O 18, r 19; CCR, O 13, rr 2(2)(b) and 5.

<sup>12</sup> Similar tests were considered in *The "Saudi Eagle"* [1986] 2 Lloyd's Rep 221, 223 and *Allen v Taylor* [1992] 1 PIQR 255, 258-259.

## **Case management of derivative actions**

*Stage at which discretion to grant leave to continue a derivative action will be exercised*

- 17.6 We intend that leave should be considered at an early stage. In Part 16,<sup>13</sup> we suggested that this might be at the close of pleadings. If the Woolf Report's proposals are implemented, the convenient stage might be the case management conference.

*Power to direct the company to convene a meeting of the shareholders*

- 17.7 We provisionally recommend that the power of the court to direct the company to convene a meeting of the shareholders, for the purpose of considering a resolution as to whether the proceedings should be continued, should be specifically stated in the rules of court. The company has to be made a party to a derivative action since the claim is made on its behalf. In the absence of primary legislation, however, the court could not prevent any shareholder who had a right to vote from exercising his right, but the court could determine whether or not he was to be treated as independent of the alleged wrongdoers. Likewise, the court could not give any shareholder who was not entitled to vote the right to do so, unless it was given that power by statute. We invite consultees' views on the question of whether the court should have the additional power to determine whether any shareholder should or should not be permitted to vote at the meeting.

**We provisionally recommend that the rules of court governing the new derivative action should specifically provide that the court has power to direct the company to convene a meeting of shareholders to consider a resolution as to whether the proceedings should be continued.**

- (i) **Do consultees agree?**
- (ii) **If so, we seek consultees' views on whether the court should have additional powers to determine whether any shareholder should or should not be permitted to vote at such a meeting.**

*Costs indemnity orders*

- 17.8 We propose that the court will continue to have its power to make costs indemnity orders in derivative actions.

**We provisionally recommend that there should be no change to the court's power to make costs indemnity orders. We invite consultees' comments on this point.**

<sup>13</sup> See para 16.18 above.

*Addition or substitution of applicant*

- 17.9 Obviously the court would only exercise the power to add or substitute an applicant with the consent of the new applicant. The court already has this power,<sup>14</sup> which enables the court, for example, to substitute a new plaintiff in a derivative action if the existing plaintiff has some conflict of interest which makes him unsuitable to be a representative plaintiff.<sup>15</sup>

**Do consultees agree with our provisional view that the court’s power to add or substitute applicants should remain unchanged?**

*Leave of the court for compromise or abandonment of derivative actions*

- 17.10 We provisionally consider that the rules governing the new derivative action should provide that the applicant should not enter into any compromise or abandon the proceedings without the leave of the court. As Professor Gower has said,<sup>16</sup> the absence of such a provision “... gives rise to serious possibilities of collusion. The directors may buy off the plaintiff in disregard of the rights of the company and its members”.<sup>17</sup> A similar provision is to be found in the Federal Rules of Civil Procedure in the United States of America,<sup>18</sup> in New Zealand,<sup>19</sup> under the CBCA in Canada<sup>20</sup> and in the draft Australian provisions,<sup>21</sup> and we provisionally recommend its inclusion in these new provisions.

**Do consultees agree that the rules governing the new derivative action should provide that the applicant should not enter into any compromise or abandon the proceedings without the leave of the court?**

**Case management of all shareholder proceedings**

*Preliminary issues*

<sup>14</sup> See RSC, O 15, r 6; CCR, O 15, r 1.

<sup>15</sup> See para 16.30, n 99 above.

<sup>16</sup> *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana* (1961).

<sup>17</sup> *Ibid*, at p 153.

<sup>18</sup> Rule 23.1, dealing with derivative actions; see Appendix F, para 6.3.

<sup>19</sup> See Appendix F, para 4.7.

<sup>20</sup> See Appendix F, para 2.4.

<sup>21</sup> See Appendix F, para 1.7.

17.11 Under the present law, the court may direct that preliminary issues be heard or that some issues be tried before others.<sup>22</sup> This is just one aspect of efficient case management which is open to the courts under their present powers.<sup>23</sup> We wish to encourage greater use of it in relation to shareholder remedies. A decision could be taken at the case management conference, for example, to direct, in an appropriate case, the trial of the issue whether the relationship between members of a company falls within the type contemplated in the case of *Ebrahimi*. Following the hearing and determination of this issue there would be a further review at which the court and the parties could decide, in the light of that determination, which of the claims the applicant should pursue. If the court held that there was no *Ebrahimi* type relationship, the court would not hear issues based on an alleged legitimate expectation, so time and costs would be saved.

17.12 Another example of a situation in which this power could be used constructively is where it is clear that the real issue between the parties is not whether unfairly prejudicial conduct occurred, but as to the value at which shares should be sold or purchased. It may save time and costs if that issue is determined first, on the basis of stated assumptions agreed between the parties and accepted for that purpose by the court, that certain unfairly prejudicial conduct occurred. The effect of deciding valuation issues at an early stage may be to demonstrate to the parties whether or not it is worth pursuing litigation at all and thus to dispose of the case before the accrual of large legal costs.<sup>24</sup>

**Do consultees agree with our provisional view that greater use should be made of the power to direct that preliminary issues be heard, or that some issues be tried before others?**

*Security for costs*

17.13 The power to order that a plaintiff gives security for the costs of the defendant is already available under RSC, O 23, r 1<sup>25</sup> and, where the plaintiff is a limited company, the provisions of section 726 of the Companies Act 1985 come into play.<sup>26</sup> The

<sup>22</sup> In upholding the trial judge's decision to follow this course, Lord Roskill in *Ashmore v Corporation of Lloyd's* [1992] 1 WLR 446 said "... it is the trial judge who has control of the proceedings. It is part of his duty to identify the crucial issues and to see they are tried as expeditiously and as inexpensively as possible ... Litigants are not entitled to the uncontrolled use of a trial judge's time". *Ibid*, at p 448. The other members of the House of Lords agreed with this approach to judicial control of proceedings. See the Draft Civil Proceedings Rules, r 1.3(a), (b) and (e).

<sup>23</sup> Eg practitioners and members of the judiciary informed us that in some s 459 cases the issue of liability is split from that of valuation in order to avoid expensive expert evidence being obtained and heard in a case in which the ultimate decision is that there has been no unfairly prejudicial conduct.

<sup>24</sup> Cf *Re Bird Precision Bellows Ltd* [1986] Ch 658.

<sup>25</sup> See Appendix C.

<sup>26</sup> See Appendix A.



grounds for such an order are limited to the following situations: the plaintiff is ordinarily resident outside the jurisdiction; the plaintiff sues for the benefit of another and there is reason to believe he will be unable to pay the costs of the defendant; the plaintiff's address is not given or is given incorrectly in the originating process; or that he has changed his address in the course of litigation with a view to evading the consequences of it.

- 17.14 The court has a discretion whether or not to order security for costs, and, although these provisions do not permit courts to use this power to control vexatious litigation, they may take the prospects of success into account in exercising their discretion.<sup>27</sup>
- 17.15 The question arises whether, in the context of shareholder remedies, the court should have an additional power to order security for costs whenever it thinks fit, so that by ordering security it could thereby discourage nuisance litigation.<sup>28</sup> We provisionally consider that such a power would be unfounded in principle and might discourage meritorious litigation. Accordingly, subject to consultees' views, we make no recommendation in respect of this suggestion.

**Do consultees agree with our provisional view that the court's existing power to order security for costs should not be extended to permit it to order security whenever it thinks fit?**

*Power to dismiss claim or part of claim or defence which has no realistic prospect of success*

- 17.16 We provisionally propose that the court should have the power to dismiss any claim or any part of the claim or any defence thereto which, in the opinion of the court, has no realistic prospect of success at full trial.<sup>29</sup> This is a key feature to the future streamlining of shareholder remedies. We have explained that it is relevant to the question of the imposition of a particular threshold test in relation to the merits of a derivative action at the leave stage.<sup>30</sup> In relation to claims for unfairly prejudicial conduct it would take the place of a strike out application.<sup>31</sup> It would enable the court to refine claims under section 459 so as to remove those parts based on trivial or otherwise weak allegations and so shorten and reduce the cost of such claims.

<sup>27</sup> But only where it is clear that there is a high degree of probability of success or failure: *Porzelsack KG v Porzelsack (UK) Ltd* [1987] 1 WLR 420, 423. See *The Supreme Court Practice 1995* para 23/1-3/2.

<sup>28</sup> As is the case under the Ghanaian Companies Code 1963; see Appendix F, para 3.6.

<sup>29</sup> See para 17.4 above.

<sup>30</sup> See paras 16.21-16.22 above and the proposals contained in the Woolf Report, discussed at para 17.4 above.

<sup>31</sup> See paras 11.23-11.25 above for a discussion of strike out applications in relation to petitions under s 459.

**Do consultees agree with our provisional view that in shareholder proceedings the court should have the power to dismiss any claim or part of a claim or defence thereto which, in the opinion of the court, has no realistic prospect of success at full trial?**

*Adjournment to facilitate alternative disposal arrangements*

- 17.17 There already exists a power to adjourn proceedings at any stage to enable the parties to make alternative arrangements for disposing of the case or any issue in it.<sup>32</sup> We believe that its statement in the rules relating to shareholder remedies will serve to encourage parties to consider other means for resolving disputes or issues between them.

**Do consultees agree with our provisional view that it would be helpful to include express reference in the rules relating to shareholder proceedings to the power to adjourn at any stage to enable the parties to make alternative arrangements for disposing of the case or any issue in it?**

*Determination of how facts are to be proved*

- 17.18 The court's powers as to the nature of the evidence to be put before it are flexible under the current rules.<sup>33</sup> We consider that there could be substantial savings in time and costs if, on each occasion the case is reviewed, the court considered making directions as to how facts should be proved. This proposal is not intended to change the procedural rules relating to hearsay evidence in civil proceedings.<sup>34</sup>

**Do consultees agree with our provisional view that the court's power to determine how facts are to be proved should be used pro-actively by the court?**

*Exclusion of issues from determination*

- 17.19 This may seem a radical suggestion because, currently, the court cannot exclude evidence, provided that it is legally relevant and admissible, and the rules of court applicable to its admissibility have been complied with. What we have in mind is a power which would enable the court to exclude evidence where it was satisfied that it would not have a bearing on the issues that needed to be decided. This would save time and costs. This is consistent with Rule 5.1(i) of the Draft Civil Proceedings Rules

<sup>32</sup> RSC, O 35, r 3; CCR, O 13, r 3. See also *Practice Statement (Commercial Cases: Alternative Dispute Resolution)* [1994] 1 WLR 14 and *Practice Statement (Commercial Cases: Alternative Dispute Resolution) (No 2)* [1996] 1 WLR 1024, and see also the practice directions referred to in paras 11.29-11.32 above for Chancery procedure.

<sup>33</sup> See, for example, for powers relating to the use of affidavit evidence, RSC, O 38, r 2; CCR, O 20, r 6; as to witness statements, RSC, O 38, r 2A; CCR, O 20, r 12A; and as to evidence of particular facts and how they may be proved, RSC, O 38, r 3; CCR, O 20, r 8. Also see the Draft Civil Proceedings Rules, r 28.1.

<sup>34</sup> See RSC, O 38, rr 20-34; CCR, O 20, r 14-26 and substitute rules that may be made under the Civil Evidence Act 1995.

which provides that the court may “... exclude an issue from determination if it can do substantive justice between the parties on the other issues and determining it would therefore serve no worthwhile purpose”. An excessively large number of issues is frequently raised in section 459 proceedings, but we provisionally consider that the new Rule 5.1(i) would be sufficient for shareholder proceedings.

**We seek consultees’ views as to whether the power to exclude issues as proposed in the Draft Civil Proceedings Rules is sufficient for the purposes of enabling the court to exclude issues in appropriate circumstances in shareholder proceedings.**

## **PART 18**

# **A NEW ADDITIONAL UNFAIR PREJUDICE REMEDY FOR SMALLER COMPANIES**

### **Introduction**

- 18.1 As we have said,<sup>1</sup> shareholders seeking a remedy under section 459 tend to make many allegations of fact, some trivial and some serious, in order to strengthen their claim. That they can do this is due to the generality of the wording of the section. The difficulties of litigation under section 459 are likely to be reduced by active case management. Moreover, the existence of a new procedure for derivative actions may encourage applicants to use that action where it is possible to substantiate breaches of duty, rather than wide-ranging proceedings based on unfairly prejudicial conduct. The possibility of a costs indemnity order is a significant incentive to use the derivative action.
- 18.2 We consider that it could be useful to consider another discrete remedy which would apply in restricted circumstances. It would require fewer issues of fact to be proved and, therefore, lead to shorter, cheaper litigation than a full blown section 459 case. The aim of this provision is to reduce yet further the number of claims brought under the general wording of section 459. Members in those companies which have adopted the first of the articles set out in Part 19 below may not have to resort to this remedy as the two could overlap.
- 18.3 We express no provisional view as to the introduction of the new remedy. Below we set out a wording in order to indicate the type of scheme which we think could be useful. In order to shorten proceedings, the circumstances in which it would be available are restricted, thus excluding some situations and types of company in respect of which consultees may feel that a remedy of this type should be provided. Below we invite views as to what these should be.

### **Suggested scheme for new remedy for smaller companies**

- 18.4 We here set out a suggested wording for the new remedy:<sup>2</sup>
- (1) Where the conditions in sub-section (2) are satisfied a member of a private company may apply to court for an order under this section on the grounds of his exclusion from participation in management of the company/removal of a director (in either case) save for gross misconduct.
  - (2) Such an application may only be made if there are a minimum of two and a maximum of five members in the company and if:

<sup>1</sup> See para 11.10, n 38 and para 14.5 above.

<sup>2</sup> The suggested wording is also reproduced in Appendix I.

(a) the company is an association formed or continued on the basis of a personal relationship, involving mutual confidence;

(b) before the applicant's exclusion from management, there was an agreement or understanding between all the shareholders that he or she should participate in the conduct of the business.

(3) Under this section the court is empowered only to make an order that the shares of any members of the company are to be purchased by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly, but such purchase will be at fair value without a discount for the fact that the applicant's shares represent a minority shareholding.

18.5 Turning now to explain the elements of the scheme, it would be open to a shareholder in a private company which has a minimum of two and a maximum of five shareholders, between whom there is a relationship such as that set out in *Ebrahimi*,<sup>3</sup> to obtain a purchase order for his shares on a basis which is not discounted by reason of the shares being a minority shareholding if he can prove exclusion from management.<sup>4</sup>

18.6 Those elements follow from a review which we have conducted of 156 section 459 petitions lodged in the years 1994 and 1995 at the High Court in London.<sup>5</sup> 96 per cent related to private companies, just under 85 per cent of which had five or fewer shareholders, and 67 per cent contained allegations of exclusion from management which was by far the most commonly pleaded allegation.<sup>6</sup> In almost 70 per cent of cases the remedy sought was the purchase of the petitioners' shares and in nearly 21 per cent it was the sale of the respondents' shares. The draft is a reflection of those statistics. The provision that there should be no discount for a minority shareholding is designed to reduce the number of contested issues and produces what we provisionally consider would be the fair result. The most common ground on which petitioners under section 459 seek a non-discounted valuation of their shareholding is that the relationship between the members falls within the type contemplated in *Ebrahimi*.<sup>7</sup>

<sup>3</sup> See para 8.9 above.

<sup>4</sup> The purchase is to be at a fair value, that is, generally, as a going concern, but it should be noted that if a company has low profitability and valuable assets (eg hotel on prime city site), going concern may be unfair.

<sup>5</sup> The full results can be seen in Appendix E, Table 1.

<sup>6</sup> The next most common, appearing in 42% of petitions, was failure to provide information. See Appendix E, Table 1.

<sup>7</sup> See paras 10.14-10.17 above.

- 18.7 There are a number of criticisms that could be made of elements that have been included in and excluded from the proposed remedy. One problem arises out of the number of shareholders. It is arbitrary and it could be said that the remedy should just as well be available to companies of six shareholders. Furthermore, if a majority wished to prevent a minority from taking this action they might issue more shares.<sup>8</sup> A second problem is that the creation of such a remedy could itself give rise to extra litigation as to whether particular situations fell within the provisions. This would relate not only to the meaning of the words taken from the judgment of Lord Wilberforce in *Ebrahimi*,<sup>9</sup> on which there is authority, but also those in clause (1) defining the grounds. Such litigation would, however, be considerably more focused than much of the current litigation under section 459.
- 18.8 It could also be argued that, if this provision is to be useful, it should contain a procedure for valuation of the shares outside court, for example, by reference to an independent accountant. We consider this to be unnecessary as the court can make an order to this effect where it would be appropriate to do so.
- 18.9 Yet further criticism could be made of the choice of grounds. The remedy is designed to deal with one situation in which there is a breach of legal or equitable rights or interests. It could be argued that other fault situations should be covered.
- 18.10 Additionally, it may be argued that there should be a statutory remedy in situations in which there is no fault. Suggestions for such situations which have been given to us by academics and practitioners include: those where all parties are agreed that certain members should leave the company but it is not possible to reach agreement as to the terms of departure; those where there is no question of fault by any officers or members, but some members have acquired their shares by transmission or operation of law<sup>10</sup> and want to dispose of them; or where a member simply wants to cease to be involved with the company. However, as we have said in Part 14 above,<sup>11</sup> one of our guiding principles is to maintain the sanctity of the contract binding the members and the company. To add statutory mechanisms in situations where there is no infringement of legal or equitable rights or interests would undermine this policy. It is for this reason that the provisions which we recommend<sup>12</sup> for dealing with “no-fault” situations are all model articles which can be adopted by the company. A case could,

<sup>8</sup> Although this would be for an improper purpose and, therefore, in itself open to challenge.

<sup>9</sup> It could be said to be undesirable to embody words from judgments in statute as this could hamper the development of the law, for example, in this instance, in relation to the remedy for unfairly prejudicial conduct. Moreover, Lord Wilberforce’s formulation was not intended to be exhaustive of the circumstances in which equitable considerations of a personal nature could arise; see *Ebrahimi* [1973] AC 360, 379 and para 8.9 above.

<sup>10</sup> See para 19.6 below.

<sup>11</sup> See para 14.11 above.

<sup>12</sup> See Part 19 below.

however, be made for their inclusion in statute on the ground that new provisions in Table A are unlikely to be taken up in the short term by the companies that should use them, namely small owner-managed companies that may not be able to afford adequate advice as to the content of their articles.

- 18.11 A further criticism of the proposal for a new additional remedy such as we have suggested might be that it would simply lead to applications for relief based both on the existing provisions and on the new one. This would result in a multiplicity of litigation rather than a reduction of issues as is intended. We do not think that a person should have to choose between the two remedies. The answer to the criticism in our view lies in active case management and particularly in the rigorous exercise by the court of its power to determine the order in which issues are tried. If, therefore, a minority shareholder relied on both the existing provision and the new remedy, the court would, we suggest, in an appropriate case, determine that the issues raised by the application based on the new remedy should be heard first and that, in the meantime, there should be an order staying the remaining issues. If the application based on the new remedy was successful, those remaining issues would not have to be tried, with consequent savings of cost and court time.<sup>13</sup>

**Do consultees favour the introduction of a new unfair prejudice remedy for smaller companies along the lines proposed in paragraph 18.4?**

**We have suggested that problems may arise out of:**

- (i) the specified number of shareholders;**
- (ii) the meaning of the wording taken from the judgment of Lord Wilberforce in *Ebrahimi*;**
- (iii) the grounds for the claim;**
- (iv) failure to set down a procedure for valuation of the shares;**
- (v) failure to provide a remedy in certain situations in which there is no fault;**
- (vi) the risk of increasing litigation.**

**Which of these (if any) do consultees consider to be problems, and are there any other problems in relation to the draft remedy?**

<sup>13</sup> See Parts 12 and 13 above for a summary of provisions for purchase orders in current legislation. Current provisions of this nature are to be found in ss 5, 54(1), 430A and 127 of the Companies Act 1985 and s 111 of the Insolvency Act 1986; see paras 12.11-12.18, 12.22 and 13.2 above. We have not considered creating other new rights to purchase orders in situations where they are not available here but are available in foreign jurisdictions. One example is when a company parts with a major part of its business or assets. For a similar remedy, see s 110 of the Insolvency Act 1986.

**We are of the provisional view that a shareholder should not have to choose between such a new unfair prejudice remedy and the remedy available under section 459. We believe that any duplication of issues could be dealt with by case management by the court. Do consultees agree?**

**If consultees are in favour of a new remedy, but are not content with the draft proposed in paragraph 18.4, would they let us have their views on the following issues:**

- (i) what situations and what companies should be covered;**
- (ii) should there be a discount for a minority shareholding;**
- (iii) should there be an express procedure for valuation of the shares outside court;**
- (iv) what other provisions should be included?**



# PART 19

## ARTICLES OF ASSOCIATION

### Introduction

- 19.1 In this part we provisionally recommend a series of regulations which would be included in Table A, thus requiring secondary legislation only. Under section 8(1) of the Companies Act 1985 a company can adopt all or part of Table A as its articles.<sup>1</sup> In the case of companies limited by shares, sub-section (2) results in the whole of Table A being included in the company's articles (or standing as the articles if no others are registered) to the extent that its provisions are not excluded. It is open to a company to adopt any regulation in Table A with modifications.
- 19.2 There are a number of reasons for recommending the introduction of new regulations:
- (i) The Court of Appeal in *Saul D Harrison*<sup>2</sup> emphasised the importance of upholding commercial agreements and thus (save in companies in which the relationships fall within the circumstances in *Ebrahimi*)<sup>3</sup> of holding shareholders to the bargain contained in the articles.
  - (ii) We too have suggested that maintaining the sanctity of contract should be one of the guiding principles of shareholder remedies.
  - (iii) In many cases the minority shareholder's real complaint is about a matter which is not prohibited by the articles. One example is where the directors decide on the one hand to pay director-shareholders fees or remuneration and, on the other hand, not to pay dividends to non director-shareholders. In such situations the result, while often not wrongful, may be unfair in terms of the equity of the situation. To maintain a claim under section 459 (unless *Ebrahimi* applies) a shareholder has to make allegations of breach of duty, and he will often include allegations as to non-compliance with the numerous requirements of the Companies Acts. In this way section 459 cases become factually complex. (Although *Saul D Harrison* made it clear that trivial matters were not within the section, it may in practice have increased the number of allegations of breach of duty. These necessarily require careful investigation). In these circumstances recent case law has highlighted the need for better protection in the articles.

<sup>1</sup> See paras 2.2-2.5 above. For the position in relation to companies limited by shares intended to be held to a substantial extent by or on behalf of employees, known as partnership companies, see para 2.3, n 10 above.

<sup>2</sup> [1995] 1 BCLC 14, 19.

<sup>3</sup> [1973] AC 360, referred to in *Saul D Harrison* [1995] 1 BCLC 14, 19 and see paras 8.8-8.9 above.

- (iv) We consider that, by inserting regulations into Table A, shareholders will be encouraged to provide in advance for what will happen if there is a dispute.<sup>4</sup> We also believe that, by so doing, litigation may be avoided, or the issues substantially reduced.

**Do consultees agree that it is desirable to include additional regulations in Table A?**

**Shareholder exit article for smaller private companies — draft regulation 119<sup>5</sup>**

*Companies to which this regulation would apply*

- 19.3 The regulation will only apply so long as the company has fewer than ten members and is not a public company. This restriction recognises that it is particularly small owner-managed companies which suffer from the problems of litigation under section 459.

*Circumstances that give rise to the exit rights*

- 19.4 An ordinary resolution may be passed which attaches the rights of exit set out in the regulation to particular shares (“the relevant shares”). Unless the resolution makes some other provision, the holder of the relevant shares may exercise his rights at any time. The company could, instead of setting out in the resolution circumstances which would entitle the holder in question to exercise his exit rights, make modifications to the regulation before adopting it so that it sets out agreements or understandings serious breach of which would trigger the exit rights. This might be appropriate where there is an *Ebrahimi* type relationship between the members which is founded on an agreement or understanding.<sup>6</sup>
- 19.5 To minimise the risk of dispute, it may be preferable not to refer to a serious breach of an agreement but to a list of circumstances in which the regulation is to apply. One example might be the removal, without cause, of a member who holds relevant shares from directorship of the company.<sup>7</sup> Other examples are misappropriation of assets and breach of statutory provisions, unless either form of conduct is trivial.<sup>8</sup>
- 19.6 Under the draft regulation, the exit rights are exercisable only by the person who held the relevant shares at the date of the resolution, or by a person to whom those shares have been transferred or transmitted by operation of law, for example, on death. A company could modify this restriction but, as it stands, it means that the regulation

<sup>4</sup> It is necessary to consider the best means for bringing them to the attention of those who might need them; see para 19.18 below.

<sup>5</sup> See Appendix H.

<sup>6</sup> See paras 8.9 and 9.24 above.

<sup>7</sup> Hence the overlap with the new statutory remedy in Part 18; see para 18.4 above.

<sup>8</sup> Others could be drawn from the list of allegations found to have been pleaded in our statistical review of s 459 petitions set out in Appendix E, Table 1.

could be used for a particular situation in which, practitioners have suggested to us, there is at present no exit route, namely where a registered shareholder has died.<sup>9</sup> In this situation, if the shareholder was an owner-manager of a small company, his or her only reward may well have been a director's salary. Thus, an inheritor would not derive any advantage from the shareholding and may, as a result, wish to sell the shares. The failure to distribute dividends in such a company would not necessarily amount to unfairly prejudicial conduct.

*Exit provisions*

- 19.7 The exit rights are exercised by the service of a notice requiring those on whom it is served to purchase the shares of the outgoing shareholder.<sup>10</sup> Unless the resolution states otherwise, the notice may be served at any time. If the resolution (or regulation as modified by the company) sets out circumstances which are to trigger the exit right, then the notice provision could require service within a specified period after knowledge of the occurrence of such an event. The regulation includes a mechanism for valuation of the shares in the event of inability to agree a price. In the event that the purchase does not go through within the timescale laid down in the regulation the outgoing shareholder can convene an EGM in order to consider a resolution for a voluntary winding up and will have sufficient votes to secure the passing of that resolution.<sup>11</sup>
- 19.8 This provision for winding up the company performs a number of functions. Its inclusion in the articles may deter majority shareholders from the conduct which will trigger these exit rights. It provides a remedy for situations where no other remedy is appropriate. On the other hand, it could be said to be unattractive as encouraging the winding up of businesses that are otherwise viable. The winding up of the company does not, however, necessarily mean that the business will cease. It could well be bought either by the minority or the majority or a third party and thus continue.
- 19.9 The regulation expressly permits withdrawal of an exit notice and lays down that, where triggering events have been specified, failure to serve an exit notice or its withdrawal does not prevent service of an exit notice on the occurrence of a fresh event entitling such service.<sup>12</sup> Failure to serve the notice may be taken into account by the court in proceedings for winding up or a remedy for unfairly prejudicial conduct. This is in accordance with current law on the availability of these remedies.<sup>13</sup>

<sup>9</sup> Or has been made bankrupt.

<sup>10</sup> The notice must also be served on the company.

<sup>11</sup> See Appendix H, draft regulation 119(8).

<sup>12</sup> See Appendix H, draft regulation 119(9).

<sup>13</sup> See paras 8.13-8.17 above.

- 19.10 We have considered whether the court should be required to take into account the failure to adopt such an article when considering a section 459 application. On balance we have provisionally rejected such a requirement. The main reason for provisionally rejecting such a provision is that its effect could be to penalise incorporators who did not appreciate the position because, for example, they could not afford to take advice as to the content of their articles.
- 19.11 Two further points arise for consideration. The first is whether the regulation should provide for the purchase price to be paid by instalments. This would ease the financial burden on the purchasing shareholders but it may result in insecurity for the vendor shareholder. The rationale for this suggested provision is that partnership agreements would normally make provision for payment of leaving partners' capital by instalments and the article is designed for small owner-managed companies which are often run in much the same way as are small partnerships. The second additional point is whether the regulation should be so restricted, in other words, should it be applicable to all companies? The proprietors of small owner-managed companies are those who are more likely to require the assistance of this regulation. Shareholders in larger companies are more likely to have access to advisers who can draft their constitutions, and there is nothing to stop such advisers drafting an analogous regulation for them if it is perceived to be appropriate.

**Do consultees agree that a provision for shareholders to exit smaller private companies should be included in Table A?**

**Consultees are asked to consider the text of draft regulation 119 in Appendix H and to give their views on the following issues:**

- (i) should its applicability be restricted to companies with less than 10 members which are not public companies;<sup>14</sup>**
- (ii) should it provide specific circumstances in which the exit rights are to be available rather than leaving it to companies to modify the regulation before adopting it. If so, which circumstances should it specify;<sup>15</sup>**
- (iii) what are consultees' views on the notice periods and procedure for valuation;<sup>16</sup>**

<sup>14</sup> See para 19.3 above and Appendix H, draft regulation 119(1).

<sup>15</sup> See paras 19.4-19.6 above and Appendix H, draft regulation 119(2)-(3).

<sup>16</sup> See para 19.7 above and Appendix H, draft regulation 119(4)-(7).

**(iv) do consultees agree with the inclusion of the provision for winding up the company;**<sup>17</sup>

**(v) are there any additional provisions that should be included, for example, payment of the purchase price by instalments?**<sup>18</sup>

**Arbitration — draft regulation 120**<sup>19</sup>

19.12 The object of including this regulation is to encourage incorporators to consider providing for means of dispute resolution other than the courts. The regulation would not require arbitration if there was no dispute that could be litigated, and so does not extend the areas in which a shareholder can interfere in the company's management. It is possible to create forms of arbitration that are less expensive than court proceedings, for example documents only schemes.<sup>20</sup> The process can be attractive to parties who wish to resolve their disputes privately. Below we set out some additional provisions that could be included in the regulation or voluntarily adopted by companies.

19.13 First, there could be reference to a mediation procedure organised by a particular body.<sup>21</sup> Such a reference would add to the certainty of the regulation. Under the regulation as drafted, there is no binding agreement to submit to ADR other than arbitration.

19.14 Secondly, there could be a time limit so that if mediation or some other ADR has not worked at the end of, say, 60 days the arbitration would be reactivated.

19.15 Thirdly, consideration would also have to be given as to whether the parties want an accountant as arbitrator in all cases. If not, it could be preferable to nominate the Chartered Institute of Arbitrators as the appointing authority. It would be possible to include both in the regulation and to leave it to incorporators to delete the one which they did not want. However, we provisionally consider that many incorporators would

<sup>17</sup> See para 19.8 above and Appendix H, draft regulation 119(8).

<sup>18</sup> See para 19.11 above.

<sup>19</sup> See Appendix H. See also para 13.2 above for arbitration under s 111 of the Insolvency Act 1986.

<sup>20</sup> These are arbitrations conducted on written submissions only, which can reduce legal fees as no oral submissions from lawyers or the parties are permitted. Some arbitration schemes also expressly restrict the amount of recoverable legal costs. The Chartered Institute of Arbitrators administers a wide variety of arbitration schemes designed to meet the needs of different industries and different financial resources of participants. There are also specialised arbitration bodies for different industries, such as the construction and maritime transport businesses.

<sup>21</sup> See, for example, Lord Chancellor's Department, *Resolving Disputes without Going to Court* (December 1995) pp 13-14 and *Alternative Dispute Resolution in Commerce and Finance* (1995), issued by the Financial Law Panel. One body that specialises in disputes in large companies is the City Disputes Panel.

not take the necessary step of deleting one reference and this could lead to difficulty in applying the regulation. Another point which could be considered is the effect of section 52 of the Arbitration Act 1996 which, in the absence of provision to the contrary, will impose a requirement for reasons to be given by the tribunal. In a claim for a small amount the cost of reasons can be disproportionate.<sup>22</sup>

**Consultees are asked whether they consider that it is desirable to include an arbitration and ADR regulation in Table A.**

**Consultees are asked to consider the text of draft regulation 120 in Appendix H and to give their views on whether it should, in addition, contain reference to:**

- (i) the mediation procedure of a particular body and, if so, which one;**<sup>23</sup>
- (ii) a time limit for reactivating the arbitration if mediation did not work within a specified time, say 60 days;**<sup>24</sup>
- (iii) the nomination of an arbitrator by the Chartered Institute of Arbitrators rather than the Institute of Chartered Accountants (or other accountancy body) or alternative bodies, leaving it to companies to delete the unwanted option;**<sup>25</sup>
- (iv) any other provisions.**

**Valuation procedure — draft regulation 121**<sup>26</sup>

19.16 Currently there is no remedy to which shareholders can resort (in the absence of unfairly prejudicial conduct) where they are all agreed that one or more should sell their shares to the rest, but no agreement can be reached on value.<sup>27</sup> This draft regulation is designed to meet that need. The regulation states that no discount is to be made for the fact that the shares form part of a minority shareholding. There would

<sup>22</sup> Compelling the tribunal to give reasons does enable the parties to ascertain that proper consideration has been given to the merits of the case.

<sup>23</sup> See para 19.13 above.

<sup>24</sup> See para 19.14 above.

<sup>25</sup> See para 19.15 above.

<sup>26</sup> See Appendix H.

<sup>27</sup> *Re a Company (No 004175 of 1986)* [1987] 1 WLR 585. See also *Re Bird Precision Bellows Ltd* [1984] Ch 419 (Ch D); [1986] Ch 658 (CA); see para 10.3 above.

be nothing to prevent incorporators, however, from making some other provision for the basis of valuation.<sup>28</sup>

- 19.17 The regulation makes no provision for default by the purchaser in completing the sale. The vendor shareholder would have to exercise his remedies at common law if this occurred. Because the company cannot provide funds for the purchase in this situation, the only alternative would be to give the vendor similar rights to those conferred by draft regulation 119(8). Our provisional view is that this is inappropriate here.

**Do consultees agree that a provision for a valuation procedure should be included in Table A?**

**Consultees are asked to consider the text of draft regulation 121 in Appendix H and to give their views on the following issues:**

- (i) do they agree that it should provide that there be no discount for the fact that the shares are a minority shareholding;<sup>29</sup> and**
- (ii) do they agree that it should not make any provision for default by the purchaser in completing the sale?<sup>30</sup>**

**General**

**Consultees are asked whether there are any other similar regulations which should be included in Table A.**

- 19.18 It is intended that attention should be drawn to these articles by the professionals acting on a company's incorporation (be they company registration agents, accountants, lawyers, or others), so that their inclusion in the articles should be considered whenever a newly incorporated business is being set up, whether by the use of an off the shelf company, or by the incorporation of a new one. We have given some thought as to how advisers might be alerted to these self-help provisions. The methods include starter packs to be distributed by Companies House and dissemination of information by trade organisations, professional bodies, Business Links and Chambers of Commerce.

**Consultees' views are sought as to the best methods of alerting advisers and incorporators to the self-help articles of association.**

<sup>28</sup> Alternatively, perhaps Table A could provide a series of alternative bases and incorporators could indicate which they wanted.

<sup>29</sup> See para 19.16 above and Appendix H, draft regulation 121(2).

<sup>30</sup> See para 19.17 above.

## PART 20 OTHER REFORMS

### Introduction

20.1 In this part we consider further reforms:

- (i) reform to section 14 by clarification of the types of situations that may fall within the section;<sup>1</sup>
- (ii) other reforms relating to proceedings under sections 459-461, namely:
  - (a) clarification of section 459 by authoritative guidance;<sup>2</sup>
  - (b) amendment of section 459 to impose a limitation period on claims under the section;<sup>3</sup>
  - (c) amendment of section 459 to make it clear that it is specific conduct, rather than the affairs of the company overall, that has to be shown to be unfairly prejudicial;<sup>4</sup>
  - (d) amendment of section 459 to ensure that “unfair prejudice” is construed as broadly as appears to have been intended by the Jenkins Committee;<sup>5</sup>
  - (e) amendment to add winding up to the remedies available under section 461;<sup>6</sup>
  - (f) extension of the power to determine relief as between respondents to a section 459 petition;<sup>7</sup>
  - (g) provision in the 1986 Rules to state that there should be no advertisement until the court so orders;<sup>8</sup>
- (iii) permitting former members to bring proceedings;<sup>9</sup>
- (iv) pre-action discovery.<sup>10</sup>

<sup>1</sup> See paras 20.2-20.4 below.

<sup>2</sup> See paras 20.5-20.8 below.

<sup>3</sup> See paras 20.9-20.14 below.

<sup>4</sup> See paras 20.15-20.16 below.

<sup>5</sup> See paras 20.17-20.23 below.

<sup>6</sup> See paras 20.24-20.28 below.

<sup>7</sup> See paras 20.29-20.30 below.

<sup>8</sup> See para 20.31 below.

<sup>9</sup> See paras 20.32-20.38 below.

<sup>10</sup> See paras 20.39-20.43 below.



**Reform to section 14 by clarification of the types of situations that may fall within the section**

- 20.2 We raise this amendment for consideration, but provisionally recommend against it. The suggestion is the inclusion in section 14 of a statutory list of personal rights enforceable under the section. It would be possible to provide a non-exhaustive list of the rights which the courts have to date allowed shareholders to enforce by personal action. The statute could indicate that the fact that these rights can be enforced by personal action does not mean that there are no others that can be enforced by the same means.
- 20.3 It can be argued that failure to give statutory guidance as to these rights neglects the needs of members, managers and advisers who are not company law experts. Our view is, however, that it is doubtful whether this would be a useful addition to the statute for a number of reasons. The list could not state every breach of the articles which could give rise to a personal action, and so cases would still arise which were not expressly mentioned. In addition, breaches of the articles of association vary from the trivial to the grave.<sup>11</sup> Where they are trivial we would not want to encourage litigation, and setting out examples in statute may have just this effect. The list would not reflect the exercise by the court of its discretion to refuse to give remedies for breaches of personal rights, for example, where a meeting has been improperly convened and another could be properly convened and take the same steps.<sup>12</sup>
- 20.4 As we are not (at this stage) aware that any hardship is caused by the absence of a list of the personal rights enforceable under section 14,<sup>13</sup> and since it appears from the enquiries that we have made thus far that actions to enforce personal rights are effectively eclipsed by proceedings under section 459, in which the remedies available are far wider,<sup>14</sup> we have provisionally concluded that we should not recommend any change to deal with the problem of difficulty of definition.

**Do consultees consider that there should be a statutory non-exhaustive list of personal rights enforceable under section 14?**

**Other reforms relating to proceedings under sections 459-461**

*Clarification of section 459 by authoritative guidance*

- 20.5 We suggested in Part 14 above<sup>15</sup> that those who are not experts in company law may have difficulty predicting whether or not a claim under the section is likely to succeed.

<sup>11</sup> See paras 2.24-2.27 above.

<sup>12</sup> See para 2.23 above.

<sup>13</sup> See para 14.8 above.

<sup>14</sup> Save where the member claims damages: compare Companies Act 1985, s 111A and para 10.27, n 72 above.

<sup>15</sup> See para 14.6 above.

Such people may have an additional difficulty in that some cases under the section are only reported in specialist series of law reports.

- 20.6 Legislative clarification may be achieved in many ways. One example is the approach being adopted in Australia. In 1993, the government commenced a programme of work on the Corporations Law “... to simplify policy and clarify wording so that users can understand and act on their rights and obligations under the Law”.<sup>16</sup> The programme is being carried out in stages. The First Corporate Law Simplification Act 1995 contains provisions that are designed to assist small businesses. In particular, it contains a small business guide that forms part of the legislation but is published separately.<sup>17</sup> It summarises the main provisions of the Corporations Law likely to be relevant to small companies and provides short answers to basic questions, such as the meaning of incorporation, directing the reader to the actual provisions of the Corporations Law for more detail. Any changes to the guide that are rendered necessary by changes to the statute will have to be made by statute but changes rendered necessary for other reasons can be effected by regulations.<sup>18</sup>
- 20.7 The issue of legislative clarity is relevant, not only to the field of shareholder remedies, but to the whole of company law and, indeed, to other areas of law. There is currently under way a wide ranging study into the simplification of tax legislation. It is reviewing many techniques for simplifying legislation.<sup>19</sup> These include, for example: the use of plain language so that where possible, legal jargon is replaced with words non-lawyers will understand;<sup>20</sup> writing short sentences;<sup>21</sup> sign posting using headings and road-map clauses (which are clauses at the beginning of legislation which describe the content fully and assist the reader in finding his way around it); explanatory notes and cross references<sup>22</sup> in the margin; and example clauses to illustrate the operation of detailed provisions. We provisionally take the view that it would not be appropriate to seek parliamentary time to address such issues in relation to just one area of company law.

<sup>16</sup> The Parliament of the Commonwealth of Australia, House of Representatives, *Explanatory Memorandum, First Corporate Law Simplification Bill 1994* (1994) p 4.

<sup>17</sup> See Appendix F, paras 1.13-1.15.

<sup>18</sup> *Ibid*, at paras 1.13-1.15.

<sup>19</sup> See Inland Revenue, *The Path to Tax Simplification, A Background Paper* (December 1995) pp 79-82, 83-88 and 100-106; and Inland Revenue, *Tax Law Rewrite, The Way Forward, A Consultative Document* (July 1996).

<sup>20</sup> See Inland Revenue, *Tax Law Rewrite, The Way Forward, A Consultative Document* (July 1996) Annex 1, paras 36-66.

<sup>21</sup> *Ibid*, at paras 2-6.

<sup>22</sup> *Ibid*, at paras 77-86.

20.8 Other short term measures could be considered. These include the methods referred to in Part 19 above<sup>23</sup> in relation to alerting advisers to new articles of association and the possibility of authoritative guidance produced by or on behalf of or in co-operation with the DTI. This guidance could be in a leaflet which could set out examples drawn from case law as to when a section 459 claim is likely to be successful and when a derivative action should be brought. The leaflet could also list the other remedies scattered throughout the Companies Acts, to encourage shareholders to use them where appropriate.<sup>24</sup> The disadvantage of such guidance is the resources required to produce it and the fact that it can become out of date and thus misleading. We accordingly make no recommendation in relation to the production of such a guide.

**We have suggested that those who are not experts in company law may have difficulty in predicting whether or not a claim under section 459 is likely to succeed and that some may have additional difficulty because some section 459 cases are only reported in specialist series of law reports. Do consultees agree?**

**Consultees are asked whether they agree with our provisional view that it would not be appropriate to seek parliamentary time for legislative simplification solely of section 459?**

**Consultees are also asked for their views on whether authoritative guidance on the application of section 459 should be provided by means other than legislation, and on how such guidance might best be provided and disseminated.**

*Amendment of section 459 to impose a limitation period on claims under the section*

20.9 There is no limitation period for bringing proceedings under section 459.<sup>25</sup> Our statistical analysis shows that just under ten per cent of cases involve allegations of conduct over a period of five or more years. Reported cases, however, include those in which allegations spanned as much as 40 years.<sup>26</sup> The historical nature of the investigations adds to the unwelcome length and cost of the cases.<sup>27</sup>

<sup>23</sup> See para 19.18 above.

<sup>24</sup> Companies House has produced a series of 31 booklets, each is no more than about 20 pages in length, they use plain English and rarely refer to statutory provisions. The booklets cover a variety of company law topics including choice of a company name and disclosure requirements. Although they are distributed free of charge they are only sent out on request. Additionally, three (the two just mentioned and one on formation of companies) are sent when those about to incorporate request a “starter pack”.

<sup>25</sup> Although it seems that delay in presentation of the petition may render it inequitable to grant relief under the section; see Peter Gibson J in *Re DR Chemicals Ltd* [1989] BCLC 383, 397-398, a case in which both parties agreed that laches could bar relief under s 459. See also para 9.3, n 11 above.

<sup>26</sup> See, for example, *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354 and see para 11.10, n 38 above.

<sup>27</sup> The consequences of such length and cost are set out in paras 1.7 and 11.10-11.11 above.

20.10 Shareholders must have a reasonable opportunity to recognise and consider circumstances which could give rise to such a claim, and it is in the nature of the phrase “unfairly prejudicial” to include a conglomeration of allegations producing a particular consequence. We provisionally consider, however, that there should be a limit to the period allowed for such consideration. This is not only for the reason set out in the last paragraph, but also because it would be beneficial to businesses to have a limit, since this produces greater certainty. Additionally, it is desirable that claims should be brought when documentary evidence is easily available and witnesses can remember the events in issue.

20.11 Whilst we recommend that there should be a limitation period, we make no provisional recommendation as to the length of limitation period, save where the conduct alleged to be unfairly prejudicial constitutes an invasion of the legal rights of, or some duty owed to, the applicant or the company. In that case, we provisionally consider that the limitation period ought to be no less than that (if any) which applies to that wrong. Accordingly, if the applicant complains that a director has taken assets belonging to the company for his own benefit, the limitation period should be no less than that applicable to that breach of duty.<sup>28</sup>

**Do consultees agree with our provisional view that there should be a time limit for bringing claims under section 459? If so:**

- (i) what time limit do they consider should be imposed;**
- (ii) do they agree that where the allegations amount to an invasion of legal rights, or some duty owed to the company, the period ought to be no less than that (if any) which applies to that wrong?**

20.12 In considering a limitation period it is also necessary to consider whether it would run from the date of the earliest conduct on which the applicant relies or from another date, such as when the applicant ought reasonably to have known the relevant facts. We would provisionally recommend the latter approach, since lack of information about the running of the company is a frequent complaint in section 459 proceedings.<sup>29</sup>

<sup>28</sup> Section 21(3) of the Limitation Act 1980 applies to express, implied and constructive trustees, and imposes a 6 year limitation period on actions to recover trust property or in respect of breach of trust. However, in the event of fraud no limitation period applies to an action by a beneficiary under a trust: s 21(1). Difficult questions can arise in relation to the determination of the limitation period applicable to fiduciaries and trustees; see, for example, *Parker and Mellows, The Modern Law of Trusts* (6th ed 1994) pp 592 ff; A McGee, *Limitation Periods* (2nd ed 1994) ch 14; A Burrows, *The Law of Restitution* (1st ed 1993) pp 449-450. As for the limitation period for claims under s 14, see *Re Compania de Electricidad de la Provincia de Buenos Aires Ltd* [1980] 1 Ch 146, 184-189 (6 years for a claim by a member and 12 for one by the company). See also para 14.9, n 15 above.

<sup>29</sup> Our statistical study shows it is alleged in 41.7% of petitions. See Appendix E, Table 1.

**Do consultees agree that any limitation period should run from the date when the applicant ought reasonably to have known the relevant facts?**

- 20.13 Another issue is whether the court should have a discretion to allow proceedings to continue that have been commenced outside the limitation period. This might be allowed on the basis of factors such as those which are applied to personal injury claims by section 33 of the Limitation Act 1980.<sup>30</sup> However, we see no reason for such a power in relation to section 459 proceedings. Moreover, it would introduce uncertainty, which is undesirable in commercial matters. Accordingly, we are of the provisional view that the court should not have a discretion to permit proceedings brought outside the limitation period to continue.

**Do consultees agree with our provisional view that the court should not have discretion to permit proceedings brought outside the limitation period to continue?**

- 20.14 The last issue is whether there should be a limit as to the age of the allegations on which the parties can rely, whether or not they are within the limitation period. For example, there could be a prohibition on any party relying on any allegations of conduct that took place more than, say, seven years before the proceedings were commenced.<sup>31</sup> This would have the advantage of reducing the age of the allegations and consequential poor quality evidence, as well as reducing the number of factual allegations to be tried. Whatever period was fixed would, however, be arbitrary. Furthermore, such a limit could cause injustice if one party needed to rely on older conduct in order to justify his more recent behaviour. In particular, it would cause severe injustice if it were to prevent a party adducing evidence that the company was founded on the basis of an *Ebrahimi* type relationship. We would provisionally reject such a limitation.

**Do consultees agree that there should not be a limit on the age of the allegations upon which parties can rely in section 459 proceedings?**

*Amendment of section 459 to make it clear that it is specific conduct, rather than the affairs of the company overall, that has to be shown to be unfairly prejudicial*

- 20.15 The question arises whether it would be helpful to amend the wording of section 459 to make it clear that it is specific conduct, rather than affairs of the company overall,

<sup>30</sup> The court has regard to all the circumstances of the case and, in particular, to such matters as: the length of and reasons for the delay; the extent to which evidence is likely to be rendered less cogent than if the action had been brought within the time period; the conduct of the defendant after the cause of action arose, including his responses to the plaintiff's reasonable requests for information; and the extent to which the plaintiff acted expeditiously once he knew of the possibility of legal action and what steps he took to obtain legal advice.

<sup>31</sup> This would not affect the limitation period being, for example, 6 years from the date when the applicant could reasonably have been expected to know of the earliest conduct upon which he relies in his claim.

that has to be shown to be unfairly prejudicial. The relevant part of the section could read:

A member of a company may apply to the court by petition for an order under this Part on the ground that conduct within the affairs of the company is or has been unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

This is to be contrasted with the present wording which is:

A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally ...

- 20.16 This amendment would not limit the conduct on which a party could rely, but may help to focus attention on specific conduct and thus potentially reduce the number of tactical allegations made. The proposed new wording would demonstrate that it is not every aspect of the company's affairs in the relevant period that is in issue. We provisionally consider that, if the opportunity is taken to amend section 459 in other respects, it should be amended in this way too.

**We provisionally consider that, if section 459 is to be amended in other respects, the opportunity should be taken to amend the wording to make it clear that it is specific conduct, rather than the affairs of the company overall, that has to be shown to be unfairly prejudicial.**

- (i) **Do consultees agree? If so, what are consultees' views on the amendment set out at paragraph 20.15?**
- (ii) **Do consultees have any suggestions as to other means of achieving this result?**

*Amendment of section 459 to ensure that "unfair prejudice" is construed as broadly as appears to have been intended by the Jenkins Committee*

- 20.17 We have set out in Part 7 above some of the detailed recommendations of the Jenkins Committee in respect of shareholder remedies. At paragraph 203 of their report<sup>32</sup> it is expressly stated that "... if the section is to afford effective protection it must extend to cases in which the acts complained of fall short of actual illegality". On this basis, conduct could be unfairly prejudicial without there being a breach of the rights

<sup>32</sup> In the course of considering proposals to amend s 210 of the Companies Act 1948: Report of the Company Law Committee (1962) Cmnd 1749.

belonging to the shareholder or the company. Although the Court of Appeal in *Saul D Harrison*<sup>33</sup> can be regarded as having laid down “guidelines” for the application of the section, and this indeed is how Neill LJ described their exposition of the law,<sup>34</sup> no reference is made to the possibility of unfairly prejudicial conduct which does not involve the invasion of a legal right, except where the shareholder has a “legitimate expectation” over and above the legal rights conferred by the company’s constitution and arising out of a relationship between shareholders which falls within the categories or analogous situations set out in *Ebrahimi*.<sup>35</sup>

20.18 Unless acts which do not involve the invasion of legal rights constitute, in appropriate circumstances, conduct which is unfairly prejudicial for the purposes of section 459, even if there is no legitimate expectation, conduct which would appear to be deserving of a remedy may be left unremedied, contrary to the expectation (as we see it) of the Jenkins Committee. Some examples are given in the following paragraphs. The second potential adverse consequence is that litigants may try to prove misconduct or legitimate expectation when that is not their real or substantial complaint, and this may lead to a proliferation of issues in section 459 proceedings.

20.19 We now turn to consider examples of conduct which may be regarded as unfairly prejudicial even though it is not wrongful. One example is where a company pays a modest level of dividend on its shares even though it has no particular use for the reserves it is building up, and this course makes the return of a shareholder who does not participate in management (for example a widow of a former director shareholder) less than that of a shareholder who does participate in management and receives remuneration as a director. The decision not to pay a higher dividend may not be capable of being challenged but yet the effect may be such that the court ought to grant a remedy. This type of situation is not considered in *Saul D Harrison*. A further example that may be given is where the directors fail to comply with some code of practice applicable to their company but this does not constitute a breach of duty. The Cadbury and Greenbury Codes of Best Practice are examples of such codes.<sup>36</sup> Directors in companies to which these codes apply are expected by shareholders to comply with them, and if they fail to do so it ought to be open to the court to conclude that their conduct of the company’s affairs in this respect is unfairly prejudicial for the purposes of section 459.<sup>37</sup>

20.20 Another type of case not mentioned in *Saul D Harrison* is where the company in general meeting passes a resolution which improperly discriminates in its effect on

<sup>33</sup> [1995] 1 BCLC 14.

<sup>34</sup> See para 9.25 above.

<sup>35</sup> [1973] AC 360.

<sup>36</sup> Another example would be where a company fails to comply with the Takeover Code.

<sup>37</sup> See *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155, 243.

shareholders. The authorities establish that, in the case of a special resolution at least, such a resolution is capable of being set aside. We consider that the passing of such a resolution ought also to qualify as “unfairly prejudicial” conduct for the purposes of section 459. The facts of *Greenhalgh v Arderne Cinemas Ltd*<sup>38</sup> are a good example. The plaintiff entered into an agreement with the company under which, in return for lending money to keep the company going, he received debentures and shares in the company, was appointed a director and, with a view to giving him substantial control,<sup>39</sup> the agreement provided that a number of shares, including shares to be allotted to the plaintiff, were to be subdivided. The plaintiff also entered into a collateral voting agreement with three other directors to the effect that they would support each other in voting as shareholders. Relations between him and the three directors broke down and, having lost litigation as to the binding nature of the collateral agreement, they circumvented its effect by transferring their shares. This resulted in litigation which the plaintiff lost. After this, the plaintiff had sufficient votes to block a special resolution but not an ordinary resolution. Subsequently, at an EGM, an ordinary resolution was carried to subdivide a number of the shares, thus effectively depriving the plaintiff of any control over the affairs of the company.

- 20.21 The plaintiff sued to set aside the resolution and lost. It was held that no term could be implied into the original voting agreement which would prevent the company from interfering with his voting control. It was further held that the subdivision of shares did not amount to a variation of the voting rights of the plaintiff’s shares. The resolution was discriminatory and would appear to have been capable of being challenged on the basis that it was not passed bona fide in the interests of the company, but the point was not argued.<sup>40</sup> In our view a plaintiff in that situation should have a remedy under section 459.<sup>41</sup>

<sup>38</sup> [1946] 1 All ER 512.

<sup>39</sup> See Vaisey J at first instance: [1945] 2 All ER 719.

<sup>40</sup> For the position if the subdivision had been capable of being effected by the directors, see *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155, 246-9.

<sup>41</sup> The situation was typical of one of those which we are trying to address in this paper by way of the self-help remedies as well as in statute in that, as Lord Greene MR said in *Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512, 513:

... the fact that the arrangement to which the parties had come did not provide for certain matters was not improbably due to the fact that the parties, being under the impression that they were entering into a permanent and friendly alliance, had not troubled their heads about them.

We have said that parties should be encouraged to provide in their own agreements for a breakdown of relations between them. We recognise, however, that they will not always do so and, therefore, that there must be a broad ranging remedy available to the court to deal with such situations in default of the parties’ own agreement.



20.22 We have in Part 2 above,<sup>42</sup> cited a passage from a later case brought by Mr Greenhalgh<sup>43</sup> which held that a special resolution could be a fraud on the minority.<sup>44</sup> We have said above<sup>45</sup> that it may be doubtful whether such a resolution would be unfairly prejudicial following *Saul D Harrison*. That depends on the willingness of the courts to enlarge on the situations constituting unfairly prejudicial conduct.

20.23 Our provisional view is that the courts will find that new situations not mentioned in *Saul D Harrison* are, in appropriate circumstances, capable of constituting unfairly prejudicial conduct. Provisionally, we would be reluctant to suggest that section 459 should be amended to make this clear. Any amendment to section 459 of this nature would run the risk of introducing some other limitation into the section. Our provisional view is that it is preferable to have the very general wording of the section as it now stands, with scope for an evolving interpretation by the courts.

**Do consultees agree with our provisional conclusion that the words “unfairly prejudicial” should not be defined in section 459? If they do not agree:**

**(i) why do they consider that those words should be defined;**

**(ii) what meaning do they consider should be given to those words?**

*Amendment to add winding up to the remedies available under section 461*

20.24 The reasons for and consequences of pleading section 122(1)(g) of the Insolvency Act 1986 in the alternative to a section 459 claim have been dealt with in Part 8 above.<sup>46</sup> If it has not been pleaded in the alternative, but the court considers that it should have been, the petition can be amended to include it.<sup>47</sup> It has been suggested to us that to streamline shareholder remedies it would be desirable to permit the court to grant a winding up on the grounds of unfairly prejudicial conduct.<sup>48</sup> This amendment of section 461 would increase the range of remedies and thus the flexibility of the court’s powers to deal with shareholders’ problems. In Australia, New Zealand and under the

<sup>42</sup> See para 2.33 above.

<sup>43</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

<sup>44</sup> *Ibid*, at p 291.

<sup>45</sup> See para 9.39 above.

<sup>46</sup> See paras 8.18-8.24 above.

<sup>47</sup> See *Re Full Cup International Trading Ltd* [1995] BCC 682, 694.

<sup>48</sup> The suggestion also stems from the view that an applicant shareholder in a respondent company should not have to look in the Insolvency Act 1986 for a remedy.

CBCA in Canada winding up is one of the remedies that can be granted under the statutory “oppression” provisions.<sup>49</sup>

20.25 What then may be the problems raised by such an amendment? The first is the very different nature of the remedies available under section 461 from winding up. In *Re a Company (No 00314 of 1989), ex parte Estate Acquisition and Development Ltd*,<sup>50</sup> Mummery J, commenting on this distinction, said that under section 122(1)(g) “... the court is asked to decide whether to pass a death sentence on the company ...”, whereas under section 459, “[a] court is more in the position of a medical practitioner presented with a patient who is alleged to be suffering from one or more ailments which can be treated by an appropriate remedy applied during the course of the continuing life of the company”.<sup>51</sup> This is not, however, necessarily a complete picture of the remedies. As a result of a purchase order under section 461, some shareholder-managers may leave the company, having sold their shares to the others who continue to run the business. In the event of winding up, exactly the same result may follow, if the majority buy the business from the liquidator and continue to run it.

20.26 Another objection that might be taken is that such amendment could be seen as encouraging shareholders to seek winding up under section 459, thus undermining the policy underlying the 1990 practice direction,<sup>52</sup> that winding up on just and equitable grounds should only be pleaded if it is the relief preferred by the applicant, or if it is considered it may be the only one to which he is entitled. The mere availability of the remedy in section 461 need not undermine the intention behind the practice direction. We think that the section as amended could provide that the court should not grant a winding up order if there was some other adequate remedy under the section or elsewhere. Moreover, the Vice-Chancellor may be prepared to issue a revised practice direction advising applicants under section 459 that they should not ask for a winding up order in their applications unless either that is the preferred relief or it is thought to be the only one which is appropriate in the circumstances. Where the court decides that it is open to it to grant this remedy, and the applicant has not pleaded it specifically but wishes to do so, the court can give leave to amend,<sup>53</sup> and adjourn the proceedings for advertisement before making the necessary order.

<sup>49</sup> In Australia liquidation commences when the order is made and transactions after that date are generally void, and in New Zealand liquidation commences on the day the liquidator is appointed; see Appendix F, paras 1.11 and 4.12, n 12 respectively.

<sup>50</sup> [1991] BCLC 154.

<sup>51</sup> *Ibid*, at p 161.

<sup>52</sup> Practice Direction (Ch D) (Companies Court: Contributory’s Petition) [1990] 1 WLR 490; see paras 8.22-8.24 above.

<sup>53</sup> However, the rules would have to provide that, contrary to the normal effect of an amendment, an amendment to add a claim for a winding up order does not relate back to the date on which the petition (under the present procedure) was presented.

20.27 Lastly, it should be noted that the presence of this remedy in section 461 will not deter applicants from pleading section 122(1)(g) in the alternative since there are cases that satisfy the latter test which will not satisfy the test of unfairly prejudicial conduct.<sup>54</sup> Thus it will not necessarily have the effect of reducing the allegations in issue. Active case management by the courts is the best answer to the situation where a winding up order is sought unnecessarily or for the purpose of putting pressure on the company (for example, because the shareholder has started a competing business). Alternatively, the amended section could provide that an application for winding up under section 459 or section 122(1)(g) would require the leave of the court. This may render part of the 1990 practice direction unnecessary.

20.28 If section 461 were amended to provide that the court might make a winding up order on an application under section 459, it would seem that the procedure for validation orders in the practice direction should apply (with any necessary modification). Thus, there would not be any need to alter the effect of relation back of the court's order for winding up, and we have not considered whether this could be achieved. However, even if inconvenience and cost were reduced by extension of the practice direction, there remains a real risk that a company will suffer reputational damage and a loss of confidence among its suppliers and customers<sup>55</sup> if an application for winding up is made unnecessarily. This risk may be increased if section 461 is amended to give the court power to make a winding up order on an unfair prejudice petition.

**We have not formed a provisional view as to whether winding up should be added to the remedies available under section 461. Consultees are asked:**

- (i) whether they consider that the absence of winding up from section 461 causes problems in practice;**
- (ii) whether they consider that section 461 should be amended so as to enable the court to make a winding up order (unless there is some other adequate remedy); and**
- (iii) if so, whether an applicant should require the court's leave to apply for winding up in proceedings under section 459.**

*Extension of the power to determine relief as between respondents to a section 459 petition*

20.29 In Part 11 above<sup>56</sup> we suggested that the court may have limited powers under section 459 to determine the basis on which respondents or a respondent and a non-party should, as between themselves, bear the burden of relief which is ordered in favour of

<sup>54</sup> See para 8.18, n 52 above.

<sup>55</sup> See paras 8.20-8.21 and 8.24 above.

<sup>56</sup> See paras 11.19-11.20 above.

the applicant. This could be a factor which prevents early settlement of some disputes by encouraging respondents to contest liability. If the court had full powers in petition proceedings in this respect, it may be that respondents would combine contributions to settle more cases.

- 20.30 We provisionally consider that, as a matter of principle, in the interests of fairness, the court should have jurisdiction to order contributions or indemnity where relief is given under section 459, but we invite consultees' views.

**Do consultees agree with our provisional view that in proceedings under section 459 the court should have the same powers that it has in a writ action to order joinder and contributions and indemnities between respondents or respondents and non-parties?**

*Provision in the 1986 Rules to state that there should be no advertisement until the court so orders*

- 20.31 Although it is now clear from case law<sup>57</sup> that no advertisement of section 459 petitions is allowed prior to the return date, we consider that it would be helpful to include an express provision to this effect.<sup>58</sup>

**Do consultees agree with our provisional view that, if the 1986 Rules are amended in other ways, it would be useful to include an express provision stating that no advertisement of section 459 petitions is allowed prior to the return date?**

**Permitting former members to bring proceedings**

- 20.32 Under this head we consider whether former members should be able to bring derivative actions and petitions under section 459. The position in some foreign jurisdictions is as follows. In the United States of America, under Federal Rule 23.1, derivative actions cannot be brought by former members.<sup>59</sup> In South Africa and Ghana, statutory derivative actions must be brought by current members.<sup>60</sup> Under the CBCA in Canada, both remedies are available to former members.<sup>61</sup> In New Zealand, the

<sup>57</sup> See paras 11.21-11.22 above.

<sup>58</sup> It has been suggested to us that there are other respects in which the rules applicable to s 459 proceedings may need reconsideration, such as the rules permitting service out of the jurisdiction (see, for example, *Re Harrods (Buenos Aires) Ltd* [1992] Ch 72). However, it seems to us that these are matters for the Insolvency Rules Committee rather than for us in this project.

<sup>59</sup> See Appendix F, para 6.2.

<sup>60</sup> See Appendix F, para 5.3, n 4 (South Africa) and para 3.3, n 8 (Ghana). But note that under the Ghanaian Companies Code 1963, relief can be ordered in a derivative action in favour of former members.

<sup>61</sup> See Appendix F, paras 2.3 and 2.7.

oppression remedy is available to former members,<sup>62</sup> but the statutory derivative action is not.<sup>63</sup> In Australia, the oppression remedy is not available to former members,<sup>64</sup> but the proposed derivative action would be.<sup>65</sup>

- 20.33 We feel that there can be no point in extending the derivative action to former members, since there is bound to be a current member who (if the wrong has not been ratified) could maintain proceedings. It is difficult to see why a former member should be able to bring a derivative action if the current members are not willing to do so.

**We have provisionally concluded that there is no justification for permitting former members to bring derivative actions. Do consultees agree?**

- 20.34 In the United Kingdom neither remedy is currently available to former members. This position is to be contrasted with the remedy of just and equitable winding up under section 122(1)(g) of the Insolvency Act 1986.<sup>66</sup>

- 20.35 We are unable to cite any examples which suggest that the fact that a remedy under section 459 is not available to former members is a particular problem.<sup>67</sup> One type of factual situation in which it may arise is where directors have made personal profits at the expense of the company. They then induce a minority shareholder to leave and give him a price for his shares which represents an under value because it reflects the reduced value of the company and that value has only been reduced because of the directors' wrongdoing. In small private companies it may well be that a former shareholder would be able to prove an actionable misrepresentation and therefore obtain a remedy. In a family company, in certain circumstances, the former shareholder may be able to establish that the directors owe him personally a duty of disclosure.<sup>68</sup> Another situation might be where a shareholder has sold his shares at a price to be fixed by reference to future profits, and, thereafter, the remaining shareholders conduct the company's affairs improperly so as to reduce its profits. However, the former member is only without a remedy if he has failed to obtain

<sup>62</sup> See Appendix F, para 4.9.

<sup>63</sup> See Appendix F, para 4.3, n 3.

<sup>64</sup> See Appendix F, para 1.9, n 25.

<sup>65</sup> There was a debate in respect of the derivative action, but the final form of the proposed legislation permits former members to sue. See Appendix F, para 1.5, n 11.

<sup>66</sup> See para 8.3 above.

<sup>67</sup> Although Marsden in "Prejudicial Relief?" (1994) 15 Co Law 178 sets out an example. A director resigned, the articles gave the remaining directors an option to purchase his shareholding but did not provide a time for the exercise of the option. The price was to be a proportion of the net asset value of the company and the other directors first deliberately acted so as to reduce that value and then exercised their option. The director was left without a remedy.

<sup>68</sup> *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192, 208, *per* Sir Nicholas Browne-Wilkinson V-C.

appropriate covenants and warranties. To provide a statutory remedy in these cases would be to interfere with the contractual situation.

- 20.36 Arguably, there is a particular need for the statutory remedies to be available to former owner-managers of smaller private companies. The main part of their personal assets may have been tied up in the business, they may not be sufficiently well-advised to make the relevant enquiries when they depart, and thus they may not be able to make a case on the grounds of misrepresentation.
- 20.37 Another situation in which this issue could be relevant is following a takeover in the event that shareholders are dissatisfied with the price received for their shares.<sup>69</sup> Permitting former shareholders to sue might, however, result in an increase in litigation which might, for example, make it difficult to effect and implement a rationalisation of the acquired company's business. That would be undesirable.
- 20.38 If the remedy under section 459 is made available to former members it would be necessary to safeguard those running the company from uncertainty as to future actions. This could, but only to a limited extent, be met by the limitation proposals set out above.<sup>70</sup>

**We have not formed a provisional view as to the desirability of permitting former members to bring claims under section 459. Consultees are asked whether they consider that the lack of availability of the section 459 remedy to former members causes problems.**

**Pre-action discovery**

- 20.39 Under this head we raise for consideration, without making a recommendation, giving shareholders pre-action discovery of relevant documents. Its effect is merely to bring forward the time of disclosure of documents. It could, however, extend to discovery against third parties who would not be parties to shareholder proceedings.

**Do consultees consider that shareholders' current rights of discovery in court proceedings are adequate and that no change is necessary?**

- 20.40 Discovery prior to commencement of legal proceedings is available to an applicant who appears to the High Court to be likely to be a party to subsequent proceedings in that court in which a claim in respect of personal injuries to a person, or in respect of a person's death, is likely to be made. He can obtain such discovery against:

<sup>69</sup> Or with the operation of s 429 of the Companies Act 1985, which gives rights to purchasers of 90% of shares to acquire the remainder.

<sup>70</sup> See paras 20.9-20.11 above.

... a person who appears to the court to be a likely party to the proceedings and to be likely to have or to have had in his possession ... documents which are relevant to an issue arising or likely to arise out of that claim ... .<sup>71</sup>

This provision was introduced, following a 1968 report into personal injury litigation,<sup>72</sup> in order to provide medical experts with all the information necessary to enable them to make an accurate assessment of the nature and extent of the injuries<sup>73</sup> and in accordance with an underlying theme of the report that fair settlements should be facilitated by the provision of as much information to parties at as early a stage as possible.<sup>74</sup>

20.41 The test of likelihood of a claim being made does not mean that the applicant has to show that he has a good cause of action, it could be taken to mean that the claim “may” or “may well” be made dependent on the outcome of the discovery.<sup>75</sup>

20.42 There is no such provision available for shareholder litigation in England and Wales.<sup>76</sup> It should be noted, however, that the Woolf Report recommends that parties should be able to make applications for pre-action discovery in all cases in the same way as is currently possible in personal injury cases.<sup>77</sup>

20.43 In Scotland the position is different. Under section 1 of the Administration of Justice (Scotland) Act 1972<sup>78</sup> pre-action discovery of documents is available in all cases.

<sup>71</sup> Section 33(2) of the Supreme Court Act 1981. Under s 34 discovery is also available against non-parties. Section 34 provides that discovery may be ordered against “... a person who is not a party to the proceedings and who appears to the court to be likely to have in his possession ... documents which are relevant to an issue arising out of the ... claim”.

<sup>72</sup> The Report of the Committee on Personal Injuries Litigation (1968) Cmnd 3691, paras 126-137.

<sup>73</sup> *Ibid*, at paras 273-318.

<sup>74</sup> *Ibid*, at paras 126-137.

<sup>75</sup> See Lord Denning in *Dunning v United Liverpool Hospitals' Board of Governors* [1973] 1 WLR 586, 590. See, on the concept of a fishing expedition, the judgment of Stamp LJ at p 591.

<sup>76</sup> Section 33(1) permits orders for pre-action inspection of property in all actions, but this will only cover documents where there is some question as to the document itself (eg authenticity), and not if the only issue is as to the information in the document: *Huddleston v Control Risks Information Services Ltd* [1987] 1 WLR 701. Failure to provide information could, however, amount in itself to unfairly prejudicial conduct under s 459; see para 9.35 above.

<sup>77</sup> Chapter 12, paras 48-50. The application would have to be for specific documents shown to be in the respondent's possession, the respondent would be a likely party and the documents would be relevant to the potential claim. Discovery would be known as “disclosure” under the new regime.

<sup>78</sup> 1(1) Without prejudice to the existing powers of the Court of Session and of the sheriff court, those courts shall have power, subject to the provisions of sub-section (4) of this section, to order the inspection, photographing, preservation, custody and detention of documents and other property (including, where appropriate, land) which appear to the court to be property as to which any question may relevantly arise in any existing civil proceedings

**Do consultees consider that a right of pre-action discovery similar to that available in relation to personal injury claims (including such a right against non-parties) in England and Wales should be available in relation to derivative actions, claims under section 459 and under any new unfair prejudice remedy that may be created as a result of this project?**

before that court or in civil proceedings which are likely to be brought, and to order the production and recovery of any such property, the taking of samples thereof and the carrying out of any experiment thereon or therewith.

(2) Notwithstanding any rule of law or practice to the contrary, the court may exercise the powers mentioned in subsection (1) of this section—

(a) where proceedings have been commenced, on the application, at any time after such commencement, of a party to or minuter in the proceedings, or any other person who appears to the court to have an interest to be joined as such party or minuter;

(b) where proceedings have not been commenced, on the application at any time of a person who appears to the court to be likely to be a party to or minuter in proceedings which are likely to be brought;

unless there is special reason why the application should not be granted.



## PART 21

# SUMMARY OF PROVISIONAL RECOMMENDATIONS AND CONSULTATION ISSUES

- 21.1 We have raised a number of questions in this paper and have formed provisional views on what we perceive to be the two major issues. The first relates to the rule in *Foss v Harbottle*, which governs the rights of shareholders to bring actions on behalf of the company. Our provisional conclusion is that it is necessary to abolish it in part and to replace it with a new derivative action.<sup>1</sup>
- 21.2 The second main issue to which our provisional recommendations relate is the means by which personal proceedings brought by shareholders can be streamlined.<sup>2</sup> Our provisional view is that the prime method is by efficient case management and by the introduction of a judicial power, exercisable at any stage after service of the defence, to dismiss any claim or part of a claim or any defence which has no realistic prospect of success.
- 21.3 We also seek consultees' views on an additional unfair prejudice remedy for shareholders in smaller private companies; we provisionally recommend that companies should include more provisions in the articles of association designed to deal with disputes and canvas views on three possible additional provisions; and seek consultees' views on a number of other reform possibilities relating to the enforcement of rights under section 14, proceedings under section 459, the remedies of former members, and disclosure of documents.
- 21.4 We set out below a summary of the particular issues on which we invite the views of consultees. More generally we invite comments on any of the matters raised by this paper and any other suggestions that consultees may want to put forward. Consultees should not feel obliged to answer all the questions if they have views or experience relevant to only some of them. **Where they consider that different answers are appropriate to different types and sizes of company<sup>3</sup> we ask consultees to state this specifically.**

<sup>1</sup> See paras 14.13 and 15.2-15.4 above.

<sup>2</sup> See paras 14.13 and 15.5 above. Although our recommendations in this respect stem from concerns expressed in the context of personal proceedings under s 459, we propose that they should apply to all forms of shareholder action, including the new derivative action which we are recommending in this paper. Some specific issues of case management in respect of derivative actions are also raised.

<sup>3</sup> Ie public listed company, unlisted public company, private company, small private company (eg 9 or less or 5 or less shareholders — consultees are asked to indicate their view as to the appropriate number of shareholders).

## **Deficiencies in the present law and the approach to reform**

### *Problems in actions on behalf of the company*

1. Do consultees agree that the operation of the rule in *Foss v Harbottle* and its exceptions is unsatisfactory or would they like to see it retained without change?<sup>4</sup>
2. If they consider it to be unsatisfactory, do they agree with our provisional identification of the four major problems which it presents to a member who wishes to take action on behalf of a company, namely:
  - (i) that the rule can only be found in case law, much of which is many years old;
  - (ii) that an action to recover damages suffered by a company by reason of a director's breach of fiduciary duty cannot be brought unless the wrongdoers have control;
  - (iii) that unless the negligence benefits the controlling shareholders a minority cannot bring an action for damages suffered by the company by reason of the negligence of a director;
  - (iv) that standing to bring a claim has to be determined as a preliminary issue and this results in a mini trial which increases the length and cost of litigation?<sup>5</sup>

### *Problems in the remedy for unfairly prejudicial conduct, sections 459-461*

3. Do consultees agree with our provisional views that:
  - (i) proceedings under section 459 are often costly and cumbersome; and
  - (ii) small owner-managed companies are particularly affected by this problem?<sup>6</sup>
4. Do those who are not experts in company law have difficulty predicting whether or not a court is likely to find that there has been unfairly prejudicial conduct? If so, does this cause hardship?<sup>7</sup>

### *Remedies for breaches of contract in the articles of association*

5. Do consultees agree with our provisional findings that no hardship is being caused by:
  - (i) any difficulty in identifying personal rights conferred by the articles; and

<sup>4</sup> See paras 14.1-14.4 above.

<sup>5</sup> See paras 14.2-14.4 above.

<sup>6</sup> See para 14.5 above.

<sup>7</sup> See para 14.6 above.

- (ii) the fact that section 14 does not state that the company is bound by the articles as if it had executed them under seal?<sup>8</sup>

*Guiding principles for resolving the problems identified*

6. Do consultees agree with the six guiding principles for our provisional proposals in relation to the reform of the law and procedure relating to shareholder remedies, namely:

- (i) the proper plaintiff rule;
- (ii) the internal management rule;
- (iii) the court's respect for the commercial decisions of directors;
- (iv) sanctity of contract;
- (v) freedom from unnecessary shareholder interference;
- (vi) efficiency and cost effectiveness?

Are there any which have been excluded that should have been included, and are there any which we have included with which consultees do not agree?<sup>9</sup>

**A new derivative action**

*The need for a derivative action*

7. Consultees are asked whether they agree with our views:

- (i) that section 461(2)(c) is not being used because it requires two full sets of proceedings; and
- (ii) that section 459 proceedings are being brought against third parties in circumstances where the ground for complaint could have given rise to a derivative action.<sup>10</sup>

8. Do consultees agree with our views that:

- (i) an applicant should have the right to choose whether to bring a derivative action or proceedings under section 459, or cumulative claims under both; and
- (ii) where the applicant is seeking personal relief under section 459 (eg a buy out order) in circumstances where the facts of the case would also justify relief for the company (eg the return of company property), the court should not have the

<sup>8</sup> See paras 14.8-14.9 above.

<sup>9</sup> See paras 14.10-14.13 above.

<sup>10</sup> See para 16.3 above.

power to make an order in favour of the company where such an order is not in fact sought by the applicant?<sup>11</sup>

*Availability of the new derivative action*

9. Do consultees agree with our provisional view that the new procedure should only be available for claims in respect of breaches of duty (including claims against third parties as a result of such breaches)?<sup>12</sup>

10. Consultees views are sought on our provisional view that this action should be available for breach of directors' duties of skill and care.<sup>13</sup>

11. Do consultees consider that the new procedure should also be available for breach of duty by officers and employees other than directors, but only where there has been a fraud on the minority?<sup>14</sup>

*Partial abrogation of the rule in Foss v Harbottle*

12. Consultees are asked whether an action which can be brought under the new procedure should only be capable of being so brought, and not also under the exceptions to the rule in *Foss v Harbottle*.<sup>15</sup>

13. Consultees are asked for their views on whether actions within paragraph (4) of the definition of the rule in *Foss v Harbottle* given in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*, namely actions in respect of transactions requiring approval by special majority, should be governed by specific rules of court requiring the court's leave for continuation of the action. If so, which of the matters set out in paragraph 16.20<sup>16</sup> (or other matters) should apply to such actions?<sup>17</sup>

*Notice to the company*

14. Do consultees agree with our provisional recommendations that:

(i) notice to the company should be a precondition to the grant of leave to a shareholder to maintain a derivative action;

<sup>11</sup> See paras 16.4-16.6 above.

<sup>12</sup> See para 16.8 above.

<sup>13</sup> See para 16.9 above.

<sup>14</sup> See paras 16.10-16.11 above.

<sup>15</sup> See paras 16.12-16.13 above.

<sup>16</sup> Listed in question 25 below.

<sup>17</sup> See para 16.14 above.

- (ii) the requirement for notice should be waived if the shareholder can show that urgent relief is required and/or if the court dispenses with the requirement;
- (iii) the notice period should be 28 days;
- (iv) the notice should specify the grounds of the proposed derivative action?<sup>18</sup>

*Consideration by the court*

15. Do consultees agree with our provisional view that the court should normally consider leave at the close of pleadings, but should be able to do so earlier, and that the application should normally be heard by a judge rather than a Master?<sup>19</sup>

16. Our provisional view is that all the parties to the proceedings should:

- (i) be parties to the application for leave; and
- (ii) be entitled to receive evidence filed on it; and
- (iii) be present at the hearing unless the court otherwise directs.

Do consultees agree?<sup>20</sup>

*Issues relevant to the grant of leave*

17. We provisionally recommend that there should be no threshold test on the merits of the case and seek consultees' views on this issue.<sup>21</sup>

18. Do consultees agree that in considering the issue of leave the court should take into account all the relevant circumstances without limit?<sup>22</sup>

19. We provisionally recommend that, in considering the issue of leave, the good faith of the applicant is one of the circumstances which the court should take into account. Do consultees agree? If so:

- (i) do they consider that "good faith" should be defined for these purposes; and
- (ii) if so, what do they consider would be the appropriate definition;

<sup>18</sup> See para 16.17 above.

<sup>19</sup> See para 16.18 above.

<sup>20</sup> See para 16.19 above.

<sup>21</sup> See paras 16.21-16.22 above.

<sup>22</sup> See para 16.25 above.

(iii) do consultees agree with our provisional view that the good faith of the applicant should be relevant but not a prerequisite to the grant of leave?<sup>23</sup>

20. We provisionally recommend that in considering the issue of leave:

(i) the court should take account of the interests of the company; and

(ii) in doing so, the court should have regard to the views of directors on commercial matters;

(iii) the court should not be bound to refuse leave if the proceedings are not in the interests of the company.<sup>24</sup>

Do consultees agree?

21. We provisionally recommend that in considering the issue of leave:

(i) the court should take account of the fact that the wrong has been, or may be, approved by the company in general meeting; and

(ii) the court should not be bound to refuse leave where there has been ratification.

Do consultees agree?<sup>25</sup>

22. We provisionally recommend that, in considering the issue of leave, the court should take account of the views of an independent organ that for commercial reasons the action should or should not be pursued, but that its views should not necessarily be conclusive on the issue of whether or not leave should be granted. Do consultees agree?<sup>26</sup>

23. We provisionally recommend that, in considering the issue of leave, the court should take account of the availability of alternative remedies, but that their availability should not necessarily be conclusive on the issue of whether or not leave should be granted. Do consultees agree?<sup>27</sup>

<sup>23</sup> See paras 16.27-16.31 above.

<sup>24</sup> See paras 16.32-16.34 above.

<sup>25</sup> See paras 16.35-16.37 above.

<sup>26</sup> See para 16.38 above.

<sup>27</sup> See paras 16.39-16.40 above.

24. Do consultees agree that in the absence of circumstances justifying the grant of leave the proper plaintiff principle should apply?<sup>28</sup>

25. Our provisional view is that there should be an express statement in the rules of court that regard should be had to all relevant circumstances and that they include the five criteria mentioned above, namely: whether the applicant is acting in good faith; whether the proceedings are in the interests of the company; ratification; views of an independent organ; and the availability of alternative remedies. Do consultees agree?<sup>29</sup>

*Additional qualifying requirement*

26. Do consultees agree with our provisional rejection of a requirement that the applicant should have been a shareholder for a minimum period of time?<sup>30</sup>

*Court's power to appoint an independent expert*

27. We provisionally recommend against creating a special power to allow the court to appoint an independent expert to investigate and advise on the action. Do consultees agree?<sup>31</sup>

*Remedy*

28. Do consultees agree with our provisional view that the court should not have power to grant a personal benefit in a derivative action? If consultees do not agree with this view, what types of order do they consider that the court should be able to grant? In particular, do they consider that the court's power should be limited to the grant of orders for compensation or should it extend to orders for purchase of shareholdings?<sup>32</sup>

*Multiple derivative actions*

29. We are not making any provisional recommendation on this issue, but would be grateful if consultees could inform us whether they consider that provision should be made for multiple derivative actions. If so, do they envisage any particular difficulties with such actions, or do they consider that they should be treated in the same way as any other derivative action?<sup>33</sup>

## **Case management of derivative actions**

<sup>28</sup> See para 16.41 above.

<sup>29</sup> See paras 16.42-16.44 above.

<sup>30</sup> See para 16.45 above.

<sup>31</sup> See paras 16.46-16.47 above.

<sup>32</sup> See paras 16.48-16.50 above.

<sup>33</sup> In other words, should they be subject to the six features listed in para 15.4 above and the same powers of case management as are set out in Part 17 above? See para 16.51 above.

*Power to direct the company to convene a meeting of the shareholders*

30. We provisionally recommend that the rules of court governing the new derivative action should specifically provide that the court has power to direct the company to convene a meeting of shareholders to consider a resolution as to whether the proceedings should be continued.

(i) Do consultees agree?

(ii) If so, we seek consultees' views on whether the court should have additional powers to determine whether any shareholder should or should not be permitted to vote at such a meeting.<sup>34</sup>

*Costs indemnity orders*

31. We provisionally recommend that there should be no change to the court's power to make costs indemnity orders. We invite consultees' comments on this point.<sup>35</sup>

*Addition or substitution of applicant*

32. Do consultees agree with our provisional view that the court's power to add or substitute applicants should remain unchanged?<sup>36</sup>

*Leave of the court for compromise or abandonment of derivative actions*

33. Do consultees agree that the rules governing the new derivative action should provide that the applicant should not enter into any compromise or abandon the proceedings without the leave of the court?<sup>37</sup>

**Case management of all shareholder proceedings**

*Preliminary issues*

34. Do consultees agree with our provisional view that greater use should be made of the power to direct that preliminary issues be heard, or that some issues be tried before others?<sup>38</sup>

*Security for costs*

<sup>34</sup> See para 17.7 above.

<sup>35</sup> See para 17.8 above.

<sup>36</sup> See para 17.9 above.

<sup>37</sup> See para 17.10 above.

<sup>38</sup> See paras 17.11-17.12 above.



35. Do consultees agree with our provisional view that the court's existing power to order security for costs should not be extended to permit it to order security whenever it thinks fit?<sup>39</sup>

*Power to dismiss claim or part of claim or defence which has no realistic prospect of success*

36. Do consultees agree with our provisional view that in shareholder proceedings the court should have the power to dismiss any claim or part of a claim or defence thereto which, in the opinion of the court, has no realistic prospect of success at full trial?<sup>40</sup>

*Adjournment to facilitate alternative disposal arrangements*

37. Do consultees agree with our provisional view that it would be helpful to include express reference in the rules relating to shareholder proceedings to the power to adjourn at any stage to enable the parties to make alternative arrangements for disposing of the case or any issue in it?<sup>41</sup>

*Determination of how facts are to be proved*

38. Do consultees agree with our provisional view that the court's power to determine how facts are to be proved should be used pro-actively by the court?<sup>42</sup>

*Exclusion of issues from determination*

39. We seek consultees' views as to whether the power to exclude issues as proposed in the Draft Civil Proceedings Rules is sufficient for the purposes of enabling the court to exclude issues in appropriate circumstances in shareholder proceedings.<sup>43</sup>

#### **A new additional unfair prejudice remedy for smaller companies**

40. Do consultees favour the introduction of a new unfair prejudice remedy for smaller companies along the lines proposed in paragraph 18.4?<sup>44</sup>

41. We have suggested that problems may arise out of:

(i) the specified number of shareholders;<sup>45</sup>

<sup>39</sup> See paras 17.13-17.15 above.

<sup>40</sup> See para 17.16 above.

<sup>41</sup> See para 17.17 above.

<sup>42</sup> See para 17.18 above.

<sup>43</sup> See para 17.19 above.

<sup>44</sup> See paras 18.1-18.6 above. The suggested wording for the new remedy is also set out in Appendix I.

<sup>45</sup> See para 18.7 above.

- (ii) the meaning of the wording taken from the judgment of Lord Wilberforce in *Ebrahimi*;<sup>46</sup>
- (iii) the grounds for the claim;<sup>47</sup>
- (iv) failure to set down a procedure for valuation of the shares;<sup>48</sup>
- (v) failure to provide a remedy in certain situations in which there is no fault;<sup>49</sup>
- (vi) the risk of increasing litigation.<sup>50</sup>

Which of these (if any) do consultees consider to be problems, and are there any other problems in relation to the draft remedy?

42. We are of the provisional view that a shareholder should not have to choose between such a new unfair prejudice remedy and the remedy available under section 459. We believe that any duplication of issues could be dealt with by case management by the court. Do consultees agree?<sup>51</sup>

43. If consultees are in favour of a new remedy, but are not content with the draft proposed at paragraph 18.4, would they let us have their views on the following issues:

- (i) what situations and what companies should be covered;
- (ii) should there be a discount for a minority shareholding;
- (iii) should there be an express procedure for valuation of the shares outside court;
- (iv) what other provisions should be included?<sup>52</sup>

#### **Articles of association**

44. Do consultees agree that it is desirable to include additional regulations in Table A?<sup>53</sup>

<sup>46</sup> See para 18.7 above.

<sup>47</sup> See para 18.9 above.

<sup>48</sup> See para 18.8 above.

<sup>49</sup> See para 18.10 above.

<sup>50</sup> See para 18.11 above.

<sup>51</sup> See para 18.11 above.

<sup>52</sup> See para 18.3 above.

<sup>53</sup> See para 19.2 above.

*Shareholder exit article for smaller private companies — draft regulation 119*

45. Do consultees agree that a provision for shareholders to exit smaller private companies should be included in Table A?<sup>54</sup>

46. Consultees are asked to consider the text of draft regulation 119 in Appendix H and to give their views on the following issues:

- (i) should its applicability be restricted to companies with less than 10 members which are not public companies;<sup>55</sup>
- (ii) should it provide specific circumstances in which the exit rights are to be available rather than leaving it to companies to modify the regulation before adopting it. If so, which circumstances should it specify;<sup>56</sup>
- (iii) what are consultees' views on the notice periods and procedure for valuation;<sup>57</sup>
- (iv) do consultees agree with the inclusion of the provision for winding up the company;<sup>58</sup>
- (v) are there any additional provisions that should be included, for example, payment of the purchase price by instalments?<sup>59</sup>

*Arbitration — draft regulation 120*

47. Consultees are asked whether they consider that it is desirable to include an arbitration and ADR regulation in Table A.<sup>60</sup>

48. Consultees are asked to consider the text of draft regulation 120 in Appendix H and to give their views on whether it should, in addition, contain reference to:

- (i) the mediation procedure of a particular body and, if so, which one;<sup>61</sup>

<sup>54</sup> See paras 19.3-19.11 above.

<sup>55</sup> See para 19.3 above and Appendix H, draft regulation 119(1).

<sup>56</sup> See paras 19.4-19.6 above and Appendix H, draft regulation 119(2)-(3).

<sup>57</sup> See para 19.7 above and Appendix H, draft regulation 119(4)-(7).

<sup>58</sup> See para 19.8 above and Appendix H, draft regulation 119(8).

<sup>59</sup> See para 19.11 above.

<sup>60</sup> See paras 19.12-19.15 above.

<sup>61</sup> See para 19.13 above.

- (ii) a time limit for reactivating the arbitration if mediation did not work within a specified time, say 60 days;<sup>62</sup>
- (iii) the nomination of an arbitrator by the Chartered Institute of Arbitrators rather than the Institute of Chartered Accountants (or other accountancy body) or alternative bodies, leaving it to companies to delete the unwanted option;<sup>63</sup>
- (iv) any other provisions.

*Valuation procedure — draft regulation 121*

49. Do consultees agree that a provision for a valuation procedure should be included in Table A?<sup>64</sup>

50. Consultees are asked to consider the text of draft regulation 121 in Appendix H and to give their views on the following issues:

- (i) do they agree that it should provide that there be no discount for the fact that the shares are a minority shareholding; and
- (ii) do they agree that it should not make any provision for default by the purchaser in completing the sale?<sup>65</sup>

*General*

51. Consultees are asked whether there are any other similar regulations which should be included in Table A.

52. Consultees' views are sought as to the best methods of alerting advisers and incorporators to the self-help articles of association.<sup>66</sup>

**Reform to section 14 by clarification of the types of situations that may fall within the section**

53. Do consultees consider that there should be a statutory non-exhaustive list of personal rights enforceable under section 14?<sup>67</sup>

**Other reforms relating to proceedings under sections 459-461**

<sup>62</sup> See para 19.14 above.

<sup>63</sup> See para 19.15 above.

<sup>64</sup> See paras 19.16-19.17 above.

<sup>65</sup> See paras 19.16-19.17 above.

<sup>66</sup> See para 19.18 above.

<sup>67</sup> See paras 20.2-20.4 above.

*Clarification of section 459 by authoritative guidance*

54. We have suggested that those who are not experts in company law may have difficulty in predicting whether or not a claim under section 459 is likely to succeed and that some may have additional difficulty because some section 459 cases are only reported in specialist series of law reports. Do consultees agree?<sup>68</sup>

55. Consultees are asked whether they agree with our provisional view that it would not be appropriate to seek parliamentary time for legislative simplification solely of section 459?

56. Consultees are also asked for their views on whether authoritative guidance on the application of section 459 should be provided by means other than legislation, and on how such guidance might best be provided and disseminated.<sup>69</sup>

*Amendment of section 459 to impose a limitation period on claims under the section*

57. Do consultees agree with our provisional view that there should be a time limit for bringing claims under section 459? If so:

- (i) what time limit do they consider should be imposed;
- (ii) do they agree that where the allegations amount to an invasion of legal rights, or some duty owed to the company, the period ought to be no less than that (if any) which applies to that wrong?<sup>70</sup>

58. Do consultees agree that any limitation period should run from the date when the applicant ought reasonably to have known the relevant facts?<sup>71</sup>

59. Do consultees agree with our provisional view that the court should not have discretion to permit proceedings brought outside the limitation period to continue?<sup>72</sup>

60. Do consultees agree that there should not be a limit on the age of the allegations upon which parties can rely in section 459 proceedings?<sup>73</sup>

*Amendment of section 459 to make it clear that it is specific conduct, rather than the affairs of the company overall, that has to be shown to be unfairly prejudicial*

<sup>68</sup> See paras 14.6 and 20.5 above.

<sup>69</sup> See paras 20.6-20.8 above.

<sup>70</sup> See paras 20.9-20.11 above.

<sup>71</sup> See para 20.12 above.

<sup>72</sup> See para 20.13 above.

<sup>73</sup> See para 20.14 above.

61. We provisionally consider that, if section 459 is to be amended in other respects, the opportunity should be taken to amend the wording to make it clear that it is specific conduct, rather than the affairs of the company overall, that has to be shown to be unfairly prejudicial.

(i) Do consultees agree? If so, what are consultees' views on the amendment set out at paragraph 20.15?

(ii) Do consultees have any suggestions as to other means of achieving this result?<sup>74</sup>

*Amendment of section 459 to ensure that "unfair prejudice" is construed as broadly as appears to have been intended by the Jenkins Committee*

62. Do consultees agree with our provisional conclusion that the words "unfairly prejudicial" should not be defined in section 459? If they do not agree:

(i) why do they consider that those words should be defined;

(ii) what meaning do they consider should be given to those words?<sup>75</sup>

*Amendment to add winding up to the remedies available under section 461*

63. We have not formed a provisional view as to whether winding up should be added to the remedies available under section 461. Consultees are asked:

(i) whether they consider that the absence of winding up from section 461 causes problems in practice;

(ii) whether they consider that section 461 should be amended so as to enable the court to make a winding up order (unless there is some other adequate remedy); and

(iii) if so, whether an applicant should require the court's leave to apply for winding up in proceedings under section 459.<sup>76</sup>

*Extension of the power to determine relief as between respondents to a section 459 petition*

64. Do consultees agree with our provisional view that in proceedings under section 459 the court should have the same powers that it has in a writ action to order joinder and contributions and indemnities between respondents or respondents and non-parties?<sup>77</sup>

<sup>74</sup> See paras 20.15-20.16 above.

<sup>75</sup> See paras 20.17-20.23 above.

<sup>76</sup> See para 20.24-20.28 above.

<sup>77</sup> See paras 20.29-20.30 above.

*Provision in the 1986 Rules to state that there should be no advertisement until the court so orders*

65. Do consultees agree with our provisional view that, if the 1986 Rules are amended in other ways, it would be useful to include an express provision stating that no advertisement of section 459 petitions is allowed prior to the return date?<sup>78</sup>

#### **Permitting former members to bring proceedings**

66. We have provisionally concluded that there is no justification for permitting former members to bring derivative actions. Do consultees agree?<sup>79</sup>

67. We have not formed a provisional view as to the desirability of permitting former members to bring claims under section 459. Consultees are asked whether they consider that the lack of availability of the section 459 remedy to former members causes problems.<sup>80</sup>

#### **Pre-action discovery**

68. Do consultees consider that shareholders' current rights of discovery in court proceedings are adequate and that no change is necessary?<sup>81</sup>

69. Do consultees consider that a right of pre-action discovery similar to that available in relation to personal injury claims (including such a right against non-parties) in England and Wales should be available in relation to derivative actions, claims under section 459 and under any new unfair prejudice remedy that may be created as a result of this project?<sup>82</sup>

<sup>78</sup> See para 20.31 above.

<sup>79</sup> See paras 20.32-20.33 above.

<sup>80</sup> See paras 20.35-20.38 above.

<sup>81</sup> See para 20.39 above.

<sup>82</sup> See paras 20.40-20.43 above.

# **APPENDIX A RELEVANT EXTRACTS FROM THE COMPANIES ACT 1985**

## **Section 14**

(1) Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.

(2) Money payable by a member to the company under the memorandum or articles is a debt due from him to the company, and in England and Wales is of the nature of a specialty debt.

...

## **Section 35**

(1) The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum.

(2) A member of a company may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity; but no such proceedings shall lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

(3) It remains the duty of the directors to observe any limitations on their powers flowing from the company's memorandum; and action by the directors which but for subsection (1) would be beyond the company's capacity may only be ratified by the company by special resolution.

A resolution ratifying such action shall not affect any liability incurred by the directors or any other person; relief from any such liability must be agreed to separately by special resolution.

(4) The operation of this section is restricted by section 65(1) of the Charities Act 1993 and section 112(3) of the Companies Act 1989 in relation to companies which are charities; and section 322A below (invalidity of certain transactions to which directors or their associates are parties) has effect notwithstanding this section.

## **Section 35A**

(1) In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution.



- (2) For this purpose—
- (a) a person “deals with” a company if he is a party to any transaction or other act to which the company is a party;
  - (b) a person shall not be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company’s constitution; and
  - (c) a person shall be presumed to have acted in good faith unless the contrary is proved.
- (3) The references above to limitations on the directors’ powers under the company’s constitution include limitations deriving—
- (a) from a resolution of the company in general meeting or a meeting of any class of shareholders, or
  - (b) from any agreement between the members of the company or of any class of shareholders.
- (4) Subsection (1) does not affect any right of a member of the company to bring proceedings to restrain the doing of an act which is beyond the powers of the directors; but no such proceedings shall lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.
- (5) Nor does that subsection affect any liability incurred by the directors, or any other person, by reason of the directors’ exceeding their powers.
- (6) The operation of this section is restricted by section 65(1) of the Charities Act 1993 and section 112(3) of the Companies Act 1989 in relation to companies which are charities; and section 322A below (invalidity of certain transactions to which directors or their associates are parties) has effect notwithstanding this section.

...

### **Section 459**

- (1) A member of a company may apply to the court by petition for an order under this Part on the ground that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.
- (2) The provisions of this Part apply to a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law, as

those provisions apply to a member of the company; and references to a member or members are to be construed accordingly.

(3) In this section (and so far as applicable for the purposes of this section, in section 461(2)) “company” means any company within the meaning of this Act or any company which is not such a company but is a statutory water company within the meaning of the Statutory Water Companies Act 1991.

#### **Section 460**

(1) If in the case of any company—

- (a) the Secretary of State has received a report under section 437, or exercised his powers under section 447 or 448 of this Act or section 43A or 44(2) to (6) of the Insurance Companies Act 1982, and
- (b) it appears to him that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members, or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial,

he may himself (in addition to or instead of presenting a petition for the winding up of the company) apply to the court by petition for an order under this Part.

(2) In this section (and, so far as applicable for its purposes, in the section next following) “company” means any body corporate which is liable to be wound up under this Act.

#### **Section 461**

(1) If the court is satisfied that a petition under this Part is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of.

(2) Without prejudice to the generality of subsection (1), the court’s order may—

- (a) regulate the conduct of the company’s affairs in the future,
- (b) require the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do,
- (c) authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct,
- (d) provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company’s capital accordingly.

(3) If an order under this Part requires the company not to make any, or any specified, alteration in the memorandum or articles, the company does not then have the power without leave of the court to make any such alteration in breach of that requirement.

(4) Any alteration in the company's memorandum or articles made by virtue of an order under this Part is of the same effect as if duly made by resolution of the company, and the provisions of this Act apply to the memorandum or articles as so altered accordingly.

(5) An office copy of an order under this Part altering, or giving leave to alter, a company's memorandum or articles shall, within 14 days from the making of the order or such longer period as the court may allow, be delivered by the company to the registrar of companies for registration; and if a company makes default in complying with this subsection, the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(6) The power under section 411 of the Insolvency Act to make rules shall, so far as it relates to a winding-up petition, apply for the purposes of a petition under this Part.

...

#### **Section 726**

(1) Where in England and Wales a limited company is plaintiff in an action or other legal proceeding, the court having jurisdiction in the matter may, if it appears by credible testimony that there is reason to believe that the company will be unable to pay the defendant's costs if successful in his defence, require sufficient security to be given for those costs, and may stay all proceedings until the security is given.

(2) Where in Scotland a limited company is pursuer in an action or other legal proceeding, the court having jurisdiction in the matter may, if it appears by credible testimony that there is reason to believe that the company will be unable to pay the defender's expenses if successful in his defence, order the company to find caution and sist the proceedings until caution is found.

## **APPENDIX B RELEVANT EXTRACTS FROM THE INSOLVENCY ACT 1986**

### **Section 122**

- (1) A company may be wound up by the court if—
- (a) the company has by special resolution resolved that the company be wound up by the court,
  - (b) being a public company which was registered as such on its original incorporation, the company has not been issued with a certificate under section 117 of the Companies Act (public company share capital requirements) and more than a year has expired since it was so registered,
  - (c) it is an old public company, within the meaning of the Consequential Provisions Act,
  - (d) the company does not commence its business within a year from its incorporation or suspends its business for a whole year,
  - (e) except in the case of a private company limited by shares or by guarantee, the number of members is reduced below 2,
  - (f) the company is unable to pay its debts,
  - (g) the court is of the opinion that it is just and equitable that the company should be wound up.

...

### **Section 125**

- (2) If the petition is presented by members of the company as contributories on the ground that it is just and equitable that the company should be wound up, the court, if it is of opinion—
- (a) that the petitioners are entitled to relief either by winding up the company or by some other means, and
  - (b) that in the absence of any other remedy it would be just and equitable that the company should be wound up,

shall make a winding-up order; but this does not apply if the court is also of the opinion both that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy.

...

**Section 127**

In a winding up by the court, any disposition of the company's property, and any transfer of shares, or alteration in the status of the company's members, made after the commencement of the winding up is, unless the court otherwise orders, void.

## **APPENDIX C RELEVANT EXTRACTS FROM THE RULES OF THE SUPREME COURT**

### **Order 15, rule 12A**

(1) This rule applies to every action begun by writ by one or more shareholders of a company where the cause of action is vested in the company and relief is accordingly sought on its behalf (referred to in this rule as a “derivative action”).

(2) Where a defendant in a derivative action has given notice of intention to defend, the plaintiff must apply to the Court for leave to continue the action.

(3) The application must be supported by an affidavit verifying the facts on which the claim and the entitlement to sue on behalf of the company are based.

(4) Unless the Court otherwise orders, the application must be issued within 21 days after the relevant date, and must be served, together with the affidavit in support and any exhibits to the affidavit, not less than 10 clear days before the return day on all defendants who have given notice of intention to defend; any defendant so served may show cause against the application by affidavit or otherwise.

(5) In paragraph (4), the relevant date means the later of

- (a) the date of service of the statement of claim;
- (b) the date when notice of intention to defend was given (provided that, where more than one notice of intention to defend is given, that date shall be the date when the first notice was given).

(6) Nothing in this rule shall prevent the plaintiff from applying for interlocutory relief pending the determination of an application for leave to continue the action.

(7) In a derivative action, Order 18, rule 2(1) (time for service of defence) shall not have effect unless the Court grants leave to continue the action and, in that case, shall have effect as if it required the defendant to serve a defence within 14 days after the order giving leave to continue, or within such other period as the Court may specify.

(8) On the hearing of the application under paragraph (2), the Court may

- (a) grant leave to continue the action, for such period and upon such terms as the Court may think fit;
- (b) subject to paragraph (11), dismiss the action;

(c) adjourn the application and give such directions as to joinder of parties, the filing of further evidence, discovery, cross examination of deponents and otherwise as it may consider expedient.

(9) If the plaintiff does not apply for leave to continue the action as required by paragraph (2) within the time laid down in paragraph (4), any defendant who has given notice of intention to defend may apply for an order to dismiss the action or any claim made in it by way of derivative action.

(10) On the hearing of such an application for dismissal, the Court may

(a) subject to paragraph (11), dismiss the action;

(b) if the plaintiff so requests, grant the plaintiff (on such terms as to costs or otherwise as the Court may think fit) an extension of time to apply for leave to continue the action; or

(c) make such other order as may in the circumstances be appropriate.

(11) Where only part of the relief claimed in the action is sought on behalf of the company, the Court may dismiss the claim for that part of the relief under paragraphs (8) and (10), without prejudice to the plaintiff's right to continue the action as to the remainder of the relief and Order 18, rule 2(1) shall apply as modified by paragraph (7).

(12) If there is a material change in circumstances after the Court has given leave to the plaintiff to continue the action in pursuance of an application under paragraph (2), any defendant who has given notice of intention to defend may make an application supported by affidavit requiring the plaintiff to show cause why the Court should not dismiss the action or any claim made in it by way of derivative action. On such application the Court shall have the same powers as it would have had upon an application under paragraph (2).

(13) The plaintiff may include in an application under paragraph (2) an application for an indemnity out of the assets of the company in respect of costs incurred or to be incurred in the action and the Court may grant such indemnity upon such terms as may in the circumstances be appropriate.

(14) So far as possible, any application under paragraph (13) and any application by the plaintiff under Order 14 shall be made so as to be heard at the same time as the application under paragraph (2).

...

**Order 23, rule 1**

(1) Where, on the application of a defendant to an action or other proceeding in the High Court, it appears to the Court—

- (a) that the plaintiff is ordinarily resident out of the jurisdiction, or
- (b) that the plaintiff (not being a plaintiff who is suing in a representative capacity) is a nominal plaintiff who is suing for the benefit of some other person and that there is reason to believe that he will be unable to pay the costs of the defendant if ordered to do so, or
- (c) subject to paragraph (2) that the plaintiff's address is not stated in the writ or other originating process or is incorrectly stated therein, or
- (d) that the plaintiff has changed his address during the course of the proceedings with a view to evading the consequences of the litigation,

then if, having regard to all the circumstances of the case, the Court thinks it just to do so, it may order the plaintiff to give such security for the defendant's costs of the action or other proceeding as it thinks just.

(2) The Court shall not require a plaintiff to give security by reason only of paragraph (1)(c) if he satisfies the Court that the failure to state his address or the mis-statement thereof was made innocently and without intention to deceive.

(3) The references in the foregoing paragraphs to a plaintiff and a defendant shall be construed as references to the person (howsoever described on the record) who is in the position of plaintiff or defendant, as the case may be, in the proceeding in question, including a proceeding on a counterclaim.



## **APPENDIX D PREDECESSORS TO THE CURRENT SECTION 459 OF THE COMPANIES ACT 1985**

### **Section 210 of the Companies Act 1948**

(1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) ... may make an application to the court by petition for an order under this section.

(2) If on any such petition the court is of opinion—

- (a) that the company's affairs are being conducted as aforesaid; and
- (b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up;

the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.

...

### **Section 75 of the Companies Act 1980**

(1) Any member of a company may apply to the court by petition for an order under this section on the ground that the affairs of the company are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

...

(3) If the court is satisfied that a petition under this section is well founded it may make such order as it thinks fit for giving relief in respect of the matters complained of.

(4) Without prejudice to the generality of subsection (3) above, an order under this section may -

- (a) regulate the conduct of the company's affairs in the future;

- (b) require the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do;
- (c) authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct;
- (d) provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly.

...

**Section 459 of the Companies Act 1985 (pre amendment by the Companies Act 1989)**

(1) A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

...

# **APPENDIX E STATISTICS**

## **Statistics relating to the filing of section 459 petitions**

1.1 The court files relating to petitions presented to the Companies Court at the Royal Courts of Justice between January 1994 and December 1995 seeking relief under section 459 of the Companies Act 1985 were inspected with the leave of Mr Registrar Buckley.

1.2 A total of 170 petitions were recorded as presented during the relevant period. All but ten were inspected (owing to availability). Of those inspected, 156 were found to be petitions under section 459.

**Table 1: Statistics relating to petitions under section 459**

		of 156	%
Petitioner	minority shareholder/s	113	72.4
	50% shareholder	35	22.4
	majority shareholder	3	1.9
	personal representative	4	2.6
	unknown	1	0.6
Sections	459 alone	94	60.3
	459 and 122(1)(g)*	61	39.1
	54† (in addition to any of above)	1	0.6
	371† (in addition to any of above)	2	1.3
Type of company	private	150	96.2
	public	6	3.8
No of shareholders	2	54	34.6
	3 - 5	78	50.0
	6 - 10	13	8.3
	over 10	8	5.1
	not known	3	1.9
Pre-existing partnership	no partnership	140	89.7
	partnership of		
	<i>up to 3 years</i>	5	3.2
	<i>over 3 years</i>	2	1.3
	<i>unknown length</i>	9	5.8
Involvement in management	all/most of shareholders involved		
	<i>joint venture</i>	13	8.3
	<i>family company</i>	28	17.9
	<i>other cases where all/most involved</i>	82	52.6
	not mostly involved/unclear	33	21.2
Ebrahimi considerations pleaded‡	mutual trust and confidence	51	32.7
	continued participation	61	39.1
	restriction on transfer of shares	0	0
Specific reference to quasi-partnership		47	30.1
Legitimate expectation pleaded‡		97	62.2
Time span of allegations	up to 1 year	58	37.2
	1 - 2 years	24	15.4
	2 - 5 years	41	26.3
	5 - 10 years	9	5.8
	over 10 years	6	3.8
	not given/applicable	18	11.5
<b>Average: 2.9 years</b>			

Allegations pleaded	exclusion from management	105	67.3	
	failure to provide information	65	41.7	
	mismanagement	36	23.1	
	misappropriation of assets	64	41.0	
	excessive remuneration	18	11.5	
	failure to remunerate/pay dividend	39	25.0	
	improper allotment/unfair increase in capital	16	10.3	
	unfair offer for shares/failure to purchase	6	3.8	
	failure to register	4	2.6	
	breach of statute	36	23.1	
	breach of articles	13	8.3	
	breach of agreement	39	25.0	
	other breach of fiduciary duty	31	19.9	
	deadlock	6	3.8	
	other	51	32.7	
	Relief sought under s 461	purchase of P's shares	109	69.9
		sale of R's shares	32	20.5
purchase or sale of shares in related co		3	1.9	
injunction		39	25.0	
declaration		23	14.7	
regulation of co affairs		14	9.0	
461(2)(c)		26	16.7	
duty to account		30	19.2	
compensatory damages		11	7.1	
interest		5	3.2	
rectification		8	5.1	
appointment of receiver		5	3.2	
other		10	6.4	
Relief under 122(1)(g)	61	39.1		
Other statutory relief	5	3.2		
Rule 5 hearing	points of claim ordered	39	25.0	
	petition to stand as points of claim	61	39.1	
	no order made as to pleadings	56	35.9	
	order preventing advertisement	42	26.9	
	pre-trial hearing ordered	1	0.6	
Strike out	applied for	33	21.2	
	<i>successful (including in part)</i>	12	36.4	
	<i>failing completely</i>	8	24.2	
	<i>no order made</i>	13	39.4	

Outcome	ongoing	66	42.3
	settlement	37	23.7
	struck out entirely	10	6.4
	full hearing	7	4.5
	adjourned generally/stayed	8	5.1
	dormant	28	17.9
Time for disposal of first instance proceedings	up to 3 months	19	12.2
	3 - 6 months	16	10.3
	6 - 12 months	12	7.7
	over 12 months	7	4.5
	not disposed of	102	65.4
Average: <b>5.38 months</b>			
Legally aided petitioner		30	19.2

#### NOTES

- \* Of the Insolvency Act 1986.
- † Of the Companies Act 1985.
- ‡ Note that any given petition may include reference to one or more of these considerations.
- Ⓟ Including reliance on agreement, without necessarily specific reference to legitimate expectations.
- Ⓟ Note that any given petition may include reference to one or more of these allegations.
- Ⓟ Note that any given petition may include reference to one or more of these forms of relief.
- Ⓟ Under sections 54, 359 or 371 of the Companies Act 1985, or statutory interest under section 35A of the Supreme Court Act 1981.
- Ⓟ In one of these, points of claim were ordered only “if different from the petition”.
- Ⓟ In another case, the initial hearing at trial of specified issues was ordered.
- Ⓟ One of these was ordered to be struck out unless the petitioner accepted the offer made by the respondent.

## Statistics relating to the size of companies

**Table 2: Size of companies by accounts filed in 1994-95 (Great Britain)<sup>1</sup>**

Type of accounts	Thousands of companies	%
Full	266.8	34.0
Small <sup>2</sup>	379.6	48.4
Medium	3.8	0.5
Group <sup>3</sup>	15.3	1.9
Dormant	117.8	15.0
Interim/initial	0.3	0.0
<b>TOTAL</b>	<b>783.7</b>	<b>100.0</b>

<sup>1</sup> Source: DTI, *Companies in 1994-95* (1995).

<sup>2</sup> For the definition of small and medium-sized companies, see Part 12, para 12.29.

<sup>3</sup> Group accounts must be prepared in addition to individual accounts if at the end of a financial year a company is a parent company (s 227(1) of the Companies Act 1985). Group accounts contain (a) a consolidated balance sheet dealing with the state of affairs of the parent company and its subsidiary undertakings, and (b) a consolidated profit and loss account dealing with the profit or loss of the parent company and its subsidiary undertakings (s 227(3)). Group accounts need not be prepared if the parent company is itself a subsidiary of a different company (s 228). A parent company need not prepare such accounts if the group qualifies as small or medium-sized (s 248). A group is small or medium-sized if 2 or more of its aggregate turnover, aggregate balance sheet total and aggregate number of employees satisfy the conditions for small or medium-sized companies set out at Part 12, para 12.29 (s 249).

**Table 3: Size of companies by turnover in 1995 (United Kingdom)<sup>4</sup>**

Turnover size (£1000s)	Number of companies	%
1-49	92,700	18
50-99	83,560	16
100-249	108,355	21
250-499	73,875	14
500-999	60,420	12
1000-1999	40,030	8
2000-4999	30,190	6
5000-9999	12,015	2
10000 and over	14,820	3
<b>TOTAL</b>	<b>515,965</b>	<b>100</b>

**Table 4: Size of companies by issued share capital as at 31 March 1995 (Great Britain)<sup>5</sup>**

Issued share capital	Thousands of companies	Issued capital £m
No issued capital	39.1	0.0
Up to £100	702.3	28.5
Over £100 - under £1,000	53.5	20.0
£1,000 - under £5,000	111.0	177.5
£5,000 - under £10,000	33.3	205.5
£10,000 - under £20,000	44.8	527.5
£20,000 - under £50,000	39.8	1,151.4
£50,000 - under £100,000	30.0	1,865.0
£100,000 - under £200,000	22.4	2,767.7
£200,000 - under £500,000	17.2	4,752.8
£500,000 - under £1m	8.9	5,869.4
£1m & over	21.9	495,087.5
<b>TOTAL</b>	<b>1,124.2</b>	<b>512,784.2</b>

<sup>4</sup> Source: Office for National Statistics, *Business Monitor PA1003: Size Analysis of UK Businesses* (1995). The companies include building societies, but exclude 28,739 enterprises with zero VAT turnover and all enterprises without a VAT basis. Turnover relates mainly to a 12 month period ending in Spring 1994.

<sup>5</sup> Source: DTI, *Companies in 1994-95* (1995).



# APPENDIX F

## SUMMARY OF “OPPRESSION” OR “UNFAIR PREJUDICE” REMEDIES AND DERIVATIVE ACTIONS IN OTHER JURISDICTIONS

### AUSTRALIA

1.1 The Corporations Law is a single legislative provision which, by virtue of the Corporations Act 1989 and similar Acts in each of the states of Australia, is applicable in each state.

#### The proposed statutory derivative action

1.2 In 1990 the Companies and Securities Law Review Committee (“CSLRC”) recommended the enactment of a statutory derivative action, as did the Companies and Securities Advisory Committee (“CASAC”) in 1993.<sup>1</sup> In September 1995, draft provisions were published by the Attorney-General’s Department.<sup>2</sup> The Federal Government is considering whether to proceed with the reform. The provisions would be located in a new Part 2F.2 of Chapter 2F of the Corporations Law and would be numbered sections 245A-245G.<sup>3</sup>

1.3 The background to the proposals was “widespread discontent” with the rule in *Foss v Harbottle*,<sup>4</sup> the expense of litigation and shareholders’ difficulties in obtaining information from the company.<sup>5</sup> The CASAC set out the goals of their reform in section B of their report.<sup>6</sup> They considered that shareholder litigation could be seen as a mechanism for maintaining investor confidence as it assists in policing management. They thought that in many respects private enforcement would be preferable to public enforcement of directors’ duties.<sup>7</sup> They recognised that management needs to be protected against hostile and

<sup>1</sup> CSLRC, *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action, Report No 12* (1990); CASAC, *Report on a Statutory Derivative Action* (1993). Recommendations for a statutory derivative action were also made by the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991) and by the Australian Securities Commission (“ASC”) in its submissions to the Standing Committee.

<sup>2</sup> *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995). The change of name was to reflect better the nature of the proceedings involved, *ibid*, at p 3.

<sup>3</sup> See Appendix G.

<sup>4</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>5</sup> CASAC, *Report on a Statutory Derivative Action* (1993) p 1. The proposals include increased rights of access to information; see Appendix G. The Attorney-General’s consultation document referred to difficulties as to the effect of ratification of impugned conduct, lack of access to company funds by shareholders to finance proceedings and the strict criteria which need to be established before the courts grant leave. *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 2.

<sup>6</sup> *Report on a Statutory Derivative Action* (1993) pp 4-5.

<sup>7</sup> Among other reasons because it is cheaper for the tax payer and likely to be less bureaucratic for business.

vexatious litigants who are not acting in the best interests of the company and thus that any law reform in this area should contain safeguards to prevent harmful shareholder litigation.

1.4 The draft legislation expressly abolishes the common law right to bring an action on behalf of a company.<sup>8</sup> This is said, in the Attorney-General's consultation paper, "... to promote certainty ... and avoid confusion between diverging principles of the statutory action and the common law action".<sup>9</sup> The CASAC noted that in Canada the common law had not been expressly repealed, but that the courts had held that common law actions were impliedly prohibited by the legislation.<sup>10</sup>

1.5 Under the proposals if a person, including a former member,<sup>11</sup> obtains the leave of the court he may bring proceedings<sup>12</sup> on behalf of a company or intervene in proceedings to which the company is party.<sup>13</sup> The court is obliged to grant leave if five preconditions are satisfied. They are: that it is probable that the company will not take the proceedings; that the applicant is acting in good faith;<sup>14</sup> that the grant of leave is in the best interests of the company;<sup>15</sup> that there is a serious question to be tried;<sup>16</sup> and either 14 days written notice of the application and the reasons for it have been given to the company or, even if the notice requirement has not been satisfied, that leave is appropriate.<sup>17</sup>

<sup>8</sup> See cl 245A(3); Appendix G.

<sup>9</sup> *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 4.

<sup>10</sup> *Report on a Statutory Derivative Action* (1993) p 13.

<sup>11</sup> See cl 245A(1); Appendix G. The CASAC disagreed with the CSLRC's recommendation that former members should be included, as it considered that this would create too wide a category of persons that could apply; *ibid*, at p 14. The CSLRC considered that it is the "appropriateness of the applicant" to enforce the company's right of action that should be the most important factor rather than his status in respect of the company which, however, could also be taken into account: *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action, Report No 12* (1990) p 10.

<sup>12</sup> There is no restriction on the cause of action.

<sup>13</sup> See cl 245A(1); Appendix G.

<sup>14</sup> This is intended to prevent the proceedings from being used to further the purposes of the applicant rather than the company as a whole and the court could be expected to have regard to the applicant's complicity in the matters complained of: Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 5.

<sup>15</sup> This is intended to focus on the "true purpose" of the proceedings and to allow the court to take into account "... that a company might have sound business reasons for not pursuing a cause of action open to it and that its management might legitimately have decided that to refrain from taking action would be in the best interests of the company. For example, a decision may be taken in a case where, although it may be clear that there has been a breach of duty by a director, the loss to the company may only be nominal. In this case, the cost of taking proceedings may outweigh any benefit to the company". *Ibid*, at p 5.

<sup>16</sup> This test "... is a familiar and accepted test employed by the courts ..." in interim injunction cases, and is preferred as being less likely than the "prima facie" test to turn the leave application into a trial of the issues. "The applicant is simply required to show that proceedings should be commenced". *Ibid*, at p 6.

<sup>17</sup> See cl 245B(2); Appendix G.

1.6 The application for leave is not to be dismissed by reason only that an alleged breach of duty owed to the company has been or may be ratified or approved by the shareholders of that company, although the court may take that into account.<sup>18</sup> Further, the draft legislation expressly provides that such ratification or approval is not to have the effect that the derivative action must be decided in favour of the defendant.<sup>19</sup>

1.7 The court has power to substitute other people for the person granted leave.<sup>20</sup> There can be no settlement of the proceedings without the court's permission.<sup>21</sup> The court may make any orders, and give any directions, that it thinks just in relation to the proceedings. One of the powers expressly mentioned is the power to appoint an independent person to investigate and report to the court on the company's financial affairs, the facts or circumstances of the case, or the costs incurred by the parties.<sup>22</sup> Such a person is entitled, on giving reasonable notice, to inspect any books of the company.<sup>23</sup>

1.8 The court would, under the proposals, have power to make any orders it thinks just in relation to the costs of the applicant, the company, or of any other party, including an indemnity order.<sup>24</sup>

<sup>18</sup> This approach was intended to avoid the court having to consider whether or not the conduct complained of was ratifiable and whether it has been effectively ratified: Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 7.

<sup>19</sup> See, generally, cl 245D; Appendix G.

<sup>20</sup> See cl 245C; Appendix G.

<sup>21</sup> See cl 245E; Appendix G.

<sup>22</sup> See cl 245F(1)(d); Appendix G.

<sup>23</sup> See cl 245F(2); Appendix G. This is designed to ensure that when a company is funding the action the court will be able to find out independently of the parties whether those funds are being expended in a reasonable manner and whether the complaint constitutes a good cause of action: Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 8.

<sup>24</sup> See cl 245G; Appendix G.

### **The oppression remedy (section 260 of the Corporations Law)**

1.9 A member<sup>25</sup> may apply under this section if he believes:

(i) that affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members, or in a manner that is contrary to the interests of the members as a whole; or

(ii) that an act or omission, or a proposed act or omission, by or on behalf of the company, or a resolution, or a proposed resolution, of a class of members, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or was or would be contrary to the interests of the members as a whole.

1.10 Section 260 gives a general discretion to make any order. Among those expressly listed are: purchase orders; orders regulating the conduct of the company's affairs; orders to wind up companies; and orders directing the company or authorising a member to institute, prosecute, defend, or discontinue specified proceedings in the company's name.<sup>26</sup>

1.11 The remedy is closely related to that of winding up. Not only does section 260 allow the court to wind up on proof of matters there set out, but a similar provision is found in section 461 of the Corporations Law, which also sets out other grounds for winding up including on just and equitable grounds. Winding up under either provision is ordinarily deemed to have commenced on the day when the order is made.<sup>27</sup> Transactions will usually be void, pursuant to section 468(1),<sup>28</sup> if entered into after commencement.

### **First Corporate Law Simplification Act 1995**

1.12 The First Corporate Law Simplification Act 1995 ("the 1995 Act") is the first piece of legislation to emerge from the Corporations Law Simplification Programme, announced in 1993. The 1995 Act is designed to simplify the provisions of the Corporations Law in relation to share buy-backs, proprietary companies<sup>29</sup> and company registers.

1.13 The aims of its provisions for proprietary companies are to reduce regulation and to help owners of small businesses understand the rights and responsibilities resulting from

<sup>25</sup> In contrast with the statutory derivative action (see para 1.5 above), there is no reference to former members.

<sup>26</sup> This last power would be removed under the proposals for a new derivative action: Attorney-General's Department, *Proceedings on Behalf of a Company, Draft Provisions and Commentary* (1995) p 9.

<sup>27</sup> Section 513A(e) of the Corporations Law.

<sup>28</sup> "Any disposition of property of the company, other than an exempt disposition, and any transfer of shares or alteration in the status of the members of the company made after the commencement of the winding up by the Court is, unless the Court otherwise orders, void".

<sup>29</sup> I.e. private companies.

incorporation. It includes, in Schedule 3, the Small Business Guide which does not contain operative provisions, but summarises the main provisions of the Corporations Law that are likely to be relevant to small companies. It gives an overview and provides short answers to basic questions about the Corporations Law, and then directs the reader to the relevant part if more detail is required.<sup>30</sup>

1.14 Its contents include, among other chapters, the following: “What incorporation means”; “Setting up a new company”; and “Disagreements within the company”. There are three paragraphs in the last mentioned chapter. The first reads as follows:

**10.1 Special problems faced by minority shareholders**

There are remedies available to a shareholder of a company if:

- the affairs of the company are being conducted in a way that is unfair to that shareholder or to other shareholders of the company; or
- the affairs of the company are being conducted in a way that is against the interests of the company as a whole.

A Court may, for example, order the winding up of a company or the appointment of a receiver.

[sections 260, 461]

1.15 The Small Business Guide is also published separately from the 1995 Act and is available primarily through the Australian Government Publishing Service although the Corporations Law Simplification Unit hope that some organisations will arrange their own distribution and sale.

<sup>30</sup> The Parliament of the Commonwealth of Australia, House of Representatives, First Corporate Law Simplification Bill 1994, Explanatory Memorandum. (Circulated by the authority of the Attorney-General, the Hon Michael Lavarch, MP).

## CANADA

2.1 New corporate law statutes were enacted by the Canadian Federal Parliament and in seven of the ten provinces in the 1970s and 1980s. These reforms followed the publication in 1971 of the Dickerson Report.<sup>1</sup> Whilst the detailed provisions contained in the different statutes are not identical, six are similar to the federal Canada Business Corporations Act (“CBCA”) and the following analysis is largely based on that Act.

2.2 The Dickerson Report stated that there were two reasons for including remedies of “much wider application” than the specific remedies to enforce compliance with discrete rules. The first reason was the “extraordinarily permissive” nature of the draft Act<sup>2</sup> in omitting altogether what the authors considered to be “largely formalistic” safeguards such as “... minimum capital contributions, limited and clearly specified objects, statutory restrictions on conditions attached to shares and so on, allowing considerable scope for misconduct and therefore requiring fast, effective remedies to prevent abuse of the rights of persons having an interest in a business corporation.” The second reason for including wide remedies was said to be the impossibility of anticipating all the possibilities of “misuse” of the versatile nature of the company.<sup>3</sup>

### **The derivative action (section 239 of the CBCA)<sup>4</sup>**

2.3 The Dickerson Committee intended that the new statutory regime should abrogate the rule in *Foss v Harbottle*<sup>5</sup> and substitute a new regime to govern the conduct of derivative actions.<sup>6</sup> The section creates a right to apply for leave to bring an action on behalf of a corporation or to intervene in an action to which it is party. The application may be made by complainants who are defined widely to include former members among others.<sup>7</sup> The control over the right created by this section is to be found in the prerequisites for leave. It will only be granted if the court is satisfied on three counts. The first is that reasonable notice has been served on the directors, the second is that the complainant is acting in good faith and the third is that the action is in the interests of the company.

2.4 Ratification does not bar the action but is to be taken into account by the court in considering the application for leave to bring a derivative action.<sup>8</sup> The action cannot be

<sup>1</sup> *Proposals for a New Business Corporations Law for Canada* (1971).

<sup>2</sup> Which formed part of the Dickerson Report.

<sup>3</sup> *Proposals for a New Business Corporations Law for Canada* (1971) Vol 1, para 474.

<sup>4</sup> It seems from information that we have received that this action is not frequently used, principally because the “oppression” remedy is of such broad application.

<sup>5</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>6</sup> *Proposals for a New Business Corporations Law for Canada* (1971) Vol 1, para 482.

<sup>7</sup> See s 238 of the CBCA.

<sup>8</sup> And in oppression claims. At para 487, the Dickerson Committee stated that they preferred this approach of characterising ratification as an evidentiary issue to setting out a specific rule as to how an act of directors could be ratified. They set out the way the provision might operate:

If, for example, the alleged misconduct was ratified by majority shareholders who were also the

settled or discontinued, except with the approval of the court.<sup>9</sup> No security for costs may be ordered against the complainant and the company may be ordered to make an interim costs payment to him.<sup>10</sup>

2.5 Turning to the relief available in these actions, section 240 makes provision that a court may at any time make such order as it thinks fit. Examples given include: orders as to the identity of the person who should control the proceedings; orders directing payment to shareholders of sums awarded against the defendant;<sup>11</sup> and costs indemnities.

2.6 Double derivative actions are available under section 239 in that it permits applications for leave to bring actions on behalf of "... a corporation or any of its subsidiaries".<sup>12</sup> "Subsidiary" is defined in section 2 as a company controlled by another company, and control is defined as holding securities to which are attached more than 50 per cent of the votes that can be cast in electing directors, the votes must also be sufficient, if exercised, to elect a majority of directors.

### **The oppression/unfair prejudice remedy (section 241 of the CBCA)**

2.7 This is open to complainants who are defined widely in section 238 and include former shareholders. In order to obtain a remedy under this section it is necessary to prove conduct that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, any security holder, creditor, director, or officer. Such conduct is expressed to include acts or omissions of the company or its affiliates, and the exercise of powers by directors. The remedies available are not limited, but the section sets out a list of 14 including, in section 241(3)(h), an order setting aside a contract to which the company is party and compensating the company and, in section 241(3)(l), an order liquidating and dissolving the company.

2.8 There is a close relationship between this remedy and winding up, in that, under section 214 of the CBCA, a shareholder can apply for liquidation and dissolution of the company on the same grounds as are set out in section 241, or other grounds, including that it is just and equitable. On such an application, the court may grant section 241 relief. As mentioned above, on finding that there has been unfair prejudice under section 241, the court may order winding up.

directors whose conduct is attacked, evidence of shareholder ratification would carry little or no weight. If, however, the alleged misconduct was ratified by a majority of disinterested shareholders after full disclosure of the facts, that evidence would carry much more weight indicating that the majority of disinterested shareholders condoned the act or dismissed it as a mere error of business judgment.

<sup>9</sup> See s 242(2) of the CBCA.

<sup>10</sup> See s 242 of the CBCA.

<sup>11</sup> At para 483, the Dickerson Committee gave examples of situations in which this power might be exercised as follows: "... where a corporation has redeemed or purchased its own shares or has been liquidated or dissolved ...".

<sup>12</sup> *Proposals for a New Business Corporations Law for Canada* (1971) para 481.

2.9 Under similar provisions in British Columbia, it has been held that facts can satisfy the test for just and equitable winding up while not amounting to unfairly prejudicial conduct.<sup>13</sup>

2.10 A number of the provisions that relate to the statutory derivative action also apply to these applications. These are:<sup>14</sup> no settlement of the case without the court's approval; ratification is not a bar but may be taken into account; complainants cannot be ordered to provide security for costs; and the company may be ordered to pay the complainant interim costs which the complainant may later have to repay.

<sup>13</sup> *Safarik v Ocean Fisheries Ltd and Safarik* 20 September 1995 (unreported, Court of Appeal for British Columbia) pp 58 and 63. The issue of whether there could be facts which, while not justifying winding up on just and equitable grounds, would justify winding up on the grounds of unfairly prejudicial conduct was not addressed.

<sup>14</sup> See s 242 of the CBCA.



## **GHANA**

### **Statutory derivative action (section 210 of the Companies Code 1963)**

3.1 The 1963 legislation enacted the recommendations made in the Final Report of the Commission of Enquiry into the Working and Administration of the Company Law of Ghana in 1961 which was the work of Professor Gower. Prior to the enactment of the Companies Code 1963, derivative actions in this jurisdiction were governed by the rule in *Foss v Harbottle*.<sup>1</sup> In his commentary on the draft statutory derivative action,<sup>2</sup> Professor Gower summarises his criticisms of the rule and explains how each provision is intended to abrogate the problems highlighted. Our comments are based on his text.

3.2 The statutory derivative action set out in section 210 of the Companies Code 1963<sup>3</sup> provides a remedy for breaches of directors' duties as set out in sections 203-205.<sup>4</sup> Section 203(1) states the general principle that a director is in a fiduciary relationship with the company and shall observe the utmost good faith towards it, and section 203(2) imposes the duty that he must act in the best interests of the company as a whole, and act "... in such manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances".<sup>5</sup> Section 204 concerns the exercise of directors' powers, whereby directors must act within the powers granted to them, and must exercise their powers for a proper purpose.<sup>6</sup> Section 205 states that a director should not place himself in a position in which his duty to the company conflicts with his personal interests or other duties.<sup>7</sup> Under section 206 the company can ratify a breach of this duty if full disclosure of all material facts has been made, but any interested director may not vote on such a resolution. A director is made accountable for any breaches of duty by section 209. Section 210 sets out how proceedings may be brought to enforce those liabilities or to restrain a threatened breach of duty by court action.

<sup>1</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>2</sup> *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana* (1961) pp 152-153.

<sup>3</sup> See Appendix G. Unless otherwise stated, references to specific sections will be to provisions of the Companies Code 1963.

<sup>4</sup> See also s 218 which provides a remedy against oppression.

<sup>5</sup> These duties are seen as being of the utmost importance, and sub-section (4) states that such duties cannot be contracted out of either by means of the company's Regulations, any contract, or by any resolution of the company, nor can a director be relieved of any liability incurred as a result of such breach. As a result, it would appear that, whilst the company may resolve not to institute proceedings against the director in respect of such a breach, such a resolution will not prevent a member from bringing proceedings.

<sup>6</sup> A breach of s 204 may be ratified by an ordinary resolution of the company, but this is subject to the directors having acted in good faith.

<sup>7</sup> Eg, he should not be interested in a business in competition with the company, or use for his own advantage information obtained by him in his capacity as a director. Section 207 makes special provisions for directors to declare their interest in contracts to be entered into by the company.

3.3 Proceedings against directors for breach of duty may be brought by the company or by any member<sup>8</sup> of the company. Section 210(2) lays down the circumstances in which proceedings may be brought by the company. Of particular note is that the decision to bring proceedings may be made by the members by ordinary resolution at general meeting at which the proposed defendants are not entitled to vote.

3.4 Section 210(5) provides that an action by a member must be brought in a representative capacity<sup>9</sup> on behalf of himself and all other members (except the defendants). A purported ratification of a breach of a section 203 duty would not, by contrast with approval or ratification of breaches of sections 204 or 205, bar an action.<sup>10</sup>

3.5 There is no requirement for notice to be given to the company prior to the commencement of proceedings, nor is the leave of the court required. The grounds on which proceedings may be brought are clearly set out. They are to enforce liability for breaches of directors' duties under sections 203-205; to restrain any threatened breach of such duties; or to recover any company property from a director. There are no statutory requirements that the proceedings should be in the best interests of the company,<sup>11</sup> nor that the plaintiff should be acting in good faith, although, where the proceedings are brought by a member, a defendant may apply to the court for the proceedings to be stayed on the grounds that it is inequitable for the plaintiff member to have conduct of the action.<sup>12</sup> In determining this, the court will have regard to all the relevant circumstances, however, the section specifically mentions as relevant the member's participation in the transaction complained of and the circumstances in which he became a member of the company.

3.6 It is also possible, under section 210(6), for the court, whilst allowing the action to continue, to order that the plaintiff member gives security for costs. This subsection was introduced to discourage vexatious and blackmailing litigation. The court may also order that the action be heard in chambers, again, this possibility was intended to prevent litigation being used to blackmail directors.

<sup>8</sup> "Member" is defined in s 30, and, in the case of a company limited by shares, a member is defined by s 30(4) as a shareholder, who must be registered as such by the company: s 30(5).

<sup>9</sup> So that the company should not be harassed by a multiplicity of actions.

<sup>10</sup> See n 5 above.

<sup>11</sup> The proceedings need not be brought on behalf of the company; where a member brings proceedings under s 210 he does so in a representative capacity on behalf of himself and all other members, rather than on behalf of the company: s 210(5). Moreover, by s 210(8), the remedies available in such proceedings include a personal remedy for members or former members, as well as relief for the company itself. See para 3.7 below.

<sup>12</sup> See s 210(6).

3.7 Section 210(8) specifically adds to the remedies set out in section 209<sup>13</sup> so that the court has power to order that any sum found payable to the company by the defendant, may, instead, be paid to the members and former members.<sup>14</sup> Thus personal relief may be granted for corporate wrongs.<sup>15</sup>

3.8 By section 210(9), no proceedings under section 210 may be dismissed, settled or compromised without the consent of the court. This is to prevent the directors from buying off the plaintiff in disregard of the rights of the company and its members. Notice of any intention to dismiss, settle or compromise the action must first have been given to all the members of the company and to the Registrar, and they may make submissions to the court about the application. If the court is unwilling to approve the settlement or compromise, it may give the conduct of the action to any other member willing to continue it. Where no member is able or willing to pursue the action, but the court believes that the action should continue, the Registrar may take over, proceeding in the name of the company.

<sup>13</sup> By which the company may be compensated for any loss suffered as a result of the breach. The director may be made to account to the company for any profit made, and the company has the option to rescind any contract entered into between the director and the company.

<sup>14</sup> This is to avoid results such as that in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n where the purchasers of the holding company effectively obtained an unmeritorious reduction in the price which they paid for their shares. See Part 5, para 5.11 for the facts of this case.

<sup>15</sup> A member is not precluded from bringing proceedings under s 210 by the availability of a personal remedy other than under this section; see s 217(1)(c), which states that the right afforded to a member to apply to the court for an injunction or declaration in the event of an illegal or irregular act is without prejudice to any right he may have to institute proceedings under s 210, or make an application under the oppression remedy in s 218.

## NEW ZEALAND

4.1 The Companies Act 1993 (“the 1993 Act”),<sup>1</sup> introduced a new company law regime in New Zealand. During a transitional period two regimes are in operation. The Companies Act 1955 applies to companies which existed before 1 July 1994 until they re-register, which must be done by 30 June 1997. The 1993 Act applies to all companies which incorporated after 1 July 1994 and any older companies which re-register.

### **Statutory derivative action (sections 165-168)**

4.2 In 1993, not only was a statutory derivative action included in the new legislation, but it was also inserted into the Companies Act 1955 so that from that time it was available to shareholders in all New Zealand companies.<sup>2</sup>

4.3 There is no circumscription of the cause of action in respect of which a shareholder<sup>3</sup> can seek leave to bring a derivative action. It can be brought on behalf of a related company. Pursuant to section 165(6) no derivative action can be brought except as provided in the section. Notice of the application for leave must be served on the company. Leave will only be granted if either the court is satisfied that the company does not intend to bring the proceedings, or that it is in the interests of the company that the conduct of the proceedings should not be left to the directors or the shareholders as a whole. In exercising its discretion to grant leave, the court is to take into account: the likelihood of the action being successful; action already taken by the company; and the interests of the company in the proceedings being commenced.

4.4 In the first reported application for leave under the new provisions, *Vrij v Boyle*,<sup>4</sup> Fisher J held that, in considering the “likelihood of the proceedings succeeding”, he should not conduct an interim trial on the merits but apply the test that “... would be exercised by a prudent business person in the conduct of his or her own affairs when deciding whether to bring a claim”.<sup>5</sup> He went on to explain that this requires consideration of the amount at stake, the apparent strength of the claim and the prospect of enforcing any judgment.

4.5 The judge also considered that the fact that an applicant had an independent personal cause of action against the defendant should not prevent him conducting a derivative action on behalf of the company.<sup>6</sup>

<sup>1</sup> Unless otherwise stated, references to specific sections will be to provisions of the 1993 Act.

<sup>2</sup> Section 165 of the 1993 Act and Companies Act 1955, s 209X.

<sup>3</sup> Unlike the prejudiced shareholders remedy (see para 4.9 below), no reference is made to former shareholders.

<sup>4</sup> [1995] 3 NZLR 763.

<sup>5</sup> *Ibid*, at p 765.

<sup>6</sup> *Ibid*, at p 767.

4.6 Unless the court considers such an order to be unjust or inequitable, it must, on the application of the person to whom it granted leave, order the company to pay his costs or part of them.

4.7 At any stage in the proceedings the court can make any order it thinks fit and this includes: appointing either the shareholder applying or any other person to control the conduct of the proceedings; giving directions for the conduct of the proceedings; and ordering that sums awarded in the proceedings be paid to current or former shareholders instead of to the company. Furthermore, no derivative action can be settled or compromised without the approval of the court.

4.8 Section 177 deals with ratification.<sup>7</sup>

#### **Prejudiced shareholders remedy (section 174)**

4.9 This remedy is open to a shareholder or former shareholder “... who considers that the affairs of a company have been, or are being, or are likely to be, conducted in a manner that is, or any act or acts of the company have been, or are, or are likely to be, oppressive, unfairly discriminatory, or unfairly prejudicial to him or her in that capacity or in any other capacity ...”<sup>8</sup>

4.10 *Thomas v H W Thomas Ltd*<sup>9</sup> is the main case on the court’s approach to the interpretation of the words under section 209 of the Companies Act 1955.<sup>10</sup> Richardson J considered the meaning of “oppressive, unfairly discriminatory, or unfairly prejudicial”. He said:

The three expressions overlap, each in a sense helps to explain the other, and read together they reflect the underlying concern of the sub-section that conduct of the company which is unjustly detrimental to any member of the company whatever form it takes and whether it adversely affects all members alike or discriminates against some only is a legitimate foundation for a complaint under section 209.<sup>11</sup>

4.11 Under the provisions of section 175, failure to comply with the twelve sections specified is deemed to be unfairly prejudicial. They include: failure to give pre-emptive rights on issue of shares; failure by the board to comply with a provision as to authorisation of dividends; failure by the company to comply with provisions relating to alterations of shareholders’

<sup>7</sup> Consultees are referred to the text of the section set out in Appendix G. The final wording resulted from amendment during the legislative process and its effect is not clear.

<sup>8</sup> Section 174(1).

<sup>9</sup> [1984] 1 NZLR 686. A further passage from the judgment of Richardson J in this case is to be found in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 404.

<sup>10</sup> The equivalent to section 174 of the 1993 Act.

<sup>11</sup> [1984] 1 NZLR 686, 693.

rights; and failure to comply with a requirement for a special resolution to effect a major transaction.

4.12 Section 174(2) provides that the court, if it is “just and equitable” to do so, may make such order as it thinks fit. Without limiting the court’s power, certain orders are listed, including an order requiring the company or any other person to acquire the shareholder’s shares, an order that compensation be paid either to the company or another person, an order to put the company into liquidation<sup>12</sup> and an order setting aside action taken by the company or the board in breach of the 1993 Act or the constitution of the company.

<sup>12</sup> Liquidation commences on the date when the liquidator is appointed: s 241(5). Section 241 also gives the court power to wind up the company on just and equitable grounds.

## REPUBLIC OF SOUTH AFRICA

### Statutory derivative action

5.1 Many of the rules of the English common law of companies apply in South Africa with little or no modification, and these include the rule in *Foss v Harbottle*.<sup>1</sup>

5.2 A statutory derivative action was introduced in section 266 of the Companies Act No 61 of 1973 (“the 1973 Act”).<sup>2</sup> This was drafted by the Van Wyk de Vries Commission,<sup>3</sup> which identified as its major concerns in formulating the new remedy “... the disadvantage of the shareholder being ‘outside’ the company, in the sense that he has no access to the records of the company, the disadvantage of the defendants being in control of the company (the real plaintiff) and also the question of adequate deterrents to inhibit frivolous and vexatious proceedings”.

5.3 The statutory derivative action under section 266 serves to supplement rather than to replace a member’s right to bring a derivative action at common law. It does not provide a remedy in every situation in which one might be obtained under one of the exceptions to the rule in *Foss v Harbottle*. It is available to a member<sup>4</sup> of a company where:

- (i) the company has suffered damages or loss or has been deprived of a benefit;
- (ii) the loss was caused by a wrong, breach of trust or breach of faith committed by a director, officer,<sup>5</sup> or former director or officer of that company<sup>6</sup> whilst in office;

<sup>1</sup> (1843) 2 Hare 461; 67 ER 189.

<sup>2</sup> Unless otherwise stated, references to specific sections will be to provisions of the 1973 Act.

<sup>3</sup> *Commission of Enquiry into the Companies Act* RP 45/1970.

<sup>4</sup> By s 103, “member” is defined as a registered shareholder (or the holder of a share warrant, if the company’s articles so provide). In order to apply for an order under this section, an applicant need only be a member of the company at the time when the application for the appointment of the provisional *curator ad litem* is brought before the court. However, where the applicant has ceased to be a member of the company on the return date of the provisional order (see s 266(4) and para 5.7 below), the court will consider this as a relevant and important factor in deciding whether proceedings should be brought; see *Brown v Nanco (Pty) Ltd* 1977 (3) SA 761 (W). The fact that the applicant is also a director of the company does not preclude him from making an application under s 266, but the extent to which he has exercised his rights as a director and his conduct as director may be considered by the court in deciding whether to appoint a *curator ad litem*; see *Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC).

<sup>5</sup> “Officer” is defined in s 1(1) as including any managing director, manager or secretary of the company.

<sup>6</sup> The use of the phrase “that company” would appear to mean that the statutory derivative action is not usually available where the wrong has been committed by a director or officer of another company within the same group of companies as that in which the member was a shareholder. However, an exception to this is made in s 37(3)(b), whereby liability incurred by a director or officer as a result of his having authorised the company to give a loan or provide security to another company within the same group of companies, applies equally to directors and officers of a holding company. Section 37(3)(b) specifically states that where an action is brought to enforce a liability incurred under s 37(3), the provisions of s 266 shall be adapted to include wrongs etc committed by directors and officers of a holding company.

(iii) the company has not instituted proceedings for such damages, loss or benefit.<sup>7</sup>

A member may initiate proceedings regardless of the fact that the wrong has been condoned or ratified by the company in any way.<sup>8</sup>

5.4 Where these criteria are met, a member may initiate the action by serving a written notice on the company requesting the company to institute proceedings within one month, failing which, application will be made to the court.<sup>9</sup> If the company does not commence proceedings within one month from service of the notice, the member may apply to the court by motion, naming the company as respondent.<sup>10</sup>

5.5 The applicant member must prove to the court that there are prima facie grounds for the proceedings.<sup>11</sup> If the court is also satisfied that the company has not instituted proceedings<sup>12</sup> and that an investigation is justified, a provisional *curator ad litem*<sup>13</sup> may be appointed to investigate the claim made by the member.<sup>14</sup> The investigation of the provisional *curator ad litem* will be directed as to whether it is really worth taking action.<sup>15</sup> To enable him

<sup>7</sup> Section 266(1); see Appendix G.

<sup>8</sup> Section 266(1). However, a member of the company may intervene in the application for the purposes of opposing it; see *Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC), 684.

<sup>9</sup> Section 266(2)(a). The notice ought to be sufficiently specific to enable the company to know what proceedings it is being called upon to institute, albeit that the amount to be claimed and the precise circumstances in which the company came to suffer damages need not be specified in the notice: *Loeve v Loeve Building and Civil Engineering Contractors (Pty) Ltd* 1987 (2) SA 92 (D), 101.

<sup>10</sup> Section 266(2)(b).

<sup>11</sup> Section 266(3)(b). At this stage the question of whether an action against the wrongdoer is likely to succeed is not at issue: *Brown v Nanco (Pty) Ltd* 1976 (3) SA 832 (W), 835. However, it is necessary to prove that there are prima facie grounds; vague accusations and allegations will not suffice, even where it can be shown that an investigation by a provisional *curator ad litem* will probably expose some irregularities: *Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC), 685 and *Thurgood v Dirk Kruger Traders (Pty) Ltd* 1990 (2) SA 44 (E), 49-50.

<sup>12</sup> It is open to question whether, if the company complies with the written notice and institutes the requisite proceedings within the given period, but thereafter fails to prosecute and allows the proceedings to lapse, there is any recourse by a member to a remedy under s 266. However, it has been argued that the proceedings will not have been duly “instituted” within the meaning of subsection (3) if they have been instituted with no intention of prosecuting them to a proper conclusion, but in order to allow them to lapse for want of due prosecution. Such intention may be difficult to prove, save by lapse of time (ie the application for the appointment of a provisional *curator ad litem* is made after sufficient time has passed for the company to prosecute the case). See *Henocheberg on the Companies Act* (5th ed 1994) pp 512-513.

<sup>13</sup> This is usually a barrister of at least 10 years’ standing or a senior solicitor.

<sup>14</sup> Section 266(3). It is at the court’s discretion as to whether or not to appoint a provisional *curator ad litem*. It has been argued that facts which would preclude a particular member from bringing a derivative action under the common law would, ordinarily, cause the court to exercise its discretion against the application of such member under s 266 for the appointment of a provisional *curator ad litem*, or, if the facts emerge at a later stage, the confirmation of his appointment. See *Henocheberg on the Companies Act* (5th ed 1994) p 511.

<sup>15</sup> The provisional *curator ad litem* may conclude that, “... while there are prima facie grounds for the proceedings, the case is not of sufficient strength to justify the litigation desired by the applicants. Or his investigation may lead him to the conclusion that there is not even a prima facie cause of action”:



to do this, he has extensive investigative powers,<sup>16</sup> including a wide power to inspect the company's books and papers and to obtain all documents relating to the company from its directors, officers and agents (including its solicitors, auditors and bankers). These powers are subject to the qualification that if disclosure of any information about the affairs of the company to the *curator ad litem* would, in the opinion of the company, be harmful to its interests, the court may grant relief to the company if satisfied that the information concerned is not relevant to the investigation.<sup>17</sup>

5.6 The court will set a return day for the provisional *curator ad litem* to report on his findings. On this date, the court may discharge the provisional order (in which case no further action will be taken) or confirm the appointment of the *curator ad litem*, who will then have conduct of the proceedings on behalf of the company.<sup>18</sup> The legislation does not indicate which factors should influence the courts in making this decision, though it would appear that the wishes of the shareholders are of prime consideration.<sup>19</sup> It would, therefore, appear to be the case that, although approval or ratification will not preclude an action under section 266(1), the court will consider carefully whether it is desirable to allow the proceedings to continue, as this would, in effect, overrule the wishes of the majority. If the wrong has been ratified, it will be necessary for the court to declare the ratification of no effect, which it has the power to do under section 266(4).<sup>20</sup>

5.7 There is no specific requirement in the 1973 Act that the applicant should be acting in good faith. From early in the proceedings, and even where the appointment of a provisional *curator ad litem* is considered, it is for the court itself to guard against frivolous or vexatious applications, as the appointment of a *curator ad litem* may have far-reaching consequences for the company and its directors.<sup>21</sup> Again, on the return day, the question of

*Brown v Nanco (Pty) Ltd* 1976 3 (SA) 831, 835, per Eloff J.

<sup>16</sup> In addition to those specifically granted to him by the court, he has, by virtue of s 267, the same powers as those given by s 260 to an inspector appointed by the Minister to investigate the affairs of a company.

<sup>17</sup> Section 267(2).

<sup>18</sup> It should be noted that, as the proceedings are not brought by the member, he does not have the same problems relating to costs as there are under the common law derivative action. Rather, the *curator ad litem* brings the proceedings on behalf of the company, and the company is responsible for the costs, unless the court decides otherwise (s 266(4) gives the court a very wide discretion as to orders it may make relating to the conduct of proceedings by the *curator ad litem*). However, see also the discussion of s 268 at para 5.7 below, whereby the court may order security for costs. The costs of the *curator ad litem* (and the provisional *curator ad litem*) are likely to be great, given the extensive powers to investigate etc conferred upon him by s 267.

<sup>19</sup> See *Brown v Nanco (Pty) Ltd* 1976 (3) SA 832. However, the interests of the company and of its creditors may not be ignored completely; see Oosthuizen, (1985) TSAR 322.

<sup>20</sup> Commentators on this section have noted that the success of the statutory derivative action "... will depend on the willingness of the court to interfere in the internal management of the company against the wishes of the majority": Cilliers, Benade, Henning and Du Plessis, *Corporate Law* (2nd ed 1992) p 303.

<sup>21</sup> See *Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC), at pp 685 and 689; and *Thurgood v Dirk Kruger Traders (Pty) Ltd* 1990 (2) SA 44 (E), 49-50.

whether or not the proceedings should be brought is a matter for the court's discretion,<sup>22</sup> having regard to the findings and report of the provisional *curator ad litem*. Further, there is protection for a company and its directors and officers against vexatious litigants, as the court may make an order for security for the costs of the application and the costs of the provisional *curator ad litem*.<sup>23</sup>

5.8 Section 266 does not specify the remedies which are available under the statutory derivative action. However, it has been held that the remedies to be sought by a member under section 266 should be those for which the company should itself have sued, such as damages or an injunction.<sup>24</sup>

### **Oppression remedy**

5.9 Section 252 provides a remedy for members<sup>25</sup> for conduct which is "unfairly prejudicial, unjust or inequitable".<sup>26</sup> In certain cases,<sup>27</sup> application must be made within six weeks. If it appears "just and equitable" to do so, the court may order any relief "with a view to bringing to an end the matters complained of",<sup>28</sup> and its discretion is not limited by the relief sought by the applicant.<sup>29</sup>

<sup>22</sup> Section 266(4)

<sup>23</sup> Section 268: "The Court may, if it appears that there is reason to believe that the applicant in respect of an application under s 266(2) will be unable to pay the costs of the respondent company if successful in its opposition, require sufficient security to be given for those costs and costs of the provisional *curator ad litem* before a provisional order is made". There has been criticism of the fact that such security for costs may include costs of the provisional *curator ad litem*; see Schreiner, "The shareholder's derivative action — a comparative study of procedures" 1979 SALJ 203, 243. Given the drawn-out procedure under s 266 and the likelihood of substantial costs, it is, therefore, the case that members may be precluded from initiating proceedings under this section because they are unable to give security for costs. See also n 18 above.

<sup>24</sup> See *Loeve v Loeve Building and Civil Engineering Contractors (Pty) Ltd* 1987 (2) SA 92 (D), 100, *per* Booysen J.

<sup>25</sup> Defined in s 103. Section 252 does not appear to embrace former members as potential applicants.

<sup>26</sup> See, generally, *Henochsberg on the Companies Act* (5th ed 1994) pp 476-483.

<sup>27</sup> Where specified special resolutions are alleged to be unfairly prejudicial: s 252(2).

<sup>28</sup> Section 252(3). Note that the court may not make an order for winding up, this power is exclusively controlled by s 344: *Ex parte Muller NO; In re PL Myburgh (Edms) Bpk* 1979 (2) SA 339 (N), 340.

<sup>29</sup> *Heckmair v Beton & Sandstein Industrieë (Pty) Ltd (1)* 1980 (1) SA 350 (SWA), 353.

## **UNITED STATES OF AMERICA**

6.1 Below, we summarise the federal procedure for derivative actions, indicate the American approach to multiple derivative actions and summarise one example of state law on personal remedies.

### **Derivative actions in federal courts**

6.2 These are brought under Rule 23.1 of the Federal Rules of Civil Procedure.<sup>1</sup> Where the corporation has failed to enforce a right which it can properly assert then a shareholder can proceed under this Rule. He must allege that he was a shareholder at the time of the transaction of which he complains, or that he obtained his shares or membership thereafter by operation of law and that the action is not a collusive one to confer jurisdiction on the federal court. He must also set out the particulars of his efforts to persuade the directors and, if necessary, the shareholders to take action and the reason for his failure to persuade them or the reason he has not made such efforts.

6.3 The Rule prevents actions where it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders similarly situated and prohibits dismissal or compromise of the claim without court approval.<sup>2</sup>

### **Multiple derivative actions**

6.4 In such actions it is more complex to prove matters such as contemporaneous share ownership and demands on boards of directors.<sup>3</sup> The justification for such actions is control exercised by one company over another so that the decision making process of the subsidiary's board is influenced by the parent company. There may be less justification for these actions where there is no self-dealing by those in control, since in that situation the directors are unlikely to have a conflict of interest. Nevertheless, in cases where the wrong has been committed by a third party, American courts have allowed multiple derivative actions.<sup>4</sup>

### **Minnesota statutory equitable remedies (Minn Stat Ann s 302A.751)**

6.5 This section gives the court power to grant any equitable relief which it deems just and reasonable in the circumstances. This includes dissolution and buy-out orders. A shareholder can apply for such relief on a number of grounds. These include: deadlock in the management of the corporation; in a closely held corporation<sup>5</sup> when there have been activities by the directors which are fraudulent or illegal in relation to shareholders; in a corporation

<sup>1</sup> See Appendix G.

<sup>2</sup> Note that new constraints on plaintiffs bringing representative actions on behalf of a class have been introduced by the insertion of s 21D into the Securities Exchange Act 1934 by the Private Securities Litigation Reform Act 1995.

<sup>3</sup> See HG Henn & JR Alexander, *Law of Corporations and Other Business Enterprises* (3rd ed 1983) p 1056.

<sup>4</sup> See P I Blumberg, *The Law of Corporate Groups: Procedural Law* (1st ed 1983) pp 349-357.

<sup>5</sup> A company with no more than 35 shareholders: s 302A.011(6a).

that is not publicly held if the directors or those in control have acted in a manner which is unfairly prejudicial toward one or more shareholders; and where corporate assets are being misapplied or wasted.

6.6 The court is statutorily bound to take into account the financial condition of the corporation. If it finds that any party has acted arbitrarily, vexatiously or otherwise not in good faith it can award costs to other parties.

6.7 A buy-out may be ordered if it is fair and equitable to all parties in the circumstances of the case. It can be ordered on the application of the company or the shareholder and may be for the sale by either the plaintiff or the defendant of shares to the corporation or to applying shareholders. The section sets out a procedure for fixing the price if it cannot be agreed by the parties.

# **APPENDIX G RELEVANT EXTRACTS FROM FOREIGN LEGISLATION DEALING WITH STATUTORY RIGHTS TO BRING ACTIONS ON BEHALF OF A COMPANY**

## **AUSTRALIA**

### **Second Corporate Law Simplification Bill**

**245A** (1) A person may bring proceedings on behalf of a company, or intervene in any proceedings to which a company is a party for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings (for example, compromising or settling them), if:

- (a) the person is:
  - (i) a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
  - (ii) an officer or former officer of the company; or
  - (iii) the ASC; and
- (b) the person is acting with leave granted under section 245B.

(2) Proceedings brought on behalf of a company must be brought in the company's name.

(3) The right of a person at common law to bring, or intervene in, proceedings on behalf of a company is abolished.

**245B** (1) A person referred to in paragraph 245A(1)(a) may apply to the Court for leave to bring, or to intervene in, proceedings.

- (2) The Court must grant the application if it is satisfied that:
  - (a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the step in them; and
  - (b) the applicant is acting in good faith; and
  - (c) it is in the best interests of the company that the applicant be granted leave; and

- (d) if the applicant is applying for leave to bring proceedings — there is a serious question to be tried; and
- (e) either:
  - (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
  - (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

**245C** (1) Any of the following persons may apply to the Court for an order that they be substituted for a person to whom leave has been granted under section 245B:

- (a) a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
- (b) an officer, or former officer, of the company; or
- (c) the ASC.

The application may be made whether or not the other person has already brought the proceedings or made the intervention.

(2) The Court may make the order if it is satisfied that:

- (a) the applicant is acting in good faith; and
- (b) in all the circumstances, it is appropriate to make the order.

(3) An order substituting one person for another person has the effect that:

- (a) the grant of leave is taken to have been made in favour of the substituted person; and
- (b) if the other person has already brought the proceedings or intervened — the substituted person is taken to have brought those proceedings or to have made that intervention.

**245D** (1) A ratification or approval of conduct by members of a company:

- (a) does not prevent a person from bringing or intervening in proceedings with leave under section 245B or from applying for leave under that section; and
- (b) does not have the effect that proceedings brought or intervened in with leave under section 245B must be determined in favour of the defendant, or that an application for leave under that section must be refused.

(2) The Court may take into account a ratification or an approval of the conduct by members of a company in deciding what order or judgement (including as to damages) to make in proceedings brought or intervened in with leave under section 245B or in relation to an application for leave under that section. In doing this, it must have regard to:

- (a) how well-informed about the conduct the members were when deciding whether to ratify or approve the conduct; and
- (b) whether the members who ratified or approved the conduct were acting for proper purposes.

**245E** Proceedings brought or intervened in with leave must not be discontinued, compromised or settled without the leave of the Court.

**245F** (1) The Court may make any orders, and give any directions, that it thinks just in relation to proceedings brought or intervened in with leave, or an application for leave, including:

- (a) interim orders; and
- (b) directions about the conduct of the proceedings, including requiring mediation; and
- (c) an order directing the company, or an officer of the company, to do, or not to do, any act; and
- (d) an order appointing an independent person to investigate, and report to the Court, on:
  - (i) the financial affairs of the company; or
  - (ii) the facts or circumstances which gave rise to the cause of action the subject of the proceedings; or
  - (iii) the costs incurred in the proceedings by the parties to the proceedings and the person granted leave.

(2) A person appointed by the Court under paragraph (1)(d) is entitled, on giving reasonable notice to the company, to inspect any books of the company for any purpose connected with their appointment.

**245G** At any time, the Court may, in relation to proceedings brought or intervened in with leave under section 245B or an application for leave under that section, make any orders it thinks just about the costs of the person who applied for or was granted leave of, the company or of any other party to the proceedings or application, including an order requiring indemnification for costs.

...

**247A (1)** On an application by a member of a company or registered collective investment scheme, or by a person granted leave, or who has applied for or is eligible to apply for leave, under section 245B to bring or intervene in proceedings on a company's behalf, the Court may make an order:

- (a) authorising the applicant to inspect books of the company or scheme (but only if the applicant is a suitable person); or
- (b) authorising a suitable person to inspect books of the company or scheme on the applicant's behalf.

The Court may only make the order if it is satisfied that the applicant is acting in good faith and that the inspection is to be made for a proper purpose. If the applicant is not a member, the purpose must be connected with applying for leave under section 245B or bringing or intervening in proceedings with leave under that section.

(1A) The words "(but only if the applicant is a suitable person)" in paragraph (1)(a) do not apply if:

- (a) the applicant has been granted leave, or has applied for or is eligible to apply for leave under section 245B, to bring or intervene in proceedings on the company's behalf; and
- (b) the inspection is to be made for a purpose connected with applying for leave under that section or bringing or intervening in proceedings with leave under that section.

(2) The Court may make any other orders it thinks appropriate, including an order limiting the use that a person may make of information obtained during the inspection.

(3) A person who inspects books under the order must not disclose information they acquire in the course of the inspection unless the disclosure is to:



- (a) the ASC; or
- (b) if the person is making the inspection on behalf of another person — the other person.

## **CANADA**

### **Canada Business Corporations Act 1974-75-76**

**239** (1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

- (a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

...

**240** In connection with an action brought or intervened in under section 239, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

- (a) an order authorising the complainant or any other person to control the conduct of the action;
- (b) an order giving directions for the conduct of the action;
- (c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and
- (d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

...

**242** (1) An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the

shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section 214, 240 or 241.

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given on such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for such interim costs on final disposition of the application or action.

## **GHANA**

### **Companies Code, 1963**

**203** (1) A director of a company stands in a fiduciary relationship towards the company and shall observe the utmost good faith towards the company in any transaction with it or on its behalf.

(2) A director shall act at all times in what he believes to be the best interests of the company as a whole so as to preserve its assets, further its business, and promote the purposes for which it was formed, and in such manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances.

(3) In considering whether a particular transaction or course of action is in the best interests of the company as a whole a director may have regard to the interests of the employees, as well as the members, of the company, and, when appointed by, or as representative of, a special class of members, employees, or creditors may give special, but not exclusive, consideration to the interests of that class.

(4) No provision, whether contained in the Regulations of a company, or in any contract, or in any resolution of a company shall relieve any director from the duty to act in accordance with this section or relieve him from any liability incurred as a result of any breach thereof.

**204** The directors shall not, without the approval of an ordinary resolution of the company, exceed the powers conferred upon them by this Code and the company's Regulations or exercise such powers for a purpose different from that for which such powers were conferred notwithstanding that they may believe such exercise to be in the best interests of the company.

**205** Notwithstanding any provision in the company's Regulations, a director shall not, without the consent of the company in accordance with section 206 of this Code, place himself in a position in which his duty to the company conflicts or may conflict with his personal interests or his duties to other persons, and in particular, without such consent a director shall not,

- (a) use for his own advantage any money or property of the company or any confidential information or special knowledge obtained by him in his capacity of director;
- (b) be interested directly or indirectly, otherwise than merely as a shareholder or debentureholder in a public company, in any business which competes with that of the company; or

- (c) be personally interested, directly or indirectly, in any contract or other transaction entered into by the company except as provided by section 207 of this Code.

**206** (1) For the purposes of section 205 of this Code the company shall not be deemed to have consented unless, after full disclosure of all material facts, including the nature and extent of any interests of the directors, the transaction concerned shall have been specifically authorised by an ordinary resolution of the company which shall either have been agreed to by all the members of the company entitled to attend and vote at a general meeting or have been passed at a general meeting at which neither the director concerned nor the holders of any shares in which he is beneficially interested, either directly or indirectly, shall have voted as members on such resolution.

- (2) Consent in accordance with sub-section (1) of this section may be given either before or after the occurrence of the transaction to which it relates:

Provided that a resolution of the company ratifying a transaction or series of related transactions which has already taken place shall not be effective for the purposes of such sub-section unless it was passed not later than fifteen months after the date when the transaction or first of such transactions took place.

...

**209** If a director commits any breach of his duties under sections 203 to 205 of this Code,

- (a) the director and any other person who knowingly participated in the breach shall be liable to compensate the company for any loss it suffers as a result of such breach;
- (b) the director shall account to the company for any profit made by him as a result of such breach; and
- (c) any contract or other transaction entered into between the director and the company in breach of such duties may be rescinded by the company.

**210** (1) Proceedings to enforce the liabilities referred to in the immediately preceding section or to restrain a threatened breach of any duty under sections 203 to 205 of this Code or to recover from any director of the company any property of the company may be instituted by the company or by any member of the company.

- (2) Proceedings may be instituted by the company on the authority of the board of directors or of any receiver and manager or liquidator of the company, or of an ordinary resolution of the company which shall either have been agreed to by all the members of the

company entitled to attend and vote at a general meeting or have been passed at a general meeting.

(3) At such general meeting neither the proposed defendants nor the holders of any shares in which they or any of them are beneficially interested shall vote on such resolution and if they do vote their votes shall not be counted.

(4) After an investigation of the affairs of the company, proceedings may, pursuant to section 225 of this Code, also be instituted in the name of the company by the Registrar.

(5) Where proceedings are instituted by a member he shall sue in a representative capacity on behalf of himself and all other members, except any that are defendants to the action, and shall join the company as a defendant; and to any such representative action the provisions of section 324 of this Code shall apply.

(6) The Court, on the application of any defendant, may stay proceedings by such member if satisfied that, in all the circumstances, including his participation in the transaction complained of and the circumstances in which he became a member, it is inequitable that he should be allowed to have the conduct of the action, and may, if it shall think fit order such member to give security for payment of the costs of the defendants and may direct that the action or any part of it shall be heard in chambers.

(7) No period of limitation shall apply to any proceedings under this section, but in any such proceedings the Court may relieve a director from liability in whole or in part and on such terms as it thinks fit if, in all the circumstances including lapse of time, the Court thinks it equitable so to do.

(8) In any proceedings under this section the Court shall have power when justice so requires, to order that any sum found to be payable by any defendant shall be restored, in whole or in part, to members or former members of the company instead of to the company itself; and in that event the Court may order that the necessary enquiries shall be made to ascertain the identity of the members and former members concerned and may give such consequential directions as may be necessary or expedient.

(9) No proceedings under this section shall be dismissed, settled or compromised without the approval of the Court after notice of the proposed dismissal, settlement or compromise has been given to all members of the company and to the Registrar in such manner as the Court directs.

(10) Within the time prescribed by such notice any member of the company and the Registrar may appear and call the attention of the Court to any matters which seem relevant and may give evidence and call witnesses.

(11) If the Court shall not approve the dismissal or compromise it may give the conduct of the action to any member willing to continue the same, or to the Registrar in the name of the company, making such consequential orders regarding the parties to the action or otherwise as may be necessary or expedient.

**NEW ZEALAND**  
**Companies Act 1993**

**165** (1) Subject to subsection (3) of this section, the Court may, on the application of a shareholder or director of a company, grant leave to that shareholder or director to—

- (a) Bring proceedings in the name and on behalf of the company or any related company; or
- (b) Intervene in proceedings to which the company or any related company is a party for the purpose of continuing, defending, or discontinuing the proceedings on behalf of the company or related company, as the case may be.

(2) Without limiting subsection (1) of this section, in determining whether to grant leave under that subsection, the Court shall have regard to—

- (a) The likelihood of the proceedings succeeding:
- (b) The costs of the proceedings in relation to the relief likely to be obtained:
- (c) Any action already taken by the company or related company to obtain relief:
- (d) The interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be.

(3) Leave to bring proceedings or intervene in proceedings may be granted under subsection (1) of this section only if the Court is satisfied that either—

- (a) The company or related company does not intend to bring, diligently continue or defend, or discontinue the proceedings, as the case may be; or
- (b) It is in the interests of the company or related company that the conduct of the proceedings should not be left to the directors or to the determination of the shareholders as a whole.

(4) Notice of the application must be served on the company or related company.

(5) The company or related company—

- (a) May appear and be heard; and
- (b) Must inform the Court, whether or not it intends to bring, continue, defend, or discontinue the proceedings, as the case may be.



(6) Except as provided in this section, a shareholder is not entitled to bring or intervene in any proceedings in the name of, or on behalf of, a company or a related company.

**166** The Court shall, on the application of the shareholder or director to whom leave was granted under section 165 of this Act to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of bringing or intervening in the proceedings, including any costs relating to any settlement, compromise, or discontinuance approved under section 168 of this Act, must be met by the company unless the Court considers that it would be unjust or inequitable for the company to bear those costs.

**167** The Court may, at any time, make any order it thinks fit in relation to proceedings brought by a shareholder or a director or in which a shareholder or director intervenes, as the case may be, with leave of the Court under section 165 of this Act, and without limiting the generality of this section may—

- (a) Make an order authorising the shareholder or any other person to control the conduct of the proceedings:
- (b) Give directions for the conduct of the proceedings:
- (c) Make an order requiring the company or the directors to provide information or assistance in relation to the proceedings:
- (d) Make an order directing that any amount ordered to be paid by a defendant in the proceedings must be paid, in whole or part, to former and present shareholders of the company or related company instead of to the company or the related company.

**168** No proceedings brought by a shareholder or a director or in which a shareholder or a director intervenes, as the case may be, with leave of the Court under section 165 of this Act, may be settled or compromised or discontinued without the approval of the Court.

...

**177** (1) The purported exercise by a director or the board of a company of a power vested in the shareholders or any other person may be ratified or approved by those shareholders or that person in the same manner in which the power may be exercised.

(2) The purported exercise of a power that is ratified under subsection (1) of this section is deemed to be, and always to have been, a proper and valid exercise of that power.

(3) The ratification or approval under this section of the purported exercise of a power by a director or the board does not prevent the Court from exercising a power which might, apart from the ratification or approval, be exercised in relation to the action of the director or the board.

(4) Nothing in this section limits or affects any rule of law relating to the ratification or approval by the shareholders or any other person of any act or omission of a director or the board of a company.

## REPUBLIC OF SOUTH AFRICA

### Companies Act No 61 of 1973

266 (1) Where a company has suffered damages or loss or has been deprived of any benefit as a result of any wrong, breach of trust or breach of faith committed by any director or officer of that company or by any past director or officer while he was a director or officer of that company and the company has not instituted proceedings for the recovery of such damages, loss or benefit, any member of the company may initiate proceedings on behalf of the company against such director or officer or past director or officer in the manner prescribed by this section notwithstanding that the company has in any way ratified or condoned any such wrong, breach of trust or breach of faith or any act or omission relating thereto.

(2)(a) Any such member shall serve a written notice on the company calling on the company to institute such proceedings within one month from the date of service of the notice and stating that if the company fails to do so, an application to the Court under paragraph (b) will be made.

(b) If the company fails to institute such proceedings within the said period of one month, the member may make application to the Court for an order appointing a *curator ad litem* for the company for the purpose of instituting and conducting proceedings on behalf of the company against such director or officer or past director or officer.

(3) The Court on such application, if it is satisfied—

(a) that the company has not instituted such proceedings,

(b) that there are *prima facie* grounds for such proceedings, and

(c) that an investigation into such grounds and into the desirability of the institution of such proceedings is justified,

may appoint a provisional *curator ad litem* and direct him to conduct such investigation and to report to the Court on the return day of the provisional order.

(4) The Court may on the return day discharge the provisional order referred to in subsection (3) or confirm the appointment of the *curator ad litem* for the company and issue such directions as to the institution of proceedings in the name of the company and the conduct of such proceedings on behalf of the company by the *curator ad litem*, as it may think necessary, and may order that any resolution ratifying or condoning the wrong, breach of trust or breach of faith or any act or omission in relation thereto shall not be of any force or effect.

## **UNITED STATES OF AMERICA**

### **Federal Rules of Civil Procedure**

**23.1** In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege

- (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and
- (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have.

The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interest of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

# APPENDIX H

## PROPOSED NEW REGULATIONS TO BE INSERTED IN TABLE A

### **Shareholder exit article for smaller private companies - draft regulation 119**

(1) This article applies if the company passes an ordinary resolution (referred to in this regulation as “**the resolution**”) that the shares (referred to in this regulation as “**the relevant shares**”) specified in the resolution give the holder of those shares (referred to in this regulation as “**the relevant holder**”) the rights set out below in paragraph (3) of this regulation. Unless the resolution otherwise provides, relevant shares include shares acquired by the relevant holder after the date of the resolution in right of the relevant shares, and for the purposes of this article, a “**holder**” includes a person to whom shares shall have been transferred or transmitted by operation of law.

### **Shares to which the resolution can apply**

(2) The shares may be identified in the resolution by the name of the then holder or in any other appropriate way. The shares may be issued shares or shares which have been allotted but not issued or shares which are to be issued. If the shares have been issued or allotted, the holder or allottee must consent to the passing of the resolution. Unless otherwise specified in the resolution, the rights attached by the resolution last only so long as the then holder or the allottee (or a person to whom the shares shall have been transferred or transmitted by operation of law by reason of the death or bankruptcy of such holder or person) shall be the holder of all the shares specified in the resolution.

### **Rights conferred by the resolution**

(3) After the resolution is passed, the relevant holder (referred to below as “**the outgoing shareholder**”) may serve a notice (referred to in this regulation as “**an exit notice**”) requiring the shareholders on whom it is served to acquire all the relevant shares within three months following the service of such notice. He must serve the exit notice on the company and (except in so far as the resolution otherwise provides) on all the shareholders apart from himself and any joint holder of the relevant shares.

### **Time for serving an exit notice**

(4) The relevant shareholder may serve an exit notice at any time unless the resolution states that he may do so only if some specified event(s) occur(s).

### **Valuation of shares**

(5) If, at the expiry of three months after service of the exit notice, the price to be paid for the relevant shares has not been agreed between the outgoing shareholder and the other shareholders (apart from any second or subsequent joint holder), the outgoing member may request the President of the Institute of Chartered Accountants in England and Wales to appoint an independent accountant (referred to below as “**the expert**”) to determine the fair value of the relevant shares. The expert shall act as an expert and not as an arbitrator and his decision will be final and binding. In preparing his valuation he shall disregard the fact

that the shares form part of a minority shareholding. If the company is registered in Scotland, the valuation shall be subject to Scots law and the reference to the President of the Institute of Chartered Accountants in England and Wales shall be to the President of the Institute of Chartered Accountants of Scotland and the expert shall act as an arbiter.

(6) The shareholders on whom the exit notice is served are bound to purchase the shares of the outgoing shareholder at the value fixed by the expert within 28 days of receiving a copy of the valuation from the company. The cost of the valuation shall be borne by such shareholders and the outgoing shareholder in proportion to the number of shares held by them at the date of the valuation.

(7) If there is more than one shareholder bound to purchase the shares of the outgoing member under paragraph (6) of this regulation, they are obliged to purchase the relevant shares of the outgoing member in the proportion which the nominal value of the shares (of any class) in the company held by them bears to the aggregate nominal value of all such shares held by the shareholders so bound at the last date for the performance of such obligation. For the purposes of this paragraph joint holders shall be treated as a single holder.

#### **Default and voluntary liquidation**

(8) If any shareholder who is bound to purchase the outgoing shareholder's shares fails to do so within 14 days after the expiry of the period mentioned in paragraph (6) of this regulation, the outgoing shareholder shall be entitled to convene an extraordinary general meeting of the company for the purpose of considering a special resolution for voluntary liquidation. On that resolution the outgoing shareholder shall have such number of votes as shall be required to secure the passing of that resolution.

#### **General**

(9) A shareholder may at any time withdraw an exit notice, and, where the resolution states that an exit notice may be served only if specified event(s) occur(s), the failure to serve an exit notice on any occasion does not prevent him from serving an exit notice if a fresh event occurs entitling him to serve such notice.

(10) A shareholder who fails to serve an exit notice when he is entitled to do so is taken to accept that the court may take that failure into account in any proceedings subsequently brought by him for winding up or relief from unfair prejudice.

(11) A resolution passed under paragraph (1) of this article

(i) applies only so long as the company has less than ten members and is not a public limited company, and

(ii) may be varied or rescinded at any time but only with the prior written consent of the holder of the relevant shares.

### **Arbitration article - draft regulation 120**

(1) If a dispute arises between the company and any member or between any members about the construction of these regulations or any act or omission of the company, the dispute shall be referred to arbitration. But if at any time the parties agree to seek to resolve the dispute through an alternative dispute resolution procedure (ADR) acceptable to them, the arbitration shall be suspended. The parties to a dispute must consider whether the dispute is appropriate for ADR when one of them notifies the other(s) of his intention to refer the dispute to arbitration.

(2) If a dispute is referred to arbitration, there shall be a sole arbitrator chosen by the parties or in default by the President of the Institute of Chartered Accountants in England and Wales. If the registered office of the company is in Scotland, the word “arbiter” shall be substituted for “arbitrator” and he shall be chosen by the President of the Institute of Chartered Accountants in Scotland, if the parties cannot agree.

(3) This regulation applies only to disputes arising out of a member’s contract of membership and not to disputes arising out of any separate contract between the member and the company or any other member.

(4) The company does not by this regulation agree to submit to arbitration at the instance of a member unless that member could maintain legal proceedings against it in respect of the complaint proposed to be remitted to arbitration.

(5) This regulation applies only if the company resolves that it should apply to the company but it shall not in any event apply to any dispute which has already arisen by the date of the resolution unless the parties agree.

(6) For the purposes of this regulation, “member” includes any person to whom any share has been transferred or transmitted by operation of law.

### **Valuation article - draft regulation 121**

(1) Where shareholders are agreed (apart from price) on the sale or purchase of particular shares in the company, they shall appoint an independent accountant to determine the fair value of the shares and in default the President of the Institute of Chartered Accountants in England and Wales may do so.

(2) The expert shall act as expert and not as arbitrator, and his decision will be final and binding. In making his valuation he shall disregard the fact that the shares form part of a minority shareholding. The cost of the valuation shall be borne by the selling and purchasing shareholders in proportion to the number of shares to be bought or sold by them respectively.

(3) If the company is registered in Scotland the valuation shall be subject to Scots law and the reference to the President of the Institute of Chartered Accountants in England and

Wales shall be to the President of the Chartered Accountants of Scotland, and the expert shall act as arbiter.

(4) The sale and purchase shall be completed within 28 days of the valuation, unless otherwise agreed.

(5) If the selling shareholder makes default in transferring his shares, the directors may authorise some person to execute on behalf of and as attorney for the selling shareholder any necessary transfer and may receive the purchase money and shall then cause the name of the purchasing shareholder to be registered as the holder of the shares. The company shall hold the purchase money in trust for the selling shareholder. The receipt of the company for the purchase money shall be a good discharge to the purchaser. After the purchaser's name has been registered in the register of members, the proceedings shall not be questioned by any person.



# **APPENDIX I SUGGESTED WORDING FOR NEW REMEDY FOR SMALLER COMPANIES**

(1) Where the conditions in subsection (2) are satisfied a member of a private company may apply to court for an order under this section on the grounds of his exclusion from participation in management of the company/removal of a director (in either case) save for gross misconduct.

(2) Such an application may only be made if there are a minimum of two and a maximum of five members in the company and if:

- (a) the company is an association formed or continued on the basis of a personal relationship, involving mutual confidence;
- (b) before the applicant's exclusion from management, there was an agreement or understanding between all the shareholders that he or she should participate in the conduct of the business.

(3) Under this section the court is empowered only to make an order that the shares of any members of the company are to be purchased by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly, but such purchase will be at fair value without a discount for the fact that the applicant's shares represent a minority shareholding.

# **APPENDIX J**

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*OC Transport Services Ltd, Re* (1984) 1 BCC 99,068  
*Oliver v Dalglish* [1963] 1 WLR 1274  
*Orr v Glasgow etc Railway Co* (1860) 3 Macq 799

*PFTZM Ltd, Re* [1995] 2 BCLC 354  
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# GLOSSARY OF ABBREVIATIONS

**In this consultation paper the following terms and expressions are used for the sake of brevity:**

<b>the 1986 Rules</b>	Companies (Unfair Prejudice Applications) Proceedings Rules 1986 (SI 1986 No 2000)
<b>ADR</b>	alternative dispute resolution
<b>AGM</b>	annual general meeting
<b>CASAC</b>	the Companies and Securities Advisory Committee [Australia]
<b>CBCA</b>	the Canada Business Corporations Act 1974-75-76
<b>CCCA</b>	Company Clauses Consolidation Act 1845
<b>CCR</b>	the County Court Rules
<b>CSLRC</b>	the Companies and Securities Law Review Committee [Australia]
<b>the Cadbury Committee</b>	the Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury
<b>the Cadbury Report</b>	<i>Report of the Committee on the Financial Aspects of Corporate Governance</i> (December 1992)
<b>the Chancery Guide</b>	<i>Chancery Guide</i> (April 1995), introduced by <i>Practice Direction (Chancery Division: Procedure and Case Management)</i> [1995] 1 WLR 785
<b>the Cohen Committee</b>	the Committee on Company Law Amendment, chaired by Mr Justice Cohen
<b>the Dickerson Report</b>	<i>Proposals for a New Business Corporations Law for Canada</i> (1971) [Canada]
<b>the Draft Civil Proceedings Rules</b>	<i>Access to Justice, Draft Civil Proceedings Rules</i> (July 1996)
<b>the Draft Disclosure Rules</b>	The Company Accounts (Disclosure of Directors' Emoluments) Regulations 1996: Draft Statutory Instrument under the Companies Act 1985 (January 1996)
<b>DTI</b>	the Department of Trade and Industry
<b>EGM</b>	extraordinary general meeting
<b>the Greenbury Committee</b>	the Study Group on Directors' Remuneration, chaired by Sir Richard Greenbury
<b>the Greenbury Report</b>	<i>Directors' Remuneration: the Report of a Study Group chaired by Sir Richard Greenbury</i> (July 1995)

<b>the Hampel Committee</b>	the Second Committee on the Financial Aspects of Corporate Governance, chaired by Sir Ronald Hampel
<b>the Jenkins Committee</b>	the Company Law Committee, chaired by Lord Jenkins
<b>the Listing Rules</b>	London Stock Exchange, <i>The Listing Rules</i>
<b>RSC</b>	the Rules of the Supreme Court
<b>the Takeover Code</b>	The Panel on Takeovers and Mergers, <i>City Code on Takeovers and Mergers</i>
<b>USM</b>	the Unlisted Securities Market
<b>the Woolf Report</b>	<i>Access to Justice, The Final Report to the Lord Chancellor on the Civil Justice System in England and Wales</i> (July 1996)

## **CASES**

<b><i>Ebrahimi</i></b>	<i>Ebrahimi v Westbourne Galleries Ltd</i> [1973] AC 360
<b><i>Hickman's case</i></b>	<i>Hickman v Kent or Romney Marsh Sheep Breeders' Association</i> [1915] 1 Ch 881
<b><i>Re R A Noble</i></b>	<i>Re R A Noble &amp; Sons (Clothing) Ltd</i> [1983] BCLC 273
<b><i>SCWS v Meyer</i></b>	<i>Scottish Co-operative Wholesale Society Ltd v Meyer</i> [1959] AC 324
<b><i>Saul D Harrison</i></b>	<i>Re Saul D Harrison &amp; Sons plc</i> [1992] BCLC 724 (Ch D); [1995] 1 BCLC 14 (CA)