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Majority Rule and Minority Protection under Companies Act 1956 with special reference to Foss vs. Harbottle

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Abstract

Like a democratic country, Company Law provides for adequate protection for the minority shareholders when their rights are trampled by the majority. In the Company Law regime from the rule laid in Foss v Harbottle it can be said that the Court will not intervene at the instance of shareholders in matters of internal administration, and will not interfere in the management of a company by its directors so long with they are acting within the powers conferred on them under the articles of the company. It can be noticed that the decision taken in the case Foss v Harbottle is essentially a logical extension of the principle that a company is a separate legal person. It follows that if a wrong is done to it, and the company is the proper person to bring an action. In India the minority's rights has been given importance. The study discusses about the advantages and justifications of Foss v Harbottle rule. The aim of this paper is to deals with the corporate democracy and the principle of non-interference. The paper also analyses about the advantages that flow from the rule in Foss v Harbottle that are of a purely practical nature. Finally the paper concludes with certain sets of recommendations that can be incorporated to effectively deal with such issues.

(**Key Words** – Corporate Democracy, Internal Administration, Majority and Minority Shareholders, Foss v Harbottle)

INTRODUCTION

`In a democracy you indeed have to win by a majority'. Similarly, a company which is a large group of individuals acts in accordance with the decisions taken by the majority of its members. The dissenting minority (if there is one) is bound to accept any such decisions unless and until he is able to show that the power, which vests with the majority, has been abused. The members of a company can express their wishes at general meetings by voting for or against the resolutions proposed. However, it (the resolution) binds all the members, even those who vote against it. As far as the role of the court is concerned, in such a situation, it is well established that the interference by the courts is always minimal. This idea of balancing of interests traces back its roots from the principle of 'greatest good to the greatest number of people'. As there is also a public policy to save the minorities against the unjust behavior of the majorities, this should be done to prevent the misuse of power by the majority shareholders. In India the Companies Act, 1956, include specific provisions to save the minority shareholders against the 'oppressive' or 'mismanaged' acts, which are detrimental to the affairs of the company. In the English jurisdiction, the disadvantageous position of the minority shareholder was recognized as early as in 1945 by a Report of the Cohen Committee[1] on Company Law Amendment.

It is a well settled legal position that rule of majority will prevail if the decision of the majority is in accordance with the provisions of the company law. The major principle regarding the majority rule was developed in the case Foss vs. Harbottle.[2] Courts refused to interfere in the management of the company at the instance of a minority of its members who are dissatisfied with the conduct of the company's affairs by its board of directors. The courts further clarified that if the directors of company are supported by the majority shareholders in what they do, the minority shareholders, in general, can do nothing about it. However, the rule of majority supremacy has been to some extent restricted by modern corporate laws. One of the limitations on the rule of majority supremacy which has been statutorily recognized in India is action on the grounds of oppression and mismanagement.

The concept of oppression and mismanagement is more relevant or common to family owned concerns. The reasons are very obvious. Family owned concerns are owned by family members who over time develop vested interest in business - vested interest in their own heirs being the most common - thereby leading to oppression of other family members. Here typically, the controlling member of the

[1] Report of the Committee on Company Law Amendment 1945 (cmnd) 6659) London HMSO, 1945) Hereafter the Cohen Report

[2] Foss v Harbottle 67 E.R. 189; (1843) 2 Hare 461

family appropriates the family holdings by means of either a fresh issue or fraudulent transfers in his favor or reconstitutes the board in such a manner as to alienate the other family members. The result is the other family members get oppressed. Secondly, the family owned concerns are not professional managed and their system of functioning is usually personal. They lack probity and fair play. They generally do business in a manner where they begin to benefit personally to the exclusion of other members.

This leads to oppression of other family members/mismanagement of companies. Oppression and mismanagement is less seen in professionally managed companies where managers work for "shareholders" and not for a particular group of members. An analysis of the 50 top Economic Times ranked companies reveals that nearly 50% are still family owned[3]. The reason for such high concentration of industries in families is that entrepreneurship in early years was highly personalized and did not get corporatized. As far as small and medium sizes companies, the family owned concerns are almost fully dominating the scene and professional management rarely exists. Family owned concerns go through a lot of oppression and instances of mismanagement. The latest examples are the Bajaj family episode, the incessant quarrel in the Modi family, Ranbaxy's, Pai, Chabaria etc.

In one of the biggest frauds in India's corporate history, B. Ramalinga Raju, founder and CEO of Satyam Computers, India's fourth-largest IT services firm, announced on January 7 that his company had been falsifying its accounts for years, overstating revenues and inflating profits by $1 billion. Ironically, Satyam means "truth" in Sanskrit, but Raju's admission -- accompanied by his resignation -- shows the company had been feeding investors, shareholders, clients and employees a steady diet of '*asatyam*' (or untruth), at least regarding its financial performance. Ramlinga Raju has diverted crore of rupees from Satyam accounts to those of his kith and kin. He also invested the diverted money in Maytas properties and other sister's concerns. He also transferred his shares in the name of his brothers. Satyam's staff strength was inflated from 40.000 to 53.000, and crores of money drawn in the names of these fictitious employees was siphoned of every month. Over a period of five years, the total amount could have amounted to Rs 1,200 crore in five years.[4]

Today, a very large number of cases dealt at Company Law Board[5] are those pertaining to oppression and mismanagement, their prevention and remedies thereof are covered by section 397 and section 398 of the Companies Act 1956.[6]

LITERATURE REVIEW

Majority rule vs. Minority rights has always been the pivotal point of discussion. It is a well settled legal positioning of a company that rule of majority is in accordance with the provisions of the company law. However the rule of majority supremacy has been to some extent restricted by modern corporate laws. A number of Authors have looked into the matter and have dealt with the subject from various angels covering prevention of oppression and mismanagement and operational parameters of majority supremacy etc. In this literature review all these points have been considered.

According to Oxford dictionary[7] 'majority' means the greater number, the number by which votes cast for one party or candidate exceed those for the next; the majority of people or things in a group is more than half of them; the largest part of a group of people or things". It has been so said by the author as the majority rule is the principle that the greater number should exercise greater power. The researcher acknowledges the pattern of expression of the author.

At the inception, the reference to Taxman[8] is essential. He has discussed here that the law regarding majority rule and minority protection is far developed in company law. The general rule of a company is that since companies are governed by majority resolutions, the courts do not ordinarily intervene to protect the interests of the minority that may be alleged to have been affected thereby. The author has discussed here about the principle of majority rule which was laid down in the famous case

[4] Satyam Fallout: 150 Companies under Scanner, TIMES OF INDIA, MUMBAI, Feb .6, 2009, at 1.

[5] Now it is National Company Law Tribunal as per the Companies (Amendment) Act, 2002.But till now it has not been constituted.

[6] *Oppression and Mismanagement Especially in case of Family Owned Concerns. at:*

http://dsaca.co.in/Semi/Oppression%20&%20Mismanagement.doc (last visited 2nd January 2009)

[7] A S Hornby,Oxford Advanced Learner's Dictionary(5th Edition, Oxford University Press)

[8] A.K. MAJUMDER & .G.K KAPOOR ,COMPANY LAW AND PRACTICE,(12 th edition, 2007)

Foss vs. *Harbottle*[9].Thus author has mentioned that 'the rule laid in Foss vs. Harbottle essentially an extension of the principle that a company is a separate legal person from the members who compose it[10].''The author has also discussed about the corporate right and individual right of a member in a company and has also stated that the principle of Foss vs. harbottle only applies where a corporate right of a member is infringed. The rule does not apply where an individual right of a member is denied. However an individual member may bring a representative or derivative action to remedy a wrong done to his company. The author has also stated the various exceptions to the rule in Foss vs. Harbottle, which have been developed from time to time by adequate statutory provisions made in the companies act, 1956 as well as various judicial pronouncements. The book has also special focus on prevention of oppression and mismanagement, the true scope of S.397 and 398 of The Companies Act, 1956 and the powers of the company law tribunal and central government to prevent oppression and mismanagement with various judicial pronouncements. The book has been of great help to the researcher, as it aids to understand the various practical problems involved in matters relating to prevention of oppression and mismanagement.

The facets of prevention of oppression and mismanagement and its practical implication in our country as well as in England have been well discussed by A.Ramaiya[11]. The author has discussed the scope of S.397 to 409 of the Indian Companies Act, 1956 and the various grounds which constitutes oppression and mismanagement and the instances of cases not involving mismanagement. The author mentions that "the words unfairly prejudicial as mentioned under S.397 and 398 of The Indian Companies Act, 1956 and under sec.75 of the English Companies Act, 1980 are general words and they should be applied flexibly to meet the circumstances of particular case."[12] The author has also dealt with effect of agreements and arbitration clause. According to him proceedings under this section cannot be barred or defeated by any provision in the articles or any agreement that any matters relating to winding up or disputes between the company and its shareholders or any of them

[9]Foss v. Harbottole (1843)2Hare461

[10] MAJUMDER, *supra* note 10, at 46

[11] A.RAMAIYA. ,GUIDE TO THE COMPANIES ACT, 3364,(16TH ed.2006)

[12] *id.* at 3363

should only be referred to arbitration. This has proved quite an essential book for the researcher.

According to the authors K.M Ghosh and Dr.K.R.Chandratre's[13] it is the duty of the courts to recognize the corporate democracy of a company in managing the affairs of the company. The court should not restrict the powers of the board of directors and it shall not interfere with the day to day affairs, management and administration of a company. This book provides a better understanding of majority rule vs. minority rights and also the legislative history of sec.397 and S.398 of The Indian Companies Act, 1956. This book covers many debatable issues like "forgery in proceedings", 'internal management of company" which helps to clear the provisions regarding prevention of oppression and mismanagement. It also contains a lucid commentary on the object of S.397 and 398 of The Companies Act, 1956 and also on majority rule and minority protection. This book also has shown the different forms of action taken by the shareholders. As this book has covered many debatable issues in the company this book is essential for the research.

MAJORITY PRINCIPLE

The majority rule principle pervades much of company law as it touches on the key issue of who owns and controls the company. A company once incorporated becomes a distinct and separate legal entity and it is treated as a juristic entity separate from its shareholders. Indeed the concepts of separate corporate personality and the issue of limited liability are at the core of company law. No case illustrated the above position better than the leading case of *Salomon v A Salomon & Co Ltd*[14].

"The entire edifice of modern Company Law stands on this twin principle of separate corporate personality and limited liability. Limited liability is the logical consequence of the existence of a separate personality. The logical consequence of the creation of a separate legal personality upon incorporation of a company is that a separate legal personality capable of suing and being sued in its own name is created and capable of holding property in its own name. Thus the company can make profit and losses that are its own and in its own name and not those of its members (the shareholders)."

[13] K.M.GHOSH & K.R.CHANDRATRE , COMPANY LAW WITH SECRETARIAL PRACTICE, (13th ed. 2007)

[14] (1897) A C 462

[15]Limited liability simply means that the liability of shareholders would be limited to the unpaid amount of their shares. The concept of shareholder's democracy in the present day corporate world denotes the shareholder's supremacy in the governance of the business and affaires of corporate sector either directly or through their elective representatives. Recognizing the supreme authority of the shareholders, the Companies Act, 1956 has given authority to the shareholders to appoint directors at the annual general meetings to direct, control, conduct and manage the business and affairs of the company. Corporate democracy in a company is reckoned with the number of shares one has, which has an effect on the number of votes. Like a democratic country in a corporate world also majority rule prevails. The persons in control of the majority can abuse their power, which may lead to minority shareholders suffering a loss.

DEMOCRACY IN A CORPORATE SET UP

In a democratic country majority rule prevails. Democracy is defined in Webster's Encyclopedic Dictionary as: Government by the people; a form of government in which the supreme power is vested in the people and exercised by them either directly or through their elected agents; a state of society characterized by nominal equality of rights and privileges.

What is left out of the dictionary definition of democracy is what constitutes "the people." In practice, democracy is governed by its most popularly understood principle: majority rule. Namely, the side with the most votes wins, whether it is an election, a legislative bill, a contract proposal to a union, or a shareholder motion in a corporation. The majority (or in some cases plurality) vote decides. Thus, when it is said that "the people have spoken" or the "people's will should be respected," the people are generally expressed through its majority. Yet majority rule cannot be the only expression of "supreme power" in a democracy. The majority would too easily tyrannize the minority. Thus, while it is clear that democracy must guarantee the expression of the popular will through majority rule, it is equally clear that it must guarantee that the majority will not abuse

[15] Clement Chigbo, *An Examination of Majority Rule Principle and the Remedies Available to Shareholders*, May 12th, 2006, *available **at*** www.jonesbahamas.com/?c=135&a=8793 [last visited 24 th February 2009].

the use of its power to violate the basic rights of the minority. For one, a defining characteristic of democracy must be the people's right to change the majority through elections. This right is the people's "supreme authority." The minority, therefore, must possess all the rights necessary to compete fairly in elections—speech, assembly, association, petition—since otherwise the majority would make itself permanent and become a dictatorship.[16]

In a democracy the majority rules and decides matters but in that democracy the interests of the minority must also be upheld and protected. Democracy therefore requires minority rights equally as it does majority rule. Indeed, as democracy is conceived today, the minority's rights must be protected no matter how singular or alienated that minority is from the majority society; otherwise, the majority's rights lose their meaning. In the United States, basic individual liberties are protected through the Bill of Rights, which were drafted by James Madison and adopted in the form of the first 10 amendments to the Constitution. These enumerate the rights that may not be violated by the government, safeguarding—in theory, at least—the rights of any minority against majority tyranny. Today, these rights are considered the essential element of any liberal democracy.

The British political philosopher John Stuart Mill took this principle further. In his essay On Liberty he wrote, 'The only purpose for which power can be rightfully exercised over any member of a civilized community against his will is to prevent harm to others.' Mill's 'no harm principle' aims to prevent government from becoming a vehicle for the 'tyranny of the majority,' which he viewed as not just a political but also a social tyranny that stifled minority voices and imposed a regimentation of thought and values. Mill's views became the basis for much of liberal political philosophy since, whether it is free market or economic liberalism or social liberalism.[17]

Like a democratic country in a company also the majority rules and decides the matter. Thus the shareholders democracy like a democratic country can play an important role in stimulating the Board of Directors, raising company performance and ensuring that the community at large takes a

[16] *Majority Rule/Minority Rights: Essential Principles, at* www.democracyweb.org/majority/principles.php,(last visited 28th march)

[17] *id*

greater interest in industrial progress. Democracy means the rule of people, by the people and for the people. In that context the shareholder's democracy means the rule of shareholder's, by the shareholders and for the shareholder's in the corporate enterprise, to which the shareholders belong. Precisely it is a right to speak, congregate to communicate with co-shareholders and to lean about what is going on in the company.

APPLICATION OF FOSS V HARBOTTLE RULE HOW FAR RELEVANT IN INDIA

The Delhi High Court in *ICICI v. Parasrampuria Synthetic Ltd SCL*[18] has held that a mechanical and automatic application of Foss v Harbottle Rule to the Indian situations, Indian conditions and Indian corporate realities would be improper and misleading. The principle, in the countries of its origin, owes it genesis to the established factual foundation of shareholder power centering on private individual enterprise and involving a large number of small shareholders, is vastly different than the ground realities in our country. Here the modern Indian corporate entity is not the multiple contributions of small individual investors but a predominantly and indeed over-whelming state- supported funding structure at all stages by receiving substantial funding up to 80 % or more from financial institutions which provide entire funds for the continuous existence and corporate activities. If the Foss v Harbottle rule applied mechanically, it would amount to giving waitage to that majority of the shareholding having notionally holding more percentage of shares, than to the financial institutions which may own a small percentage of shares through contributed 80% or more in terms of the finances to such companies. It is these financial institutions which have really provided the finance for the company's existence and, therefore, to exclude them or render them voiceless on an application of the principles of Foss v Harbottle rule would be unjust and unfair.

JUSTIFICATION AND ADVANTAGES OF THE RULE IN FOSS V HARBOTTLE

[18] July 5, 1998

The justification for the rule laid down in *Foss v Harbottle*[19] is that the will of the majority prevails. On becoming a member of a company, a shareholder agrees to submit to the will of the majority. The rule really preserves the right of the majority to decide how the company' affairs shall be conducted .If any Wrong is done to the company; it is only the company itself, acting as it always act, through its majority that can seek to redress and not an individual shareholder. Moreover a company is a person at law; the action is vested in it and cannot be brought by a single shareholder. Where there is a corporate body capable of filing a suit for itself to recover property either from its directors or officers or from any other person then that corporate body is the proper plaintiff and the only proper plaintiff.

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

- **Recognition of the separate legal personality of the company**: If a company has suffered some injury, and not the individual members, it is the company itself that should seek to redress.
- **Need to preserve right of majority to decide**: The principle in Foss v Harbottle preserves the right of majority to decide how the affairs of the company shall be conducted. It is fair that the wishes of the majority should prevail.
- **Multiplicity of futile suits avoided:** Clearly, if every individual member were permitted to sue anyone who had injured the company through a breach of duty, there could be as many suits as there are shareholders. Legal proceedings would never cease, and there would be enormous wastage of time and money.
- Litigation at suit of a minority futile if majority does not wish it: If the irregularity complained of is one which can be subsequently ratified by the majority it is futile to have litigation about it except with the consent of the majority in a general meeting. In *Mac*

[19] FOSS, *supra* note 4

Dougall v. Gardiner,[20] the articles empowered the chairman, with the consent of the meeting, to adjourn a meeting and also provided for taking a poll if demanded by the shareholders. The adjournment was moved, and declared by the chairman to be carried; a poll was then demanded and refused by the chairman. A shareholder brought an action for a declaration that the chairman's conduct was illegal. Held; the action could not be brought by the shareholder, if the chairman was wrong, and the company alone could sue.

PERSONAL RIGHTS OF MEMBERS [21]

It should however be noted that the aforesaid principle Foss v Harbottle only applies where a corporate right of member is infringed. The rule does not apply where an individual right of a member is denied. The individual right of a member arise in part from the contract between the company and himself which is implied on becoming a member, and impart from the general law. Under the contract implied from his membership, he is entitled to have his name and shareholding entered on the register of members and to prevent unauthorized additions or alterations to the entry[22], to vote at meeting of members[23], to receive dividend which have been duly declared or which have become due under the articles[24], to exercise pre-emption rights over other members' shares which are conferred by the articles[25]and to have his capital returned in the proper order of priority in the winding up of the company or on a duly authorized reduction of capital[26].Under the general law he is entitled to restrain the company from doing acts which are *ultra vires*, to have a reasonable opportunity to speak at meetings of members[27] and to move amendments to resolutions proposed at such meetings, to transfer his shares, not to have his financial obligations to the company increased without his consent , and to exercise very many rights conferred on him by the Companies Act,1956, such as his right to inspect various documents and registers kept

[20] *(*1875) 1 Ch. 13 (C.A),
[21] MAJUMDER, *supra* note 10

[22] Re British Sugar Refining Company.(1857)4 K & J 408
[23] Pender v Lushington (1877)6 ch D 70
[24] Wood v Odessa Waterwords Co (1889)42 Ch D 636
[25] Rayfield v Hands (1960)Ch 1
[26] Griffith v Paget(1877)5 Ch .D 894
[27] Wall v London and Northern Assets Corporation (1898) 2 Ch .469.

by the company, to have a share certificate issued to him in respect of his shares, and to appoint a proxy to vote on his behalf at meetings of members.

The dividing line between personal and corporate rights very hard to draw, and perhaps the most that can be said is that the court will be inclined to treat provision in the memorandum or articles as conferring a personal right on member only if he has a special interest in its observance distinct from the general interest which every member has in the company adhering to the terms of its constitution. A consequence of the distinction between personal and corporate rights is that a member cannot bring a personal action for the loss he has suffered by the diminution in the value of his shares resulting from breaches by the defendants of provisions of the company's memorandum or articles which do not confer personal rights on members , or from breaches of fiduciary duties owed by the defendants to the company; even if the member can prove a conspiracy between the defendants to commit the breaches complained of , the diminution in the value of his shares is merely a reflection of the loss suffered by the company , and the proper remedy therefore is for the company to sue the defendants or, in appropriate circumstances for a derivative action to be brought.[28]

CONCLUSION

It is clear from the foregoing discussion that like a democratic country in a company also majority rule decides and upholds matters. Like a democratic country, Company Law provides for adequate protection for the minority shareholders when their rights are trampled by the majority. But in the realm of corporate matters, the value of the shareholding of the individual matters and if a single individual holding majority of the shareholding votes in favour of scheme of arrangement, the same shall be binding on several individuals, who constitute minority having regard to the fact that their shareholding constitutes a minority and is far less when compared to the majority shareholding of a single individual. In the Company Law regime from the rule laid in Foss v Harbottle it can be said that the Court will not intervene at the instance of shareholders in matters of internal administration, and will not interfere in the management of a company by its directors so long with they are acting within the

[28] GHOSH, *supra* note 15

powers conferred on them under the articles of the company. It can be noticed that the decision taken in the case *Foss v Harbottle*[29] is essentially a logical extension of the principle that a company is a separate legal person.

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29 FOSS, *supra* note 4