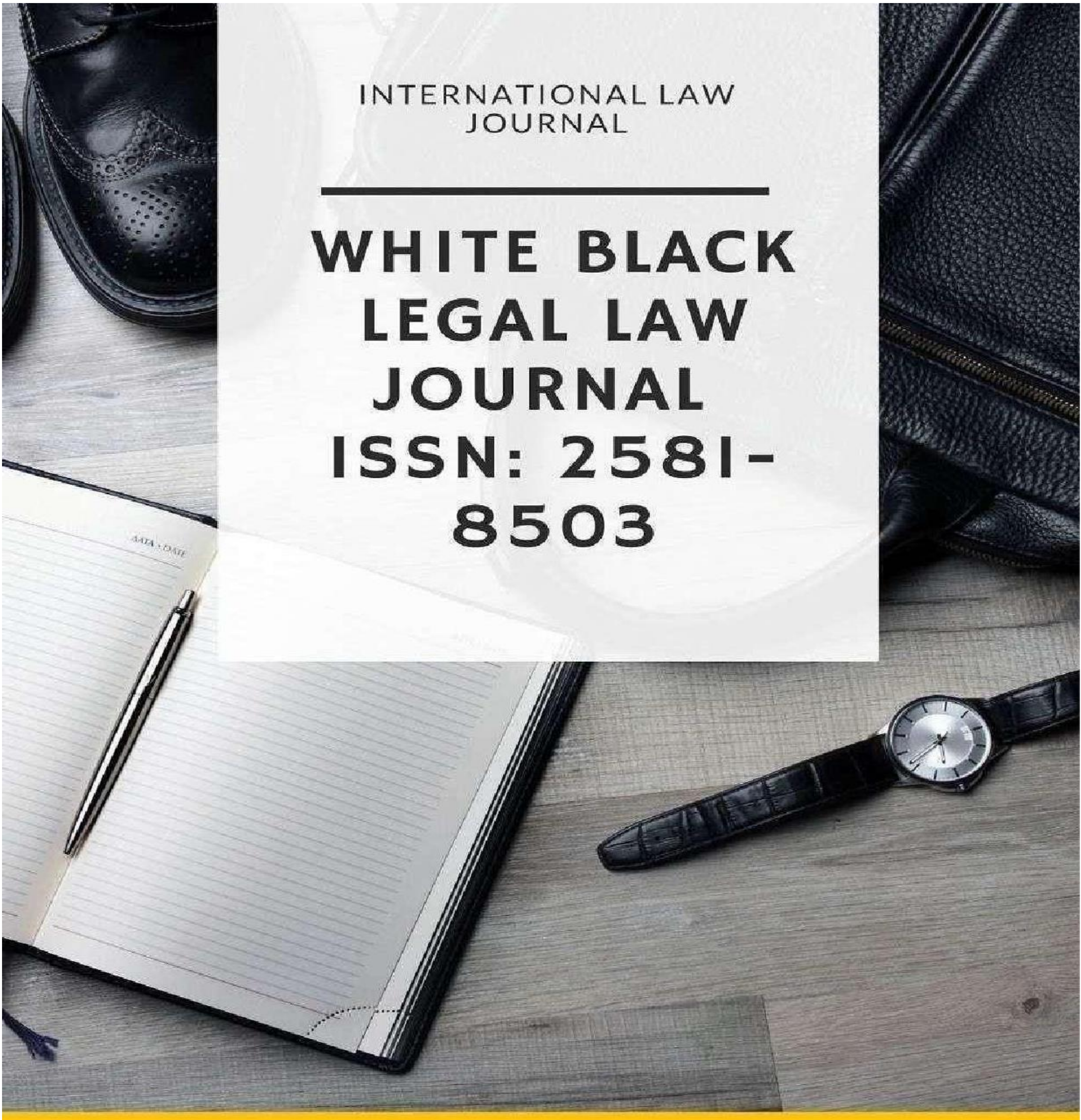

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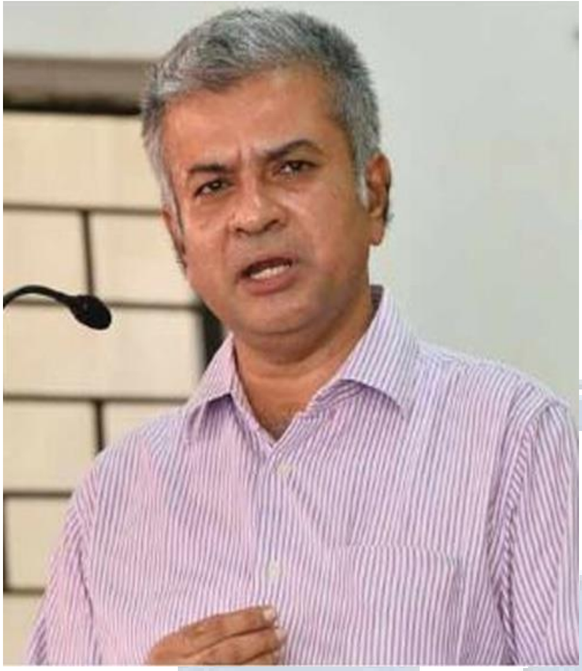

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ABOUT US

WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

Case study- Foss v Harbottle

AUTHORED BY - SINDHUJA R

INTRODUCTION:

The FOSS v HARBOTTLE case is a key English precedent in corporate law. According to the rules established in this case, if the company suffers a loss because of the negligent or fraudulent activities of its members or outsiders, the corporation can bring an action to recover such damages, either directly or through a derivative action.

The majority rule and the rights of minority shareholders were formed as a result of this rule. This regulation has to do with running the business's affairs. Any member of the corporation must abide by the resolution, which is passed by either a simple majority or a three-fourths majority when a decision needs to be made.

The court does not interfere with internal corporate management decisions, which are made by a majority of members. As a result, the corporation is the sole plaintiff in any legal proceedings against the perpetrator, preventing individual shareholders from acting. The regulation in this situation allows the corporation to remedy problems using its own procedures.

However, a balance must be established between effective corporate control and individual shareholders' interests. In such cases, individual shareholders can also file a lawsuit.

Minorities have frequently been on the receiving end of discrimination-related litigation, typically through derivative claims and unequal remedy. Numerous experts expressed worry about overlaps in derivative claims and unequal remedies for prejudice, suggesting that the Ruleof Rules was repealed after the present formal derivative actions took effect and that shareholderlawsuits will increase as well. Its fundamental principles are still extremely important today.

BACKGROUND OF THE CASE:

In 1843, the plaintiffs, who were minority owners in the Victoria Park firm, sued the firm's directors, saying that they had committed fraud and mismanagement, causing the company financial loss. The plaintiffs claimed damages from the directors on the company's behalf.

FACT OF THE CASE:

The "Victoria Park Company," which was founded in September 1835 to purchase 180 acres (0.73 km per square) of land near Manchester to develop it into a park known as "Victoria Park, Manchester," was minority owned by Richard Foss and Edward Starkie Turton. Following this, the Parliament approved an act in 1837 that allowed the business to be founded with the aim of designing and managing the ornamental park in the Lancaster County towns of Rusholme, Charlton upon Medlock, and Moss Side. They claim that in addition to being misused and squandered, the company's assets were wrongly mortgaged for several reasons. The shareholders decided to file a lawsuit on behalf of all other shareholders or proprietors of shares in the company as well as themselves. They did this by filing a claim against the five directors—Henry Byrom, John Westhead, Richard Beasley, Thomas Harbottle, Joseph Denison, the solicitor, and the architects, Thomas Bunting, and Richard Lane—as well as against the several assignees of Byrom, Adshead, and Westhead who went bankrupt.

Their claim was founded on the following grounds. The first ground was fraudulent activities that involved the misappropriation of the company's assets. The second reason was that there were not enough qualified directors in the company to form the board, and the third reason was that the corporation lacked a clerk or office. Due to these circumstances, the shareholders had no power to transfer the property from the hands of the directors and so had to initiate legal procedures against them.

ISSUES:

The questions were whether company members may file a lawsuit on behalf of the corporation and whether the guilty people could be held accountable for their wrongdoings.

ARGUMENTS:

The plaintiffs claimed that the directors broke their duty of care and diligence by selling the property for an undervalued price. They further maintained that the sale had resulted in a loss for the firm and that, as minority shareholders, they had the right to sue the directors on behalf of the company. The plaintiffs also claimed that the majority of shareholders had not approved the transaction and that they were entitled to challenge the decision.

The defendants contended that the plaintiffs lacked the authority to file the lawsuit because they were not the legitimate plaintiffs. They maintained that any loss experienced by the corporation because of the sale was a direct loss to the company rather than the shareholders individually. Therefore, any action for the loss should be brought by the corporation itself, rather than by individual shareholders.

JUDGEMENT OF THE CASE:

Wigram VC dismissed the shareholders' claim, stating that both the company and its shareholders are considered different legal entities and cannot be sued for wrongdoing. According to Section 21 (1) (a) of the Companies Act, a company can sue and be sued in its own name. Members cannot initiate legal action on the company's behalf. If a company has a right against a party under a contract, it must sue. Shareholders cannot sue a company since it is the company that has experienced injury, not its members. Therefore, the company must take legal action against members who have misused its property. The court will not intervene in cases where a majority of shareholders ratify irregular conduct, so minorities must show that they have exhausted all internal redressal options. However, this rule is unfavorable for minorities as it prevents them from taking legal action if the majority of shareholders ratify the conduct. As a result, the court effectively established the two principal rules. The "Proper Plaintiff Rule" states that if a company is harmed or loses money due to the fraudulent or negligent actions of its directors or outsiders, only the company can sue to enforce its rights.

However, due to the "Separate Legal Entity" principle, which views the company as a separate legal entity from all its members and permits it to file and receive lawsuits in its own name, neitherthe company's members nor any third parties may file a lawsuit on the company's behalf. This is the only explanation for why, to recover the damages incurred by the company, only the companyand not any member may initiate legal action or processes. Only a member of the company authorized to do so by the board of directors or by a regular resolution adopted at the general meeting may bring a lawsuit on the company's behalf against the wrongdoer. The second rule wasknown as the "Majority Principal Rule," and it stated that the court would not intervene if the alleged wrong could be verified or approved by a simple majority of members in the general assembly.

The minority shareholders were granted substantive rights, but the application of these strict principles appeared to be very harsh and unjust to them. They were forced to accept the wrongs committed by the majority, who controlled the company and had no voice because of their small number, even though they were denied access to justice under the rule.

Therefore, to mitigate this harshness, four exceptions to the general principle have been laid down where the litigation will be allowed. The first and the foremost exception is where the alleged actis ultra vires and illegal. Second exception is concerned with a situation where the alleged act couldonly have been validly done in violation of a requirement in the articles by some members of the special majority.

The third exception pertains to claimed conduct that violate the claimant's personal and private rights as a member of the company. The fourth exemption pertains to cases where the majority who control the company conduct fraud against the minority. These exceptions guarantee fundamental minority rights, regardless of the majority's vote.

ANALYSIS OF THE CASE:

The court decided that minority shareholders could not file such an action. A single shareholder or outsider cannot sue the company for wrongdoing since the company and its stockholders are independent legal entities. As an independent legal entity, a company could sue itself. The firm is the legitimate plaintiff in this case, as the wrong is done against them. The majority shareholders have the authority to act on behalf of the firm and determine the appropriate legal action for any wrongdoings. Minority stockholders lacked legal recourse under this rule, making it adverse to them. As a result, the court adopted two regulations. The first rule is the legitimate plaintiff rule, whereas the second is the majority principal rule.2 According to the proper plaintiff rule, if a corporation suffers a loss owing to fraudulent or negligent activities of members or directors, it can sue individuals responsible for the wrongdoing. Under the separate legal entity principle, a firm can sue and be sued in its own name. To take legal action, a member can either approve a resolution in the board meeting or seek approval from the board of directors of the company. Themajority principal rule prohibits courts from interfering with internal corporate concerns that can be decided or affirmed by a simple majority. This regulation has some limitations because it can be unfair and unpleasant for minority shareholders if it is strictly enforced. The following are the exception:

1. **"Ultra vires:** The company's shareholders may file a lawsuit if an action is taken that is in violation of the Articles of Association. Any member may file a complaint against the extra vires conduct since they are not beyond the purview of internal management. If the plaintiff is bringing a lawsuit, he should be doing so in good faith.

Bharat Insurance Company Ltd v. Kanhaiya Lal- The plaintiff was a stakeholder in the respondent corporation. The company's purpose was to provide interest-bearing loans against property in India, including lands, residences, and machines. The plaintiff sought a perpetual injunction to prevent the corporation from making further investments without proper security and in violation of the memorandum. The Court ruled that internal management of a company is best left to the company itself, and the Court should not intervene. However, the application of a company's assetsis not just internal management, and it is alleged that directors are acting illegally by using the company's funds.

In *Narcombe v. Narcombe*, the wife, a minority shareholder, sued her husband, a director, for wrongdoing. During their marital proceedings, she learned about the husband's improper gains, which were factored into the award. However, she was not deemed a suitable plaintiff for a derivative action.

2. **Fraud on the minority:** Any shareholder may file a lawsuit against the wrongdoer if the majority of the company's members oppress the minority and engage in any form of fraud. In certain situations, the court will step in to defend the minority.
3.

The concept of fraud on the minority can be best understood in the landmark case *Menier v. Hooper's Telegraph Works Ltd*- A firm was founded to lay a transatlantic telegraph wire by Hooper's Telegraph Works Ltd. The primary stakeholder, 'Hooper', realized a higher profit by selling the cable to another business that wanted to lay it down on the same path, but required government concessions for the project. Hooper got the trustee to transfer concessions from the first company to the second. To prevent the first company from suing for the concessions, Hooper obtained a resolution to wind up the company voluntarily and appoint a liquidator who would not pursue the company's claim against Hooper or the trustee. Menier, a minority stakeholder of the first company, filed a derivative action against Hooper to compel it to account for profits derived from unlawful arrangements. It was determined that Hooper's actions constituted an oppressive expropriation of minority shareholders, and so a derivative action could be brought against it.

Currently, every breach of duty that leads to a loss for the company is considered a fraud against the minority. The Courts have expanded minority protection due to the legislature's lack of action. This allows minorities to express their problems more regularly.

4. **Oppression and Mismanagement:** Under section 214 of the Companies Act, shareholders have a statutory right to file a complaint with the tribunal if they believe that the company is being operated in an oppressive or mismanaged manner. In such circumstances, the shareholders can approach the court under sections 397 and 3987 of the acts.

In *Kanika Mukherjee v. Rameshwar Dayal Dubey*, the Calcutta High Court ruled that Sections 397 and 398 of the Indian Companies Act, which aim to prevent oppression and mismanagement, arean exception to the majority rule established in Foss v. Harbottle.

5. Individual membership rights: Each member can take the business to court to assert their rights, such as the ability to vote and run for office. The plaintiff in one case recommended changing the resolution. Despite being seconded, the amendment was not recorded by the Chairman, and the original motion was approved without any changes. Moreover, no explanation was provided for this choice. It was decided that the right of shareholders to propose changes to resolutions.

In *Nagappan Chettyar v. Madras Race Club*, the Court observed that a shareholder is entitled to enforce his individual rights against the company, such as his right to vote, the right to have his vote recorded, or his right to stand as a director of a company at an election.
The Kerala High Court utilized this concept in the decision *Joseph v. Jos.* The plaintiff contested the election but was unsuccessful. He was nominated as a contender for the second position. However, the chairman disqualified him due to his earlier defeat.

6. Derivative action: Shareholders can seek relief for wrongdoing in the corporation by suing on behalf of other members. The corporation must be named as a co-defendant to be legally bound by the judgment. A derivative action occurs when an individual member sues a third party under a company-owned claim, resulting in a derived right.

APPLICABILITY IN INDIA:

In India, minority members' rights are guaranteed by law, hence the rule may not fully apply. The legislation and courts have established guidelines for when a minority shareholder can sue afirm if its actions harm their interests. In *Rajahmundry Electric Supply Corp. v. A. Nageswara Rao*, the Supreme Court found that the defendants' actions harmed the entire corporation, not only the plaintiffs. In such instances, corporations should sue under their own name and corporate character. Individual members of a corporation do not automatically have the power tosue on its behalf. In legal terms, a corporation and its members are distinct entities.

In *ICICI v. Parasrampuria Synthetic Ltd*, the Delhi High Court ruled that applying the Foss v. Harbottle15 rule to Indian contexts, conditions, and corporate realities is incorrect and deceptive.

The principle originated in countries with established shareholder power, centered on private individual enterprise and involving a huge number of tiny stockholders, differs greatly from the ground reality.

The modern Indian corporate entity relies heavily on state funding, with up to 80% or more coming from state-controlled financial institutions. Despite their small shareholding, these institutions provide most of the funds.

If the *Foss v. Harbottle* rule is rigidly followed, it would mean that the majority of shareholders, who are theoretically holding a larger percentage of shares would be given more weight than financial institutions, which, despite owning a smaller percentage of shares, have made significant financial contributions to these companies. Since these financial institutions have been the company's primary source of funding, it would be unfair and impractical to exclude them or give them no voice when applying the principles of *Foss v. Harbottle*. As a result, the Indian courts do not apply the principle in a mechanical manner.

CONCLUSION:

Company law protects minority shareholders when the majority violates their rights, like a democratic government. In corporate concerns, the value of an individual's shareholding is important. If a single individual with a majority shareholding votes in favor of an arrangement, it will be binding on several individuals. Majority leadership does not always have the last say in decisions. In Foss v. Harbottle, the rule applies to circumstances when corporations' actions discriminate against the minority and allow the majority to get away with it since they are 'in majority'. Therefore, the concepts established in this case are not applicable in India.

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