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ABOUT US

WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal provide dedicated 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

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CRITICAL ANALYSIS OF RIGHTS OF MINORITY SHAREHOLDERS

- Purusharth Dhull

Introduction

The members holding the maximum shares are considered to be the majority shareholders in a company. The Company Law does not define the term "minority shareholder‟. But generally, it is understood that those holding the minor shares are known as Minority shareholders. It can also be understood by saying that minority shareholders are those who hold such amount of shares which does not give them the control over the company. The management of a company is usually based on the majority rule. The general rule in any company is that the directors are the elected representatives of the company and hence, they have the right to manage the affairs of the company. Those rights that are not given to the directors are exercised by the members in their general meeting. This decision is usually decided on the basis of majority. Thus, the majority rule means the right of the majority shareholders to run the company and manage its affairs. This in turn means that the majority has its way in the general meeting. The rights of the minority shareholders are hence, limited in any company and their rights have been violated many a times. This principle is that the will of the majority should prevail and bind the minority is known as the principle of majority rule[1]. This is also known as the Foss v. Harbottle Rule[2]. Foss v Harbottle is a leading English precedent in corporate law. Thus, injuries allegedly caused to the corporation alone and not to its members, must be remedied not by the members but by corporate action. This is known as the proper plaintiff rule and it is applicable here because the company is considered a separate legal entity and hence only it can approach in case of any wrong committed to the company and not individual shareholders. This was the rule followed in India too since it is derived from common law.But there are few exceptions to this rule but they were not proper redressal mechanisms. Presently, the rule has been

[1] Dr. Ashok Sharma, Company Law and Secretarial Practice, V. K. Enterprises (India), New Delhi, 2010.

[2] (1843) 67 ER 189

diluted to suit the changing needs and offer protection to the minority shareholders as well.

Majority Rule in India

Origin - Foss v. Harbottle

The majority rule originated in this case as mentioned earlier. In this case, two shareholders in the Victoria Park Co. filed a case against the five directors. They had claimed that the company"s property had been misapplied and squandered. They also held that the defendants should be held liable for the company and sought for the appointment of a receiver. It was however, ruled that the plaintiffs were incompetent to bring any such proceedings and the sole right to do so was with the company or its representatives. "It is only necessary to refer to the clauses of the Act to show that, whilst the supreme governing body, the proprietors at a special general meeting assembled, retain the power of exercising the functions conferred upon them by the Act of Incorporation, it cannot be competent to individual corporates to sue in the manner proposed by the Plaintiffs." It was also held that the minority shareholders are bound by the actions of the majority shareholders. This is known as the Majority rule.

Rationale Behind the Rule

The principle is that "the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or association itself. It springs naturally from the treatment in law of the corporation as a "person" separate from the members of which it is composed; and it was well established by the nineteenth century that "the individual members in a corporation are quite as distinct from the metaphysical body called "The corporation" as any others of his Majesty"s subjects are. Thus, the injuries caused to the corporation alone and not to its members, must be remedied. Again, that should not be by the members" action but by corporate action[3].The rationale behind this specific rule is that the protection of the majority shareholders is supreme. When a person becomes the member of a

[3] K. W. Wedderburn, Shareholders' Rights and the Rule in Foss v. Harbottle, The Cambridge Law Journal, 1957, 15(2), pp. 194-215.

company, it is completely understood that he gives his implied consent to accept the decision of the majority in the general meeting of their company.

Exceptions

Few important exceptions have also been developed. The exceptions protect the rights of the minorities, regardless of the majority's vote because they are also a method to safeguard the minority‟s interests. Palmer‟s Company Law recognises the exceptions to the rule in Foss v. Harbottle as follows:

(a) where there is an ultra vires act;

(b) where a special majority is needed;

(c) where personal rights are infringed;

(d) where fraud has been committed by those in control.

The Common Law Derivative Action

Another redressal mechanism is the derivative action. In reality, this is considered to be the only true exception to the rule. The rule in Foss v. Harbottle is best seen as the starting point for minority shareholder remedies. It means that a derivative claim could be brought by a minority shareholder on behalf of the company. This was done to ensure that there was a redressal mechanism for the wrong committed. This action was brought instead of an action in the name of the company. The shareholders as such had no such right of their own and if their own personal right were being infringed they might bring a representative action. The Foss v. Harbottle rule in reality, barred a

minority action whenever the alleged misconduct was in law capable of ratification, whether or not an independent majority would ever be given a real opportunity to consider the matter.

Criticisms to the Rule This rule followed in England has been highly criticised by many. A contrast

was also drawn by Professor Sealy with other types of litigant. He tells that even a person approaching the Court seeking judicial review will receive a much more favourable judicial acceptance than a minority shareholder[4]. The shareholders in a

[4] Sealy, The Problems of Standing, Pleading and Proof in Corporate Litigation in B. G. Pettet (ed.), Company Law in Change (Stevens & Sons, 1987), p. 2.

large public company are unlikely to have the information to make a proper judgment of their own interests or those of the company. On the careful analysis, it is clear that the Foss v. Harbottle rule is a mixture of substance and procedure.The narrow exceptions also produced two main difficulties: the first one being that it swept into oblivion a line of cases, including by Davidson v. Tulloch which held a small category frauds and deceits incapable of “confirmation at the option of the corporation”, second one being the fact that the narrowness of it is hardly compatible with the wider exceptions that were favoured by the other judges.Indian Scenario In India, the situation was slightly similar with that of the England since we our Company Law is based on the common law. The Old Companies Act of 1956 provided few redressal mechanisms to the minority shareholders between Sections 397 to 409. It lays down certain provision in order to protect the interests of minority shareholders against the oppressive act of majority shareholders. By virtue of Sections 395 and Section 399, it can be understood that the minority shareholders have been set out as those with 10% of shares or 100

shareholders (whichever is less) in the companies with share capital; and it is 1/5th of the total number of its members, in case of the companies without any share capital.The Act provided for certain provisions that dealt with situations wherein rights of Minority Shareholders can be affected. They can be divided into two major heads, i.e.:

1) Section 397 (Application to Company Law Board for relief in cases of oppression) and

2)Section 398 (Application to Company Law Board for relief in cases of mismanagement).

The right to apply to the Company Law Board in case of any oppression and/or mismanagement under Sections 397 and 398 is given under the Section 399 of the Companies Act of 1956. The numerical threshold has also been mentioned as ten percent shareholding or hundred members or one-fifth members limit, as the case may be. However, the power to waive this was given to the Central Government.

Companies Act, 2013 Under the new Act, the relief, in case of oppression and mismanagement has been provided under the Sections 241-246, according to which the affected party can approach the National Company Law Tribunal (NCLT). Section

244(1) mentions the same numerical threshold as the parent Act. However, the power to waiver the threshold has been given to the NCLT. The concept of class action14 has also been introduced in the new Act. The class action suits can be instituted against the company as well as against the auditors of the company. Reconstruction and Amalgamation: To counter the shortcomings, Section 235 grants the power to the majority to acquire the shares of the shareholders who are dissenting from the scheme approved by the majority in not less than 9/10 in value of the shares. The company may give notice to the dissenting shareholder for acquiring his shares. It is mandatory to notify the company about the

intention of the shareholders to buy the remaining equity shares. It is further provided that the shares need to be acquired at the market price. Minority Upgraded: the minority shareholders have some right in the decision making also. According to Section 151, small shareholders have to appoint a director in listed companies. This provision is further elaborated in the Draft

Companies Rules which provides that a listed company may elect a small shareholder.15 16 The Company Rules of 2013 has clearly stated that the small shareholder director17 will not follow the concept of retiring by the rotation and that he shall enjoy his term for three more years. However, this means that he shall not be eligible for any reappointment. It is thus clear that the Companies

Act of 2013 has tried to empower the minority/small shareholders rights and ensure that they are included in the process of decision making as well as the management of the company.

Judiciary and Minority Shareholders 'Rights

In the early period, the Court followed the Majority rule completely and allowed even the irregular acts of the majority shareholders to be made regular through resolution. This was seen in the case Bhajekar v. Shinkar[5] where the board of directors of a company passed a resolution appointing certain persons as managing agents. The resolution was confirmed by the company in the general meeting with the complete knowledge of all the material facts. Some minority directors brought a suit claiming the resolution to be declared invalid since it was irregular. The court held that it was

[5] (1934) 36 BOMLR 483.

the right of the company to ratify any type of agreement even if it was irregular and the Court will not interfere in the internal affairs at any cost. Similarly, in Rajahmundry Electric Supply Corpn Ltd. v. Nageshwara Rao19, it was observed that the Courts will not interfere in the internal affairs of the Company or the management of the directors as long as they act within the ambit of the powers conferred on them under the Articles of Association of the company. Over the years, the Judiciary has deviated from the strict sense of the majority rule, so as to safeguard the interest of minority over majority shareholders. It has tried to maintain a balanced view.The Court in Sri Ramdas Motor Transport Ltd. v. Tadi Adhinarayana Reddy and Ors.20 has stated that under section 397 of the Companies Act 1956 any member of the company who complains that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members may apply to Company Law Board for an order under that section. However, the majority shareholders are not deprived of their democratic rights due to minority activism.

This was also upheld in the case of Shanti Prasad Jain v. Kalinga Tubes Ltd. A fight between broke out two groups of business magnates for the control of a certain company. The appellant chairman of the company alleged that the affairs of the company were conducted in a manner that was oppressive to him and his group of members. The appellant also contended that the allotment of new shares to outsiders was for defeating the rights of the existing shareholders and that it amounts to oppression. The Apex Court held that the High Court was right in holding no case for action under Section 397, as mere fact of allotment does not constitute oppression. The court clarified that the facts should be there to justify any potent mismanagement or oppression.

The Court in Miheer H. Mafatlal v. Mafatlal Industries Ltd. held that the Court cannot intervene if the scheme is sanctioned by the majority of shareholders and if it is lawful. Court can only go through the scheme and examine if it has complied with all the requirements under Section 391 (2) and if it is passed by the requisite majority. If the scheme passed by the company with majority is just and fair, then the Court will not interfere. But it will interfere if the the majority shareholders‟ action affects the class interest of such equity shareholders.

Recent Trends in Minority Shareholder Activism

Class Action Suit in the U.S. and India

The origin of the class actions suits in the U.S. was in the year 1842 when the Equity Rule 48 gave the individuals the right to file such suits. After multiple changes and revisions, it gained its current form in the year 1966.24 Since then, this option has been used on numerous occasions in the U.S. Even in 2006, many shareholders in the U.S. lost their money after investing in the shares of
Enron. They received a total of $7.2 billion after a probe revealed that the officials of the company had falsified their to the investors and had hidden the losses before going bankrupt. Hence, it is pretty clear that the class action suits are pretty common in U.S. and are one of the usual redressal mechanisms. In India, before the commencement of the new Act, people filed for class action
in the name of Public Interest Litigation. The class action suit dealt under Section 245 of the Companies Act of 2013 came into place only because of the Satyam Computer Services Scam, popularly known Satyam Scam25 that broke out in 2009. Lot of members were affected but were without any remedy. The investors in India did not have any legal recourse while their counterparts, who were in USA filed the class action suit against the company and got compensation from the company. The class action suit is a mechanism which evolved to overcome `Collective Action' problem, wherein the suits by smaller stakeholders are not cost effective, and hence, may never get filed.

The question that arose here was why is there a need for a separate provision under Section 245, despite remedies being there for oppression and mismanagement. It is seen that Section 245 of the Act also covers depositor sand the court generally gives restraining orders to the company under Section 245. Another added advantage here is that the National Company law Tribunalgenerally gives a public notice after the class action is filed. This serves as an opportunity for any other affected parties to join which will then make this a representative action for them.

The other question that arises here is if this mechanism is used in India as often as it is used in the U.S., considering that it has been five years since its introduction to India. The answer remains the same. It has not been the most popular redressal mechanism in India. The major difference in India and U.S. is that in the U.S., the law firms and lawyers act as catalyst and ask the affectedparties to file the case. This is because they get a share from the compensation and the aggrieved parties need not pay any for the legal assistance sought. Again, this possible because in the U.S. lawyers are allowed to charge contingency fees, i.e., the lawyer gets his fee only and if the case is won. In India, lawyers are barred from charging such fees. Relaxing this rule mightencourage class action suits as it helps both the lawyers as well as the affectedparties.Secondly, the Investor Education and Protection Fund will be used to provideany reimbursement of the expenses which were incurred while pursuing the suits under Sections 37 and 245 by the affected parties. Practically speaking, the government controlled fund cannot manage the class action suits as there is a high possibility ofmisuse.

Conclusion & Suggestions

The rule in Foss v. Harbottle is actually rule of majority supremacy. It means that once a resolution is passed by the majority, it is binding on all the members. This principle was earlier considered as the symbol of democracy. But as far as India is concerned, this principle stands diluted and is not followed in its strict sense.

The Companies Act of 1956 gave some provisions to protect the minority shareholders from the majority shareholders. It was the first step taken by the legislature to recognize the rights of the minority shareholders in India. In the Companies Act, 1956, the minority shareholders were not considered as a major part of the company due to the suppression by the majority in the company. But Companies Act of 2013 has taken various crucial steps to safeguard the interest of the minority rights of the shareholders in the company irrespective of the existence of oppression and mismanagement of the company affecting the rights of the minority shareholders. It can also be ascertained that the core intention of the legislation is to safeguard the interests of the minority shareholders. But the challenge to this is the enforcement of these rights. The minority shareholders‟ rights guarantees proper administration only when it is implemented successfully by giving importance to the minority shareholders in the management of the company.

Another major flaw in the Companies Act of 2013 is that the numerical threshold that is mentioned under Section 244 of the Companies Act of 2013. While it is understood that there should be some filters to ensure that frivolous suits are not filed and the Court‟s time is not wasted, it is difficult to meet the requisite number mentioned. This came into light after the recent Tata and

Cyrus Mistry conflict where the Mistry group‟s plea was initially rejected as they did not fulfil the numerical threshold. Though the power of waiver is given to the NCLT, there is no clarity on when the NCLT can exercise that right and what is the criteria for the same. Generally, having filters for direct actions such as for oppression, which the shareholders bring in their own names and toassert their rights (rather than that of the company), goes against the spirit of corporate law and also ends up enfeebling the minorities. The introduction of class action suit is one step in the right direction. Efforts must be taken to create awareness regarding the same, so that the affectedparties use this mechanism and get justice. This will also lead to reduction in the number of lawsuits since it has allowed a group of people to file the case against one defendant on common grounds.

Further, the companies have started taking steps to ensure that the rights of the minority shareholders are not violated. The concept of "piggybacking‟ is being followed presently. Accordingly, if the majority sells their shares then the minority shareholder right has to be included in the deal. Moreover, it also requires the party to consider the purchase of the business, in order to sell 100% of the outstanding shares.