Majority rule

James Mendelsohn explains why the numbers game is so important in limited companies. But there are several exceptions that allow minority shareholders to take their grievances to court

'MAJORITY RULE' underpins company law. At director level, board resolutions are passed by a simple majority. At shareholder level, ordinary resolutions are passed by a simple majority, special resolutions by a 75% vote. In each case, a dissenting director or shareholder is bound: 'those who take interests in companies limited by shares have to accept majority rule' (per Lord Wilberforce in *Re Kong Thai Sawmill* [1978] 2 MLJ 277).

The rule in *Foss v Harbottle*

Where a company is wronged, the company itself should seek the remedy, not a member. In *Foss v Harbottle* [1843] 2 Hare 461, directors who allegedly misapplied company property and entered illegal transactions were sued by two members 'on behalf of themselves and all other members other than the directors'.

The court dismissed the action as there was nothing to prevent the company from taking the action if it desired (the 'proper claimant' principle). Individual members may not bring an action where the company can settle an alleged wrong itself ('the internal management principle'), nor where a company can ratify or condone an irregularity by its own internal procedures ('the irregularity principle'). These rules cause difficulties to aggrieved minority shareholders: wrongdoing directors will hardly mandate the company to take action against themselves.

Where the company has been wronged and the wrongdoers are in control, a minority shareholder may bring a derivative action on behalf of the company

Derivative claims

Various exceptions to these rules developed, allowing individual shareholders to bring actions in certain circumstances – most significantly, where a fraud was perpetrated on the minority and the wrongdoers were in control. In *Cook v Deeks* [1916] 1 AC 554, the company's four shareholders were also all directors.

Three of the four diverted a company contract to themselves, excluding the fourth, and then passed an ordinary resolution purporting to waive the company's interest in that contract. The fourth member was allowed to bring a 'derivative action' against them, deriving from the company's right to sue, seeking relief on behalf of the company.

Statutory derivative procedure

Sections 260-264 of the Companies Act (CA) 2006 create a statutory procedure for a member to bring a 'derivative claim' on the company's behalf. Claims may be brought in respect of causes of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director.

The court must give the member permission to continue such a claim and considers various factors, including whether the cause of action has been authorised or ratified by the company, whether the member is acting in good faith, or whether a person seeking to promote the company's success would bring such a claim.

Oppression and unfair prejudice

Since the rule in *Foss v Harbottle* caused such difficulties, section 210 of the CA 1948 was created, allowing aggrieved minorities to petition the court for relief from 'oppression'. This was difficult to prove; only two cases succeeded in 32 years. It was replaced with what is now sections 994-996 of the CA 2006, allowing shareholders to petition the court for relief where 'the company's affairs are being or have been conducted in a manner which is unfairly prejudicial' to their interests.

The court assesses whether the conduct complained of breaches the company's articles. Often, the articles will not reflect all of the understandings between shareholders – for example, that all shareholders should also be directors – and thus the court also ascertains whether any such 'legitimate expectations' have been breached (*Re Saul D Harrison & Sons plc* [1995] 1 BCLC 94 (CA); *O'Neill v Phillips* [1999] 1 WLR 1092 (HL)).

The courts have granted relief to minority shareholders in various situations, for example where no dividend has been paid (*Re Sam Weller & Sons Ltd* [1990] Ch 682); exclusion from management (*Richards v Lundy* [1999] BCC 786); and gross mismanagement by the directors (*Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354). Many cases involve 'quasi-partnerships' – small companies where all members share management responsibilities and profits.

The court 'may make such order as it thinks fit' (section 996(1)); usually, the wrongdoing majority is ordered to purchase the petitioner's shares at a price fixed by the court. In order to minimise costs, conflicting shareholders should therefore seek to negotiate such a buy-out before petitioning the court under section 994.

Winding-up

Sections 122(1)(g) and 124 of the Insolvency Act 1986 allow a member to petition the court to wind the company up if this is 'just and equitable'. Orders have been made where, for example, there is complete management deadlock (*Re Yenidje Tobacco Co* [1916] 2 Ch 246); or where the directors are shown to lack integrity (*Loch v John Blackwood Ltd* [1924] AC 783). Clearly, this is a remedy of last resort, though the threat of this and other actions may be used in an attempt to improve any settlement.

Practical considerations

Normally, shareholders are bound by the principle of majority rule, and may not bring individual actions where the company has been wronged. Where the company has been wronged and the wrongdoers are in control, a minority shareholder may bring a derivative action on behalf of the company under sections 260-264 of the CA 2006.

Where a member has suffered 'unfair prejudice', he may seek relief under sections 994-996 of the CA 2006, though preferably only after seeking a negotiated buy-out. As a last resort, he may petition the court to wind up the company on the 'just and equitable' ground under sections 122(1)(g) and 124 of the Insolvency Act 1986.

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