FOSS VS. HARBOTTLE (1843)

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Title of the case: Foss v. Harbottle

Citation: [1843] 67 ER 189, (1843) 2 Hare 461

Court: Court of Chancery

Quorum: Wigram VC, Jenkins LJ

Parties to the dispute:

Petitioner: Richard Foss and Edward Starkie Turton

Defendants: Thomas Harbottle & Other's

INTRODUCTION

Foss vs. Harbottle case is a leading English precedent in company law. According to the rule laid down in this case, if any loss is suffered by the company by the negligent or fraudulent actions of its members or outsiders, then the action can be brought in respect of such losses, either by the company itself or by a way of derivative action.

This rule led to for formation of the rule of majority and the minority shareholders rights. This rule is related to the management of the affairs of the company. When a decision must be taken a resolution is passed in the company by a simple majority or a three forth majority, the resolution becomes binding all the members of the company.[1] The court in ordinary matters does not interfere in the internal management and matters of the company as it is decide by majority of members. The result of this makes the company the right plaintiff to institute a suit or any legal proceedings and does not let a single shareholder take any legal action against the wrongdoer. The rule in this case allows the company to correct the irregularities by its own internal procedure. However, a balance must be struck between the

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[1] AVTAR SINGH, COMPANY LAW, 509 (Eastern Book Comxpany, 15th ed.).

effective control of the company and the interests of the individual shareholders. Therefore in few circumstances an individual shareholder is also allowed to bring a legal action.

Minorities have often been on the other side of the coin, usually covered by derivative claims and unequal redress for discrimination. Many researchers suggested that the Rule of Rules was repealed after the coming into effect of the current formal derivative actions, that there will also be a rise in shareholder lawsuits and have further voiced concern over overlaps in both derivative claims and unequal remedies for prejudice. Its basic values are still of critical significance today.

FACTS OF THE CASE

In September 1835, a company called the Victoria Park Company was set up to purchase 180 acres (0.73 km2) of land near Manchester (later became Victoria Park, Manchester, when the Act of Parliament turned it into incorporation). But counter to the actual work allegedly enclosing and planting the same in an ornamental and park-like way, and constructing houses thereon having attached gardens and fields, and then selling, renting or otherwise disposing of them, the directors of the company along with others were indulging in the misappropriation of the property that belonged to the company and that may result in the misappropriation of the property that belonged to the company.

The concern was illustrated by Richard Foss and Edward Starkie Turton, two minor shareholders. They reported that the five directors of the firm were Thomas Harbottle, Joseph Adshead, Henry Byrom, John Westhead, Richard Bealey, and the lawyers and architects (Joseph Denison, Thomas Bunting, and Richard Lane), as well as H. E. Lloyd, Rotton, T. Peet, J. Biggs and S. Brooks (Byrom, Adshead and Westhead's various assignees) misapplied and falsely mortgaged the property of the company, thereby behaving in contradiction to what the company was formed for. It clearly demands that the wrongdoers be kept liable for all the transactions and that a responsible receiver be named.

Their argument was based on the ground below. The first argument was the fraudulent practices by which the company's funds were misappropriated. The second ground was due to the inadequacy of qualified directors in the company who could potentially make up the board and the third ground was that there was no clerk or office in the company. Because of

these conditions, the owners had no right to remove the property from the directors' hands and instead had to pursue legal action against them.

ISSUES OF THE CASE

The issues were whether the members of the company can file suit on behalf of the company or not and can the guilty parties be held accountable for their wrong deeds or not.

ARGUMENTS OF THE PETITIONER

It was argued by the plaintiffs that the company should not be treated as an ordinary company as it was incorporated by the Parliament. Moreover, the act of incorporation was passed with the aim to benefit the company, but the directors tried to fulfill their own interests. They further argued that directors should have acted as the trustees of the company and should be held accountable for misappropriating the assets of the company. Therefore, this act enabled the directors to sue those people who cause any harm to the company, whereas it did not give right to the members of the company or outsiders to sue the board of directors.

ARGUMENTS OF THE DEFENDANTS

It was argued by the defendants that the plaintiffs do not have any right to bring a legal action against them on behalf of the company.

JUDGEMENT OF THE CASE

In this case, Wigram VC dismissed the claim of the shareholders and held that an individual shareholder or any outsider of the company cannot take any legal action against the wrong done to the corporation as both company and its shareholders are considered as the separate legal entities. It is also mentioned under Section 21 (1) (a) of the Companies Act that a company may sue and be sued in its own name and a member may not take any legal action on behalf of the company ,and if a company has a right against the party under a contact, then it is for the company to sue. The reason that shareholders of the company cannot sue is that the company is the one who has actually suffered injury and not its members, so it is on the company to sue or take any legal action against those members who have misappropriated its property. He followed the judgements passed in older cases on the unincorporated companies and insisted the minorities to show that they have exhausted all the possibilities of redressal

within the internal forum as he has stated that the courts will not intervene in those cases where majority of the shareholders can ratify the irregular conducts, but this rule was considered as unfavorable for the minorities because it barred them from taking any legal action whenever the alleged misconduct was in law capable of ratification.

Therefore, in effect the two principle rules were established by the court. First and the foremost rule was the "Proper Plaintiff Rule" which laid down that if any wrong done to the company or company suffers any loss due to the fraudulent or negligent acts of directors or any other outsider , then in such situation only the company can sue the directors or outsiders in order to enforce its rights. Whereas, the members of the company or any outsider cannot sue on its behalf because of the principle of "Separate Legal Entity" which considers company as a separate legal person from all the members of the company, so, it can sue and be sued in its own name. This is the only reason that why only a company can bring legal action or institute legal proceedings not any member in order to cover the losses that has been suffered by the company. A member of the company can take a legal action on its behalf against the wrong doer only if he is authorized to do so by the board of directors or by an ordinary resolution passed in the general meeting. The second rule was "Majority Principle Rule" which laid down that if the alleged wrong can be confirmed or ratified by a simple majority of members in the general meeting, then in those cases the court will not interfere.

However, the application of these strict principles appeared to be very harsh and unjust for the minority shareholders, as although a substantive right have been provided to them, still they were barred from obtaining justice under the rule and have to submit to the wrongs done by the majority as they were the ones who controls the company and minority members have no say due to their small strength. Therefore, in order 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 act is ultra vires and illegal. Second exception is concerned with a situation where the alleged act could only have been validly done or sectioned, in violation of a requirement in the articles by some members of the special majority. The third exception is related with the alleged acts that cause invasion of the claimant's personal and individual rights in his capacity as a member of the company. Last but not the least, the fourth exception deals with a situation where a fraud on minority has been committed by the majority who themselves control the company. Therefore, all these

exceptions help in protecting basic minority rights that are necessary to protect regardless of majority's vote.

ANALYSIS OF THE CASE

The decision of the court was that minority shareholders cannot bring such an action. It was held that a single shareholder or an outsider to the company cannot file a suit against such wrong to the company as the company and its shareholders are separate legal entities. Company being a separate legal entity means that it can be sued, and it can sue under its own name. Therefore, the proper plaintiff here would be the company as the wrong is done against the company. The majority shareholders can act under the name of the company and they have the power to decide what suit is to be instituted for the wrong done. This rule was unfavorable for the minority shareholders as it did not allow them to take any legal action for any wrong done. This led to the formation of the two rules established by the court. The first rule being the proper plaintiff rule and the second rule is the majority principle rule.[2] The proper plaintiff rule states that when some wrong is done to the company or if any loss is suffered due to any fraudulent or negligent acts of members or directors then company sue those particular people for the wrong done. The separate legal entity principle allows the company to sue in its own name and enables the company to be sued. If a member wants to take a legal action an ordinary resolution in the board meeting can be passed regarding it or he can do so by taking approval of the board of directors on the company. The second rule is the majority principle rule, it states that the court will not interfere of the internal matters of the company where the issue can be resolved or confirmed by the simple majority. There are certain exceptions made to this rule as if the rule is applied strictly it can lead to unjust and harsh for the minority shareholders. The exceptions are as follows:

1. **Ultra vires:** When there is any action done which is ultra vires to the Articles of Association, an action by the shareholders of the company can be brought. The ultra vires actions are not covered under the internal management and any member can bring action against it.[3] The plaintiff should be acting in good faith if he is initiating a legal action.

[2] Foss v. Harbottle (July 14, 2020), https://lawlex.org/lex-bulletin/case-summary-foss-vs-harbottle-1843/24620.
[3] Bharat Insurance Co Ltd v. Kanhaiya Lal AIR 1935 Lah. 792.

2. Fraud on minority: When the majority of the members of the company oppress the minority and commit any fraud, even a single shareholder can bring legal action against the wrong doer.[4] In such cases the court will interfere to protect the minority.[5]

3. Oppression and Mismanagement: It is a statutory right granted to the shareholder where if the functioning of the company is done in a oppressive or mismanagement is being done, the shareholders can bring an action by applying to the tribunal under section 214 of the companies act.[6] Under section 397 and 398[7] of the act the shareholders can approach the court in such cases.[8]

4. Individual membership rights: The individual members can enforce their rights against the company like the right to vote, right to stand in elections etc.[9] In a case the plaintiff moved an amendment to the proposed resolution. The Chairman refused to record the amendment in spite of the fact that it was seconded, and the original resolution was passed without amendments. No reasons were given for this decision either. It was held that the shareholders have a right to move amendments to resolutions.[10]

5. Derivative action: When some wrong is done to the company the shareholders can bring an action for the wrong done as they are not suing under their own right but under the right of other members whose relief is sought. The company has to be joint as the co-defendant so that the company is bound by the judgement given. When the action is against a third party it is called a derivative action as individual member sues under a claim which belongs to the company thus the right is derived from it.

CONCLUSION

A company is a legal entity that is given a different legal body rather than the members who create it, i.e., the company's owners. The company's decisions are made on behalf of the company by the Member-Owners and the Board of Directors. The group also makes decisions on seeking lawsuits. As per the Companies Act 1956, the corporation is governed

[4] Edward v. Halliwell 1950 2 All ER 1064.
[5] Cook v. Deeks [1916] UKPC 10.
[6] Sec 214, Indian Companies Act, 2013.
[7] Section 397 & 398, Indian Companies Act, 2013.
[8] O.P. Gupta v. Shiv General Finance Ltd. 1977 47 Comp. Cas. 297.
[9] Nagappa Chettiar v. Madras Race Club (1949) 1 MLJ 662.
[10] Henderson v. Bank of Australasia 1890 45 Ch. D. 330.

by shareholders who own most of the shares. This majority theory is accepted in Foss v Harbottle, a ground-breaking case. The majority of the shareholders' vote was binding on the minority. This theory has since been replaced and under the Companies Act 2013, minority owners have been granted more control.

In order to protect the rights of minority owners, there are provisions under the Companies Act, 1956 but because of lack of time, redress or capacity, the minority was unable or unable, financial or otherwise. Hence, there have been several instances of minority shareholder discrimination. The Companies Act, 2013 has provided for the protection of the interests of minority shareholders which can be called a game-changer in the battle between majority and minority shareholders.

This rule strikes a balance as it prevents frivolous and large-scale litigation, but it also enables to take legal action for the specified exceptions. The shareholders can raise issues for mismanagement and can communicate regarding their issues. It allows the company to figure out the individual responsible for the harm caused to the company. Once a shareholder has tried to get the issues resolved within the company, then he can take a legal action if it comes within the exceptions.

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