SUMMARISED VERSION (CHART FORM)

(This page has been left to summarize the chapter in the chart form. The chart formed, would help you to recall the chapter in a simpler and more convenient manner)

CHAPTER 1- SHAREHOLDER'S DEMOCRACY & CORPORATE DISPUTES

SHAREHOLDER'S DEMOCRACY

- **INTRODUCTION:**

The concept of shareholders' democracy in the present-day corporate world denotes the shareholders' supremacy in the governance of the business and affairs of corporate sector either directly or through their elected representatives. The Government of India has been endeavoring to disperse the shareholdership as widely as possible to avoid concentration of ownership in few hands. It is a widely acclaimed fact that in any corporate enterprise the shareholders are the owners, but they are seldom able to exercise any ownership rights. In order to protect the rights of shareholders and enable them to have control over the affairs of the company, the concept of shareholder's democracy has been introduced. Shareholders, through general meeting can appoint board of directors, who then manages the day to day affairs of the company. Hence, Shareholders are not active participants in the governance of the corporate process, still the directors, as per law, are answerable to the shareholders.

- **MEANING**

Democracy means the rule of people, by people and for people. In that context the shareholders democracy means the rule of shareholders, by shareholders', and for shareholders' in the corporate enterprise, to which the shareholders belong. Precisely it is the ability of the shareholders to directly or indirectly manage the affairs of the company by electing Board of Directors who are responsible for managing the day-to-day affairs of the company.

- **CONCEPT OF SHAREHOLDER'S DEMOCRACY:**

The concept of shareholder's democracy has been introduced to provide authority to the shareholders as economic viability of the company is directly concerned with the shareholders. In order to avoid concentration of powers and to provide authority to the

shareholder's so as to enable them to exercise control over the affairs of the company, there has been a clear demarcation between the powers of board of directors and that of

shareholders. Shareholders cannot encroach upon the powers of board of directors and vice versa.

Some powers of shareholders are as following:

1. Alteration of Memorandum of Association and Articles of Association.
2. Further issue of share capital.
3. To transfer some portions of uncalled capital to reserve capital to be called up only in the event of winding up of the company.
4. To reduce the share capital of the company.
5. To shift the registered office of the company outside the state in which the registered office is situated at present.
6. To decide a place other than the registered office of the company where the statutory books, required to be maintained may be kept.
7. Payment of interest on paid-up amount of share capital for defraying the expenses on Construction when plant cannot be commissioned for a longer period of time.
8. To appoint auditors.
9. To approach Central Government for investigation into the affairs of the company.
10. To allow Related Party Transaction.
11. To allow a director, partner or his relative to hold office or place of profit.
12. Payment of commission of more than 1% of the net profits of the company to a managing or a whole-time director or a manager.
13. To make loans, to extend guarantee or provide security to other companies or make investment beyond the limit specified.
14. To borrow money and to charge out the assets of the company to secure the borrowed money.
15. To appoint directors.
16. To increase or reduce the number of directors within the limits laid down in Articles of Association.
17. To cancel, redeem debentures etc.
18. To make contribution to funds not related to the business of the company.

Some of the powers of board of directors are as following:

1. Make calls on shareholders.

2. Authorise the buyback of securities and shares.
3. Issue securities and shares.
4. Borrow monies.
5. Investing the funds.
6. Grant loans.
7. Approve the financial statement.

Thus, in order to protect rights of shareholders, Companies Act has tried to demarcate the area of control of directors as well as that of shareholders by virtue of section 179 of Companies Act, 2013 so that shareholder's can indirectly participate and manage the affairs of the company.

The courts have further determined two broad duties to be performed by a director:

1. Duties of utmost care and skill in managing the affairs of the company or else be liable for damages.
2. Fiduciary duties to act bona fide in the interest of the company, not to exercise powers for collateral benefit and not to earn profit from the position as a director.

- **PRACTICAL SCENARIO:**

  - The shareholders democracy is dependent upon the voting strength of shareholders and availability of members in General Meetings, either by themselves or through their proxy. However, the shareholders do not have enough time to spare from their busy schedules and concern themselves with the affairs of the company in which they have invested. Despite the powerful weapons handed over to the shareholders by the Companies Act, the shareholders have not been able to use them efficiently and ultimately, the Board of directors of a large number of companies are elected only by a few shareholders who have enough time to attend the Annual General Meetings of the company.
  - Although the concept of shareholders' democracy has been enshrined in the Companies Act, yet, because of the abovementioned deficiencies and flaws in the general body of shareholders, it is not reflected in the constitution of the Boards of directors of companies in India.

- For achieving the shareholders' democracy, the shareholders have to unite and organise themselves so that their voice is heard and they can assert themselves and safeguard the interests of their members.

I. MAJORITY POWERS AND MINORITY RIGHTS

• INTRODUCTION:

- Majority shareholders are those who own more than 50% shares of the Company. A company being an artificial person with no physical existence, functions through the wishes of the majority. It is a cardinal rule of company law that prima facie all the resolutions are passed according to the will of majority. The resolution of a majority of shareholders, passed at a duly convened general meeting, upon any question with which the company is legally competent to deal, is binding upon the minority and consequently upon the company. Thus, the majority of the members enjoy the supreme authority to exercise the powers of the company and generally to control its affairs.
- Since the majority members are in an advantageous position, they can misuse their power and act oppressively against minorities. In order to protect minority shareholders from abuse of authority, company law provides certain rights to minority which imposes limitation on the powers of majority and allows minority to express their grievances against majority. These rights are called as minority rights which enable them to make an application to the Tribunal and redress their grievances. However, these minority rights can be exercised only when the acts of majority are ultra vires or are not permissible under the Act. Thus, articles of the company are a protective shield for the majority of shareholders.
- There are two very important limitations to the powers of majority-

1. Firstly, the powers of the majority of members is subject to the provisions of the Company's memorandum and articles of association. A company cannot legally authorise or ratify any act which outside the ambit of the memorandum of the company.
2. Secondly, the resolution of a majority must not be inconsistent with the provisions of the Act or any other statute or constitute a fraud on minority depriving it of its legitimate rights.

PRINCIPLE OF NON-INTERFERENCE

- Principle of non-interference has been laid down in the famous case of Foss v. Harbottle. Foss and Turton, two minority shareholders filed a complaint against the directors and alleged that the property of the company had been misapplied and wasted and hence, an adequate compensation should be paid to the company. Judge dismissed the claim of shareholders on the grounds of "proper plaintiff rule" and "majority rule". It was held that company functions on the concept of separate legal entity. It can sue and be sued on its own name. Hence, when the company is wronged by its directors only company has the right to sue, Foss and Turton are not a proper party to the suit. Secondly, according to the concept of Majority rule, if acts can be ratified by the majority members through a resolution in general meeting, then court will not interfere in the same.
- The court will not usually intervene at the instance of shareholders in matters of internal administration and will not interfere with the management of a company by its directors so long they are acting within the powers conferred on them under the articles of the company. Court follows principle of non-interference in the matters of the company if they are within the scope of memorandum or articles of the company.

JUSTIFICATIONS FOR THE PRINCIPLE

Principle laid down in Foss v. Harbottle is justified and advantageous for following reasons:

1. **Recognition of the separate legal personality of company:** If a company has suffered some injury, and not the individual members, it is the company itself that should seek to redress because the company is a legal entity separate from its members.
2. **Need to preserve right of majority to decide:** The principle in Foss v. Harbottle preserves the concept of majority rule which provides right to majority to decide how the affairs of the company shall be conducted.
3. **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.

4. ***Suit filed by minority is of no use if majority does not wish it:*** *If the irregularity complained of is one which can be subsequently ratified by the majority it is of no use to have litigation about it except with the consent of the majority in a general meeting.*

> ***Application of Foss v. Harbottle Rule in Indian context*** *– The Delhi High Court in ICICI v. Parasrampuria Synthetic Ltd. has held that an automatic application of Foss v. Harbottle Rule to the Indian corporate realities would be improper. Here the Indian corporate sector does not involve a large number of small individual investors but predominantly financial institutions funding atleast 80% of the finance. It is these financial institutions which provide entire funds for the continuous existence and corporate activities. Though they hold only a small percentage of shares, it is these financial institutions which have really provided the finance for the company's existence and, therefore, to exclude them or to render them voiceless on an application of the principles of Foss v. Harbottle Rule would be unjust and unfair.*

- ***EXCEPTIONS TO THE RULE OF NON-INTERFERENCE***

The cases in which rule of majority will not apply are called as exceptional cases and these cases protects the rights of minority.
Cases in which principle laid down in Foss v. Harbottle does not apply are as following:

1. ***ULTRA VIRES ACT:*** *when the shareholders performs any act which is beyond the scope of MOA or AOA i.e. ultra vires then rule in Foss v. Harbottle will not apply and minority can make an application to the tribunal. Shareholder has the right to obtain restraining orders or orders of injunction from the court.*
2. ***FRAUD ON MINORITY:*** *when an action of shareholders amounts to fraud on minority, shareholder can individually make an application to the tribunal. Though there is no clear definition of the expression "fraud on the minority", but the court decides a particular case according to the surrounding facts.*

The general test which is applied to decide whether a case falls in the category of fraud on the minority or not is whether a resolution passed by the majority is "bona fide for benefit of the company as a whole"

3. **RESOLUTIONS REQUIRING SPECIAL MAJORITY PASSED BY SIMPLE MAJORITY:** if a resolution requires a special majority and resolution is passed by simple majority, then shareholder can individually make an application to the tribunal.
   Example- when a special resolution was required to be passed at the general meeting and resolution is passed without serving proper notice to the shareholders then shareholder can make an application to the Tribunal.

4. **BREACH OF DUTY:** The minority shareholder may bring an action against the company, where although there is no fraud, there is a breach of duty by directors and majority shareholders to the detriment of the company.
   In Daniels v. Daniels, the plaintiff, who were minority shareholders of a company, brought an action against the two directors of the company and the company itself. In their statement of the claim they alleged that the company, on the instruction of the two directors who were majority shareholders, sold the company's land to one of the directors (who was the wife of the other) for £ 4,250 and the directors knew or have known that the sale was at an under value. Four years after the sale, she sold the same land for £ 1,20,000.
   It was held that the exception to the rule in Foss v. Harbottle enabling a minority of shareholders to bring an action against a company for fraud where no other remedy was available should include cases where, although there was no fraud alleged, there was a breach of duty by directors and majority shareholders. Hence, the minority shareholders had a cause of action.

5. **WRONGDOERS IN CONTROL:** If the wrongdoers are in control of the company, the minority shareholders' representative action for fraud on the minority will be entertained by the court because if the minority shareholders are denied the right of action, their grievances in such case would never reach the court, for the wrongdoers themselves, being in control, will never allow the company to sue [Edwards v. Halliwell].

6. **PERSONAL ACTIONS:** Individual membership rights cannot be invaded by the majority of shareholders. An individual member is entitled to all the rights and privileges appertaining to his status as a member. In case there is an individual wrong, the individual can a file suit which is maintainable.

7. **PREVENTION OF OPPRESSION AND MISMANAGEMENT:** when majority shareholders are guilty of oppression and mismanagement then members of the company can make an application to the Tribunal and principle of non-interference will not be applied.
(Oppression and mismanagement has been dealt in Chapter 2)

Q1. A minority shareholder brought an action for damages against three directors and against the company itself on the ground that they have been negligent in selling a mine owned by the company for £ 82,000, whereas its real value was about £ 10,00,000. Is the action maintainable?

Q2. Majority shareholders of the company bonafide passed a resolution to sell all the assets of the company, in order to pay the dues of Creditors. However, the assets are sold at an undervalued price. Is majority guilty of Fraud?