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PROTECTION OF MINORITIES; EMPLOYEE PARTICIPATION;

DIRECTORS' DUTIES - ANALYSIS AND REFORM

by

CHUE KAI CHAN

ABSTRACT OF THESIS

The object of this thesis is to present an account of selected controversial aspects of English company law concerning protection of minorities, employee participation, and directors' duties, make critical evaluations of existing law and to propose reform.

Various ways of enforcement by minority shareholders of their rights in the company are first examined, analysed and criticised with the conclusion that although recently there has been a greater readiness on the part of the courts to intervene to correct abuse of majority power and unfairness, there is still a need for greater protection for minority shareholders. Reform is then proposed in respect of the newly improved "alternative remedy" including introduction of contingent fee system.

Next, the pressures for and arguments of employee participation are examined. Bullock's proposals and various choices are then discussed and various ways of employee participation in different countries are compared. It is concluded that employee participation should be introduced. The impact of employee participation on directors' duties and other aspects is then examined.

Finally some areas in the field of directors' duties which have been subjects of debates or which have caused some difficulties are examined and it is concluded that roughly directors' duties of loyalty are very strict whereas their duties of care diligence and skill are quite lax and with some inconsistencies in their duties of care and diligence. It is then proposed that the law should classify limited companies into three groups with separate standards of directors' duties and that in the case of the largest group of companies there

should be an evolution of managerial profession with the exception of employee directors and a watching committee be set up. Proposals for better enforcement of directors' duties are also discussed.

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DIRECTORS' DUTIES - ANALYSIS AND REFORM

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at University of Durham

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INTRODUCTION

The limited liability company, measured by volume of trade, is the overwhelmingly predominant business form in the United Kingdom as in all other Western economies. In this country it emerged in its modern form after the first Companies Act of 1862 and since that time it has been employed in all forms of manufacture, trade and commerce by companies ranging from the one man business to the multi-national conglomerate. Linking this diversity is a misleadingly simple premise, viz., that companies are "democracies" governed by directors who are answerable to a general meeting of shareholders armed with the ultimate power of dismissal. To date much company law reform has been pre-occupied with attempting to bring reality to this conception, increasing the range of disclosure to shareholders and the number of matters which have to be referred to the general meeting. But doubts persist about the practical efficacy of these measures and, more importantly, their fundamental orientation.

Even within the limited focus of company law, which until the Companies Act 1980 made not even the most formal recognition of the interests of employees, it may be queried whether shareholders' interests are sufficiently protected by disclosure provisions and the exercise of majority rule. This thesis will consider to what extent minorities can and should be able to assert claims and interests for themselves and the company despite the opposition of a majority or by those who are in effective control of the company. The worst examples of minority oppression tend to occur in the smaller companies, and given the present Government's hopes, realistic or otherwise, to encourage greater investment in small businesses the provision of effective legal protection is a necessary complement to the fiscal incentives recently awarded

in the Finance Act 1980.

Of more fundamental concern is the question whether company law can continue to be so narrowly focused or whether it must make an accommodation with labour and grant some formal recognition within the company structure if the interests of the employees in the enterprise are to be effectively protected. The concentration of capital and labour in modern companies gives them a strong position in the market and affords them many opportunities for far-reaching influence in economic, social and political affairs. It has been argued that the reason why a large section of the working population is not committed to our present system is that it fails to give employees reasonable security, satisfaction and involvement and is organised primarily for the benefit of distant shareholders who contribute little and are prepared to run away when trouble comes. The restoration of confidence of the workforce may therefore bring in a tremendous amount of energy, imagination and commonsense if they have the power, commitment and incentive, and legal recognition and protection of those who supply labour to the enterprise may improve the present sad state of industry and the economic position of the country. Politically now that the United Kingdom have joined the European Economic Communities the question of employee participation has become all the more important.

The welfare of the company, whatever the interests which are represented therein, ultimately depends upon the quality and accountability of its management. This leads to a consideration of the duties which are and should be imposed on company directors and to effective mechanisms of enforcement. The falling growth rate of our economy and high unemployment in recent years have highlighted the role and responsibility of the manager.

These three areas, though discrete topics, are conveniently considered together. It is only by providing effective protection for investors, achieving legitimacy with the workforce and subjecting management to legal duties which operate on the level of enforcement rather than precept that company law will have played its full part in ensuring that the privilege of limited liability is conferred on terms acceptable to informed public opinion in the late 20th century.

CHAPTER 1 PROTECTION OF MINORITIES

The problems faced by minority shareholders, particularly in private companies, have long been recognised. Owing to the fact that under the pattern of corporate control, majority shareholders can deprive minority shareholders of any effective voice in the running of the business, there exists the danger that majority shareholders will use their power to further their own interests to the detriment of minority shareholders.

Losses owing to Shareholder Oppression

The losses which a minority shareholder in a private company suffers in shareholder oppression are sometimes catastrophic. Frequently, when a shareholder invests in a private company, he expects to work in the company on a full-time basis. He may put practically everything he owns into the company and expect to support himself and his family from the salary he receives as an important employee of the company. Whenever a shareholder loses his post in the company, he may be in effect deprived of his chief means of income. A shareholder may also find that his investment in the company has become practically valueless. One of the most commonly used oppression techniques is not to declare dividends or declare little dividends. An aggrieved shareholder cannot withdraw the money he has invested, and he will find it difficult to find a purchaser for his shares in the company, especially where there are bitter disputes between principal shareholders. A minority shareholder may have all or a substantial part of his wealth invested in the company, and yet he cannot get back his money invested without the consent of the very people with whom he is disputing.

It is difficult or impossible to estimate the extent of the



economic loss (1) arising out of dissension and shareholder oppression. Many businesses are seriously damaged or ruined by bitter shareholder disputes. These disputes cause quarrels and conflict, loss of a lot of working hours, disruption of management, diminished confidence in the business by third parties, and costly litigation.

Derivative actions may be only a part of a prolonged struggle between majority and minority shareholders. After a minority shareholder discovers or begins to suspect the fraudulent behaviour of the majority shareholder, he probably will first attempt to get additional information from the company and the majority shareholder. There may follow argument, threats, perhaps several legal actions and ultimately (which may be as long as ten years afterwards (2)) a solution, probably not any fruit from a legal action for either side but more likely a settlement or compromise out of court. Thus the law reports just do not tell the whole story and the judges and lawyers cannot find in the law reports all they need to know about shareholder oppression. So it is proposed to set out below some of causes of shareholder oppression and some of the techniques used therefor so as to help those concerned or the courts know better the problems of shareholder oppression and perhaps help them in distinguishing with somewhat more certainty harsh and oppressive treatment of minority shareholders from unfounded minority complaints or necessary elimination of troublesome, unreasonable or uncooperative minority shareholders.

(1) See generally F.H. O'Neal, *Oppression of Minority Shareholders* (1975) pp.6-7

(2) In *Wallersteiner v. Moir* (No.2) [1975] 1 All E.R. 849; [1975] Q.B. 373; [1975] 2 W.L.R. 389; 119S.J. 97 the minority shareholder had still to proceed with legal proceedings even after 10 years of conflict with the majority shareholder. The case involved, of course, a public company.

Underlying Causes of Shareholder Oppression

There are many underlying causes (3) of shareholder oppression.

It seems that some shareholders in small limited companies do not appreciate fully the consequences of forming a private company (4). They do not understand that in the absence of special arrangement, holders of a majority of a company's voting shares control it. Some companies start as firms which are later converted into limited companies to obtain limited liability or some tax advantage (5). After incorporation, the shareholders assume that no change in their relationship has occurred and that partnership rules continue to apply. They still consider themselves as partners and act as such. However, it is company law, not partnership law, that generally governs the relationship between shareholders (6). This tendency of shareholders in some small private companies to regard themselves as partnees quite often leads to strife. In the first place, such minority shareholders, labouring under the misconception that they are still partners, are surprised and hurt when majority shareholders disregard the wishes and opinions of the minority and exercise the power under the principle of majority rule. Secondly they fail to follow company procedures leaving many company transactions and decisions with shaky legal foundations. In many small family companies, some of the shareholders and or some members of their families consider that the business belongs to the family as a whole rather than to the shareholders. Sometimes all of the

(3) See generally O'Neal, Chap.2

(4) In Re North End Motels (Huntly) Ltd. [1976] 1 NZLR 446 the petitioner was a retired farmer and did not take advice before the company was incorporated and was unaware that under the articles of association the decisions of directors could be reached by a majority in the case of dispute.

(5) See, e.g., Re Westbourne Galleries Ltd. [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492; 116 S.J. 412; where the petitioner had been an equal partner with one of the respondents before the business was incorporated in 1958.

(6) But see Re Westbourne Galleries Ltd. [1973] A.C. 360.

shareholders are descendants of the original founder, and the founder may have directed by will or otherwise that the business be used for the continued support of the big family. This outlook leads to the use of company assets by shareholders or their families, loans to shareholders or their families without interest, mixing up of company and individual money and assets, payment of compensation to officers without formal board authorization, and a general failure to observe the separate legal entity of the company and company formalities. This lax handling (7) of the company's affairs sows the seeds of later dissention.

Some controlling shareholders and company managers feel that the company belongs to those shareholders who work for it (8). Their reasoning is that as they do the work and bear the blame, if any, and responsibility, it is they who should be entitled to all or most of the profits or gains of the business. With this view, they tend to ignore the rights of those who originally invested in the company or later acquired ownership in it but who do not choose to participate in the running of the business.

Next there are some persons who see and seize opportunities to enhance their power and influence and increase their wealth. They find ways in the financial, administrative, and legal intricacies of business enterprises to take advantage of their fellow shareholders and colleagues, causing dissension (9).

Some shareholders receive their interest in a small private company by inheritance or gift and do not have an opportunity to choose their fellow shareholders (10). Personality clashes between these shareholders sometimes occur.

(7) See e.g. Re Jermyn Street Turkish Baths Ltd. [1971] 1 W.L.R. 1042 where e.g. even after the petitioners were entered on the register of members of the company as administrators of a deceased member, no notice of general meetings was ever given to them.

(8) See generally O'Neal, 2.09.

(9) See generally O'Neal, p.12

(10) See the relationship between the aunt (defendant) and niece (plaintiff) in Clemens v. Clemens Bros., Ltd. [1976] 2 All E.R. 268.

Sometimes a minority shareholder wants to withdraw from the company in order to get cash, e.g. when he wants to enter another business. But the difficulty of valuing an interest in business can start or contribute to dissension because valuation of an interest in business is not an exact science; it involves many subjective and complex factors and consideration. Further, whereas the minority shareholder naturally takes the view that all shares in the company are equal in value so that if he holds, say, twenty percent. of the shares, he expects to receive twenty percent. of the total value of the business, the majority shareholder feels that since a minority interest cannot control the company, minority shares are worth less than majority shares. More often than not the only prospective buyer of a minority interest in a private company is the majority shareholder, and a minority shareholder who wants to withdraw but is unable to dispose of his shares may show his dissatisfaction by refusing to cooperate or even by actively obstructing company operations. In order to escape an unpleasant situation the majority shareholder may in return seek ways to get rid of the minority shareholder at the price the former thinks is fair or even at a price a little lower to compensate for the trouble caused, the former thinks, by the latter. The outcome is an attempt to oppress a shareholder who originally wanted to leave the company voluntarily.

There are also cases where a shareholder who also holds a directorship and the chief executive position in a company runs the business in a one-man, autocratic manner. He disrespects the views of his co-directors and completely disregards usual company procedures and courtesy, resulting in quarrels with other strong-minded personalities among the shareholders (1). When a company

(1) In Re H.R. Harmer Ltd. [1959] 1 W.L.R. 62; [1958] 3 All E.R. 689; 103 S.J. 73 a man and his two sons formed a company. All three were directors but the father was appointed chairman and life director. The father disregarded resolutions of the board of directors, assumed powers which he did not possess and exercised them against the wishes of his sons.

has no particular need for an asset, the other shareholders may acquiesce, perhaps for a long time, in its use by one shareholder for his own use. Conflict develops, however, when the company needs the asset back but the shareholder wants to continue to enjoy the privilege (2). For example, one shareholder in a two-man company occupies vacant real property owned by the company, paying a rent which is far below the market rental value of the property. The other shareholder acquiesces in this privilege, believing that eventually the occupant will pay a suitable rental or that the company will develop the property or sell it. As the years pass, it becomes increasingly clear that the occupant intends to retain his advantage because he resists any attempt to increase the rental to reflect the market value or to improve or sell the property. The relationship between the shareholders deteriorates so much that each is anxious to get rid of the other (3).

The Memorandum and Articles of a company and other documents in writing frequently do not cover all aspects of the shareholders' business bargain. There are cases where important arrangements among shareholders in some small private companies are oral (4). They are sometimes nothing more than vague understandings, never even definitely stated orally. Misunderstanding of the terms of

(2) See, e.g. Re Westbourne Galleries Ltd. [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492; 116 S.J. 412 where the premises occupied by the company, and for which it paid the rent, were also used for an antique business carried on personally by one of the respondents.

(3) In Re Westbourne Galleries Ltd. [1973] A.C. 360 the petitioner made a number of protests which were followed by a further deterioration in the relationship between the petitioner and the two respondents. Finally, in 1969, an ordinary resolution at an extraordinary general meeting was passed to remove the petitioner from his office as director.

(4) See the crucial but much disputed agreement that the share capital should be held constantly in the ratio of 51:49 by the defendants and the plaintiff respectively in Pennell and Others v. Venida Inv. Ltd. & Others. The case has so far been unreported. For the facts thereof, see S.J. Burrige (1981) 44 M.L.R. 40.

the original agreement or of subsequent agreements modifying it can lead to bitter dispute resulting in shareholder oppression. It is unsafe to rely on oral assurances by the majority shareholder because they may later be opportunely forgotten by the majority shareholder or because persons who subsequently acquire control of the company may refuse to honour them.

Provision of insufficient funds to the business at the beginning may lead to events at a later stage which cause or attribute to shareholder oppression. An example will illustrate the point. Two shareholders each receive 1,000 shares of £10 each. The business is hard pressed when one shareholder, A, dies. A's estate cannot or is unwilling to provide any funds to alleviate the financial pressure and only the other shareholder, B, advances further funds to the company, receiving in return another 1,000 shares. The company subsequently prospers; and B, now the majority shareholder, receives substantial remunerations from the company. On the other hand, dividends are never declared, and A's estate receives no return on its interest in the company (5).

The widespread reluctance of the small businessman to obtain competent legal advice also contributes to the number of shareholder oppression. The atmosphere of optimism and goodwill which prevails during the initial stages for a business usually obscures the possibility of future dissension and conflicts among the shareholders. Furthermore, even if the shareholders foresee the possibility of future disagreement, they are reluctant to seek legal advice to

(5) In Re Jermyn Street Turkish Baths Ltd. [1971] 1 W.L.R. 1042; [1971] 3 All E.R. 184; 115 S.J. 483; A and B were the only shareholders and directors of a private company. B died in 1953, with the company then having liabilities of £20,000 and assets of only £1,700. In 1954 A appointed C a director and at a board meeting they allotted a further 100 £1 shares to A, the effect of which was to give A a 75 per cent. interest in the Company, and B's estate a 25 per cent. interest. The business prospered under A's leadership. Substantial director's and management fees were paid out to A during this period of prosperity. No dividends were ever paid. In 1969, B's administrators applied to court for assistance.

provide against the contingency because they are too busy or feel embarrassed to raise such questions in a situation which calls for the best mutual trust and good will.

To these causes one may add that unfortunately some lawyers do not fully understand the situations which give rise to shareholder oppression and are not thoroughly familiar with the rather complex and sometimes highly technical precautions which are necessary to protect minority interests, thus increasing the number of shareholder oppression by failing to give competent legal advice.

Oppression Techniques

Some of the techniques (6) which are most frequently used by controlling shareholders in a company to oppress minority shareholders are:

Withholding of dividends is one of the most frequently used techniques. By declaring no dividends at all (7) or little dividends, majority shareholders may force a minority shareholder to sell his interest at considerably less than its fair value. The effect of dividend withholding is mostly felt when a minority shareholder is in financial difficulty and is highly dependent upon income from dividends. The minority shareholder may be a former employee who has retired, the widow of a former employee or a person who is employed outside the company who is hard pressed by his creditors to repay loans or is trying to set up another business. Even if the minority shareholder is not in financial difficulty during the period of dividend withholding, he is still deprived of any return on his investment. To make matters worse, if corporate

(6) See generally O'Neal, Chap. 2 and T. Hadden, Company Law & Capitalism (2nd edn.) p.240.

(7) In Re Westbourne Galleries Ltd. [1973] A.C. 360; [1972] 2 W.L.R. 1289; and in Re Jermyn Street Turkish Baths Ltd. [1971] 1 W.L.R. 1042; [1971] 3 All E.R. 184; 115 S.J. 483; no dividends were ever paid.

earnings are plowed back into the business, the effect is to increase the size of his investment in the company without his consent while his return on the investment is still nil. Faced with the prospect of getting little or no return for an indefinite period on an ever-increasing investment for which there is no ready market, a minority shareholder may reluctantly sell out to the majority shareholders at whatever price they are willing to pay.

Another technique is to remove a minority shareholder from positions of employment and management (8). A minority shareholder sometimes invests a large share of his wealth to obtain his minority interest. He may join the company expecting to participate actively in the company's affairs as an important employee and perhaps as a director. He may give up other employment with accumulated seniority and security features to work full time for the company. He may have no income other than his salary. If a private company does not pay dividends or pays only small and infrequent dividends, a shareholder-employee of it who is dismissed from employment is effectively denied anything more than a token return on his investment even though the investment may be substantial (9). Furthermore, losing the prestige of a directorship may be of considerable consequence to the shareholder. A shareholder in this situation, hard pressed for money, may well accept a majority's offer to buy his shares even though he thinks the price offered is far less than the value of the shares.

(8) See, e.g., Re Westbourne Galleries Ltd. [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492; 116 S.J. 412; where the petitioner was removed from his office as director by the other two directors of the company who together held majority shares. Thereafter the petitioner ceased to have any part in the management of the company's affairs and, since no dividends were paid, he also ceased to participate in the profits. In Elder v. Elder & Watson 1952 S.C. 49; 1952 S.L.T. 112 two shareholders in a small family company suffered oppression at the hands of other shareholders who had used their voting power to remove the petitioners from their offices as directors and from their employment as secretary and factory manager respectively.

(9) See immediately above, n.(8) about Re Westbourne Galleries Ltd.

Majority shareholders may cause a company to pay them or members of their families or other relatives excessively high salaries or fees for services rendered as directors, officers or important employees. The payment of excessive salaries or fees reduces the net assets value of the company and so lead to an understatement of the company's earning power. This apparent earning power of the company would affect the selling price of the minority interest.

Sometimes majority shareholders drain off corporate profits by having other corporations they own perform services for the company under management or service contracts which set fees considerably higher than the fair value of the services rendered (10). Some contracts deprive a company of considerable profits by delegating to another company performance of an important business function which the former could profitably handle itself (1).

In practice majority shareholders usually combine several techniques to oppress or eliminate minority shareholders.

Legal Redress for Minorities

Having seen some of the causes and techniques of shareholder oppression, let us examine the legal redress for minorities, which is best considered under a number of headings.

Redress at Common Law and Equity

At common law and equity one of the main impediments to the obtaining of relief by minority shareholders is the well established principle that in the absence of fraud, ultra vires or illegality the courts will not interfere in the internal management of companies

(10) See Re Jermyn Street Turkish Baths [1971] 1 W.L.R. 1042 where the controlling directors appointed Nevilles Turkish Baths Ltd. of which they were shareholders to be general managers of some of the businesses of the company in question and where for 9 years Nevilles received profits of £13,524 for managing the company's Turkish baths.
(1) See generally M. Chesterman, *Small Businesses* (1977) pp.165-6.

and will allow the majority rule to prevail. The courts will not review directors' decisions in selecting officers and employees, fixing salaries, declaring or withholding dividends, authorizing contracts, or otherwise fixing business policies and determining the course of company affairs. The courts are not concerned with the management of the affairs of the company. It is the business of the shareholders and the directors (2).

Insofar as it precludes the courts from investigating into business efficacy, the rule is a sine qua non, because it cannot be the courts' function to take management decisions and to substitute their opinions for those of the directors and the majority of the members.

The rule is also referred to as the rule in Foss v. Harbottle (3) which states that if the duty to be enforced is one owed to a company, then the primary remedy for its enforcement is an action by the company against those in default (4).

The majority rule was restated by Jenkins L.J. in Edwards v. Halliwell (5) to be as follows:

"The rule in Foss v. Harbottle, as I understand it, comes to no more than this. First, 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 the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company

(2) Shuttleworth v. Cox Bros. & Co. [1927] 2 K.B. 9; 96 L.J.K.B. 104; 136 L.T. 337; 43 T.L.R. 83.

(3) (1843) 2 Hare 461

(4) See generally K.W. Wedderburn (1957) C.L.J. 194; (1958) C.L.J. 93; A. Boyle (1980) 1 Co. Law 3; A. Barak (1971) 20 I.C.L.Q. 22; S.M. Beck (1974) 52 Can. B. Rev. 159.

(5) [1950] 2 All E.R. 1064, 1066.

is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then cadit quaestio."

The rule has since been extended to cover all cases where what is complained of is some internal irregularity in the operation of the company. Thus Mellish L.J. said in Mac Dougall v. Gardiner (6):

"If the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, it is no use to litigate about it, the outcome of which is only that a meeting has to be called, and then ultimately the majority gets its wishes. It would be better if the rule is adhered to that if it is a thing which the majority are the masters of, the majority in substance shall be entitled to have their will followed."

Though the courts often treat these cases as wrongs done to the company, it is not clear why the courts should not instead regard the wrongs as breaches of the rights of each shareholder under the contract established by the memorandum and articles by virtue of section 20 of the Companies Act 1948. It may be that the courts have been influenced by the practical advantages of the rule in Foss v. Harbottle instead of giving weight to pure questions of principle. The practical advantages are: (a) If every individual member were permitted to sue anyone who had injured the company through a breach of duty, there could be as many actions as there are shareholders. Legal proceedings would never cease, and there

(6) (1875) 1 Ch. D. 13; 45 L.J. Ch.27; 33 L.T. 521; 24 W.R. 118.

would be enormous wastage of time and money. (b) If an individual member could sue a person who caused loss to the company, and the company then ratified that person's act at a general meeting, the legal proceedings would be quite useless, for a court will naturally hold that the will of the majority prevails.

Exceptions to Majority Rule

The majority rule greatly strengthens the positions of the majority; indeed, if there were no exceptions to it, the minority would be completely in their hands (7).

It may be stated that a suit by a shareholder instead of by the company is allowed in the following five circumstances:

(i) Where the act complained of is ultra vires the company or illegal.

(ii) Where the act complained of can only validly be done by a special or extraordinary resolution, but in fact has been done by a simple majority.

(iii) Where the personal rights of the individual member have been infringed.

(iv) Where those who control the company are perpetrating a fraud on the minority.

(v) Where the interests of justice require the rule to be dispensed with.

Except the fifth exception, the other four exceptions could be reduced to one that a shareholder can sue, notwithstanding the majority rule, where what he complains of could not be validly ratified or effected by an ordinary resolution (8)

Exceptions (iii), (iv) and (v) are of more importance and require more discussion.

(7) L.C.B. Gower, Principles of Modern Company Law, (4th ed.) p.644.
(8) See Gower, p.645.

1. Personal Rights of Members

A member can sue for wrongs done to himself in his capacity as a member (9). Some of the individual rights of a member arise from the contract between the company and himself which is implied on his becoming a member (10) and some from the general law.

Under the contract implied from his membership, a member is entitled, for example, to receive dividends which have been duly declared or which have become due under the articles (1); and to have his capital returned in the proper order of priority in the winding up of the company or on a duly authorised reduction of capital (2).

Under the general law, he is entitled, for example, to have a reasonable opportunity to speak at general meetings (3); and to transfer his shares (4).

In a case about a personal right of a member being infringed, Sir George Jessel M.R. remarked (5):

"He is a member of the company, and whether he votes with the majority or the minority he is entitled to have his vote recorded - an individual right in respect of which he has a

(9) Pender v. Lushington (1877) 6 Ch. D. 70; 46 L.J. Ch. 317; 25 W.R.Dig. 64; Edwards v. Halliwell [1950] 2 All E.R. 1064; [1950] W.N. 537; 94 S.J. 803.

(10) Section 20 of the Companies Act 1948 provides that the memorandum and articles shall bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all their provisions.

(1) Wood v. Odessa Waterworks Co (1889) 42 Ch. D. 636; 58 L.J. Ch. 628; 5 T.L.R. 596; 1 Meg. 265; 37 W.R. 733.

(2) Griffith v. Paget (1877) 5 Ch. D. 894; 46 L.J.Ch. 493; 25 W.R. 523. See also Rayfield v. Hands [1960] Ch. 1; [1958] 2 W.L.R. 851; 102 S.J. 348; [1958] 2 All E.R. 194; Re British Sugar Refining Co (1857) 3 K & J 408; 26 L.J.Ch. 369; 5 W.R. 379.

(3) Wall v. London and Northern Assets Corporation [1898] 2 Ch. 469; 67 L.J.Ch. 596; 79 L.T. 249; 14 T.L.R. 547; 47 W.R. 219.

(4) Re Smith Knight & Co., Weston's Case (1868) 4 Ch. App. 20; 38 L.J.Ch. 49; 19 L.T. 337; 17 W.R. 62. See also Hutton v. West Cork Rly. Co. (1833) 23 Ch. D. 654; Henderson v. Bank of Australasia (1890) 45 Ch. D. 330; 59 L.J.Ch. 794; 63 L.T. 597; 6 T.L.R. 424; 2 Meg. 301.

(5) Pender v. Lushington (1877) 6 Ch.D. 70 at 80.

right to sue. That has nothing to do with the question like that raised in Foss v. Harbottle and that line of cases. He has a right to say, 'Whether I vote in the majority or minority, you shall record my vote, as that is a right of property belonging to my interest in this company, and if you refuse to record my vote I will institute legal proceedings against you to compel you.'

2. Fraud on the Minority

There are two senses in which the term 'fraud on the minority' is used. The first is in fact a fraud on the company where the wrongdoers are in control of the company and refuse to institute legal proceedings in the company name and the minority indirectly bear the loss of the unremedied wrong to the company. In such cases the minority are allowed to bring a derivative action (6) with the wrongdoers joined as defendants to assert the company's rights against them and the company joined, usually as nominal defendant, so that it may be bound by the judgement, and cannot have a larger claim to relief than the company would have if it were the plaintiff. The term 'fraud on the minority' is used in the second sense where the minority, as individuals or collectively, have been wronged directly by some action of majority. The fraud in this case is in fact, as well as in name, on the minority. The claim asserted is thus a personal claim and may, but need not be, brought in representative form.

Joinder of derivative and personal Claims

Until recently the extent to which derivative and personal

(6) Although its form has long been used, the term "derivative action" has only recently received judicial recognition in the United Kingdom. See Lord Denning M.R. in Wallersteiner v. Moir (No.2) [1975] 1 All E.R. 849, 857. It seems that the term is now established; see Prudential Assurance Co. Ltd. v. Newman Industries Ltd. And Others (No.2) [1980] 3 W.L.R. 543, 565.

claims could be joined in one and the same action was somewhat obscure (7), but has now been clarified to a great extent by the recent case of Prudential Assurance Co. Ltd. v. Newman Industries Ltd. And Others (No.2) (8). In that case the plaintiff brought three claims, one direct, one derivative and one representative. Vinelott J. was of the opinion that a given set of facts could give rise to both derivative and personal claims and ruled that there was no objection to the three claims being joined in one action.

Usually cases concerning fraud on the minority are only allowed where there is fraud and where the wrongdoers are in control. Two concepts are then involved, namely 'fraud' and 'control' and it is convenient to consider them separately.

(a) Fraud

From the decided cases it is not possible to state with any certainty what constitutes 'fraud' in a fraud on the minority. The term is used somewhat loosely. It covers certain acts of a fraudulent character in the wider sense (9). It is clear that direct misappropriation of company assets is fraud (10), but mere negligence by directors is not covered by the term. The minority need not prove the element of deceit in the strict sense. And the courts have not been guided by any clear principle, but have preferred to consider the nature of the transaction or complaint in each case. Recently it has been remarked by Vinelott J. in the Prudential case that fraud lies in the use by the majority of their voting power not in the character of the act or transaction giving rise to the cause of action (1).

(7) As to the position previously, see Gower, p.655, n.99

(8) [1980] 3 W.L.R. 543; [1980] 2 All E.R. 841.

(9) Gower, p.616.

(10) E.g. Menier v. Hoopers Telegraph (1874) L.R. 9 Ch. App. 350.

(1) [1980] 2 All E.R.841,862 See also below, p.111

(b) Control

Traditionally the rule is that "a minority shareholder is not entitled to proceed in a representative action if he is unable to show when challenged that he has exhausted every effort to secure the joinder of the company as plaintiff and has failed". (2) However where the directors are to be the defendants, the courts have recognised that there is no point in formally asking the directors to institute the proceedings (3). As to what constitutes control, the traditional test is a majority of the voting stock (4). Thus in Pavlidis v. Jensen (5) where the directors did not own shares in the company in question but controlled the board of a company which owned shares in the company in question, Danckwerts J. ruled that he was not satisfied in these circumstances that the defendant directors had such control as to justify a minority shareholders' action (6). This traditional test of control caused some difficulty in the Prudential case because the wrongdoers there did not have voting control in the traditional sense. But Vinelott J. held that it is not necessary to establish voting control by the wrongdoers before a minority shareholder could be allowed to bring a derivative action. He is of the opinion that the control element would be sufficiently established where "the persons against whom the action is sought to be brought on behalf of the company are shown to be able by any means of manipulation of their position in the company to ensure that the action is not brought by the company." (7)

In ascertaining the view of the majority whether it is in the interests of the company that the claim be pursued, Vinelott J. is

(2) Ferguson v. Wallbridge [1935] 3 D.L.R. 66, 83.

(3) Gower, p.650.

(4) Menier v. Hooper's Telegraph Works (1874) 9 Ch.App.350,353.

(5) [1956] Ch. 565.

(6) [1956] Ch. 565, 577.

(7) [1980] 3 W.L.R. 543, 584.

of the opinion that the rule should be that "the court will disregard votes cast or capable of being cast by shareholders who have an interest which directly conflicts with the interest of the company If shareholders having a majority of votes in general meeting are nominees, the court will look behind the register to the beneficial owners to see whether they are the persons against whom relief is sought There seems no good reason why the court should not have regard to any other circumstances which show that the majority cannot be relied upon to determine in a disinterested way whether it is truly in the interests of the company that proceedings should be brought." (8)

It is submitted that this realistic approach of Vinelott J. in ascertaining the true majority's view on 'the interests of the company' is another advance for the protection of minorities and suits the needs of modern times (9) because e.g. nowadays few shareholders of a public company attend and vote in person at a general meeting and directors in default might use the proxy system to further their wrongful aims (10).

Most of the cases in which the principle of fraud on the minority has been applied appear to fall (1) within one of the following two classes (a) Fraud on the Company and (b) true Fraud on the Minority.

(a) Fraud on the Company

The leading case of this type is Menier v. Hooper's Telegraph Works (2) where the majority of the members of A Co. were also members of B Co., and at a meeting of A Co. they passed a resolution

(7) [1980] 3 W.L.R. 543, 584.

(8) Ibid. at p.583.

(9) But see K.W. Wedderburn (1981) 44 M.L.R. 202.

(10) See also Atwool v. Merryweather (1876) L.R. 5 Eq. 464n; 37 L.J.Ch. 35 where the defendant offered an indemnity to some shareholders who voted against the resolution authorising proceedings.

(1) Cf. Gower, p.616.

(2) (1874) 9 Ch.App. 350; 43 L.J.Ch. 330; 30 L.T. 209; 22 W.R. 396.

to compromise an action against B Co. in a manner alleged to be favourable to A Co. It was held that a minority shareholder of A Company was entitled to have the compromise set aside because the passing of the resolution by the majority was a fraud on the minority. The arrangement which had been made was one concerning matters affecting the whole company, the interest in which belonged to the minority as well as to the majority. Sir W.M. James L.J. remarked in that case (3):

"The defendants, who have a majority of shares in the company, have made an arrangement by which they have dealt with matters affecting the whole company, the interest in which belongs to the minority as well as to the majority. They have dealt with them in consideration of their obtaining for themselves certain advantages. The minority of the shareholders say in effect that the majority has divided the assets of the company, more or less, between themselves, to the exclusion of the minority. I think it would be a shocking thing if that could be done, because if so the majority might divide the whole assets of the company, and pass a resolution that everything must be given to them, and that the minority should have nothing to do with it. Assuming the case to be as alleged in the bill, then the majority have put something into their pockets at the expense of the minority. If so, it appears to me that the minority have a right to have their share of the benefits ascertained for them in the best way in which the court can do it, and given to them."

The Menier case principle was followed in Cook v. Deeks (4). In that case the directors of a railway construction company obtained a contract in their own names to construct a railway.

(3) [1874] 9 Ch.App.350 at 353.

(4) [1916] 1 A.C. 554; 85 L.J.P.C. 161; 114 L.T. 636.

The contract was obtained as a result of a breach of trust by the directors, who then used their voting powers to pass a resolution of the company declaring that the company had no interest in the contract. It was held by the Privy Council that the benefit of the contract belonged in equity to the company, and the directors could not validly use their voting power to keep it to themselves.

More recently in Daniels v. Daniels (5) the minority shareholders of a company brought an action against the two directors and the company. Their complaint was that in 1970 the company, on the instructions of the two directors, who were the majority shareholders, sold the company's land to one of the directors, who was the wife of the other, for £4,250 and that the directors knew, or ought to have known, that the sale was at an undervalue. Four years later the wife sold the landed property for £120,000. The directors took out a summons to strike out the statement of claim as disclosing no reasonable cause of action or otherwise as an abuse of the process of the court. But the court dismissed the summons and held that the exception to the rule in Foss v. Harbottle, enabling a minority shareholder 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 of directors and majority shareholders to the detriment of the company. Templeman J. observed at p.413:

"The authorities which deal with simple fraud on the one hand and gross negligence on the other do not cover the situation which arises where, without fraud, the directors and majority shareholders are guilty of a breach of duty which they owe to the company, and that breach of duty not only harms the company

(5) [1978] 1 Ch. 406; [1978] 2 W.L.R. 73; [1978] 2 All E.R. 89; (1977) 121 S.J. 605. See also B.A.K. Rider (1978) 37 C.L.J. 270; D.D. Prentice (1979) 43 Conv. 47.

but benefits the directors. In that case it seems to me that different considerations apply. If minority shareholders can sue if there is fraud, I see no reason why they cannot sue where the action of the majority and the directors though without fraud, confers some benefit on those directors and majority shareholders themselves. It would seem to me quite monstrous - particularly as fraud is so hard to plead and difficult to prove - if the confines of the exception to Foss v. Harbottle, 2 Hare 461, were drawn so narrowly that directors could make a profit out of their negligence. Lord Hatherley L.C. in Turquand v. Marshall, L.R. 4 Ch.App. 376, opined that shareholders must put up with foolish or unwise directors. Banckwerts J. in Pavlides v. Jensen 1956 1 Ch. 565 accepted that the forbearance of shareholders extends to directors who are "an amiable set of lunatics." Examples, ancient and modern, abound. To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £115,000 odd at the expense of the company is something entirely different. The principle which may be gleaned from Alexander v. Automatic Telephone Co. [1900] 2 Ch. 56 (directors benefiting themselves), from Cook v. Deeks [1916] 1 A.C. 554 (directors diverting business in their own favour) and from dicta in Pavlides v. Jensen [1956] 2 Ch. 565 (directors appropriating assets of the company) is that a minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company."

From the cases discussed above and in this field, it seems that the authorities show that exception to Foss v. Harbottle applies not only where the allegation is that the directors who control a company have improperly appropriated to themselves money, property or advantages which belong to the company or, in breach of their duty

to the company, have diverted business to themselves which ought to have been given to the company, but more generally where the allegation is that directors, though believing that they were not doing anything wrong, are in breach of duty to the company, including perhaps their duty to exercise proper care, and as a result of that breach obtain some benefit.

(b) True Fraud on the Minority

We are concerned here with a true fraud on the minority. The classic illustrations of this type of cases are Brown v. British Abrasive Wheel Co. (6) and Dafen Tinsplate Co. Ltd. v. Llanelly Steel Co. (7)

In the first of these, a company required more capital. A majority of shareholders holding 98% were prepared to provide more capital but would only do so on condition that the minority holding the remaining 2% would sell their shares to the majority. Negotiations for a sale failed and an alteration to the articles was proposed to allow the majority to buy out the minority. It was held that the alteration was designed to allow the majority to do compulsorily what they could not do by agreement and was not for the benefit of the company as a whole.

The Brown case was followed in Dafen Tinsplate Co. Ltd. v. Llanelly Steel Co. In that case the plaintiff company was a shareholder in the defendant company and purchased its steel from it. When it stopped buying its steel from the defendant and set up its own steel plant, an article providing for the compulsory acquisition of the shares of any member was passed by the defendant company.

(6) [1919] 1 Ch. 290; 88 L.J.Ch. 143; 120 L.T. 529; 35 T.L.R. 268; 63 S.J. 373.

(7) [1920] 2 Ch. 124; 89 L.J.Ch. 346; 123 L.T. 225; 36 T.L.R. 428; 64 S.J. 446

Peterson J. set aside the article remarking that it was wider than was necessary to protect the interests of the company because it enabled the majority to acquire the shares of any shareholder.

There are, however, cases going the opposite direction, one of which is Sidebottom v. Kershaw, Leese & Co. Ltd. (8) In that case the article concerned provided for the compulsory acquisition of the shares of any competitor. The plaintiff was a competitor-shareholder and brought an action, but it was held that it was bona fide for the benefit of the company to be protected from competitors and the article was upheld. The Brown case was distinguished on the finding of fact that the article there was only for the benefit of the majority.

In Shuttleworth v. Cox Bros. & Co. (Maidenhead), Ltd. (9) the articles provided that B and some others were to be permanent directors who could only be removed on one of several specified events. On 22 occasions in one year B failed to account for the company's money received by him. Failure to account was not one of the specified grounds for removal of a director, and so the articles were altered to add one more ground for removal of a director, namely a written request signed by all the other directors. The Court of Appeal held that the alteration was for the benefit of the company as a whole and was valid, and Bankes L.J. remarked that it was for the shareholders, not the court, to say what was in the interests of the company and the court should not interfere unless the alteration was such that on reasonable men could consider it for the benefit of the company (10).

(8) [1920] 1 Ch. 154; 89 L.J.Ch. 113; 122 L.T. 325; 36 T.L.R. 45; 64 S.J. 114.

(9) [1927] 2 K.B. 9; 96 L.J.K.B. 104; 136 L.T. 337; 43 T.L.R. 83.

(10) Cf. Dafen Tinsplate Co. v. Llanelly Steel Co. [1920] 2 Ch. 124 where Peterson J. was of the opinion that the onus of proof lay on those supporting the resolution and the test was an objective one and not what the shareholders honestly believed.

In Allen v. Gold Reefs of West Africa (1), the majority were held entitled to alter the articles so as to give the company a lien on fully paid shares even for debts which had been incurred prior to the passing of the resolution.

Furthermore, in Greenhalgh v. Arderne Cinemas Ltd. (2) the articles of a private company prohibited a transfer of shares to an outsider if another member was willing to buy them at a fair value. The majority shareholder, with a view to transferring his shares to an outsider, caused the articles to be altered so as to permit a transfer to any person with the sanction of an ordinary resolution. It was held by the Court of Appeal that the alteration was bona fide and valid although as a result the minority shareholders lost their rights of pre-emption.

In the more recent case of Clemens v. Clemens Bros. Ltd. (3) however, the minority shareholder met with more luck. There proposals to increase the share capital of the company which would result in the minority shareholder's voting power being reduced were held to be oppressive.

It is interesting to note that although Foster J. in the Clemens case purported to apply the same principles as those in the Greenhalgh case, opposite conclusions were reached in the two cases. But perhaps it is of importance to note that Evershed M.R. was much affected by the bona fides of the majority in the Greenhalgh case because the purchaser was bidding for all the shares of the company at a fair price (4). Had this fact been different, the decision might have been different. On the contrary in the Clemens

(1) [1900] 1 Ch. 656; 69 L.J.Ch. 266; 82 L.T. 210; 16 T.L.R. 213; 7 Mans. 417, 48 W.R. 452.

(2) [1951] Ch. 286; [1950] 2 All E.R. 1120; 94 S.J. 855.

(3) [1976] 2 All E.R. 268. See also below, pp.40-1; G.R. Sullivan (1977) 41 Conv. (N.S.) 169.

(4) [1950] 2 All E.R. 1120, 1128.

case the predominant motive of the aunt was to injure the niece.

Thus Foster J. remarked:

"But I cannot escape the conclusion that the resolutions have been framed so as to put into the hands of Miss Clemens and her fellow directors complete control of the company and to deprive the plaintiff of her existing rights as a shareholder with more than 25 per cent. of the votes and greatly reduce her rights under art. 6. They are specifically and carefully designed to ensure not only that the plaintiff can never get control of the company but to deprive her of what has been called her negative control."

From the cases discussed above and in this field, it appears that the courts will not interfere with majority decisions unless the conduct complained of is deliberately aimed in a discriminatory manner at the minority, with little or no benefit to the company as a commercial entity. The difficulty in this area is to reconcile the principle that a shareholder's vote is a right of property that may be exercised from motives or promptings of what he considers his own individual interests with the principle that the power to alter the articles should be exercised bona fide for the benefit of the company as a whole.

A general Principle ?

It is difficult to formulate a general fraud on the minority principle. It appears that a number of considerations are relevant in determining the question of what will constitute a fraud on the minority. These would include bona fides, mala fides, discrimination, oppression, appropriation of company assets or benefits, advancement of the interests of the company as a whole, and proper purposes; all these would be relevant but not conclusive considerations. Gower (5) has suggested that there seems to be a general

(5) Gower, p.623.

principle that the majority must always exercise their powers "bona fide for the benefit of the company as a whole."

3. Interests of Justice

From time to time the courts have suggested the exception "where the interests of justice require the rule to be dispensed with." In Foss v. Harbottle itself Vice-Chancellor Wigram suggested such an exception. Recently in Prudential Assurance Co. Ltd. v. Newman Industries Ltd. And Others (No.2) (6) Vinelott J. expressed the opinion:

"These two cases are consistent with observations in another strand of authority where the rule in Foss v. Harbottle, 2 Hare 461 has been described as a flexible rule. In Foss v. Harbottle itself Sir James Wigram V.-C. said, at p.492:

"If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that the principle so forcibly laid down by Lord Cottenham (L.C.) in Wallworth v. Holt (1840) 4 Myl. & Cr. 619, 635 and other cases, would apply, and the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue."

In Edwards V. Halliwell [1950] 2 All E.R. 1064 Jenkins L.J. said, at p.1067, of the exception that is showed "that the rule is not an inflexible rule and that it will be relaxed where necessary in the interests of justice." In Burland v. Earle [1902] A.C. 83, 93 Lord Davey, in stating the "elementary" rule, that the court

(6) [1980] 3 W.L.R. 543; [1980] 2 All E.R. 841.

would not interfere with the management of companies acting within their powers, added: "and in fact has no jurisdiction to do so"; but he stated the narrow rule, that in an action to redress a wrong to a company the company must be the plaintiff, as a prima facia rule only."

His lordship Vinelott went on to say at p.582:

". . . the relevant or "true" exception may apply not only where the wrongdoers are a majority but where some other reason can be shown for saying that unless the minority are allowed to sue on behalf of the company the interests of justice will be defeated in that an action which ought to be pursued on behalf of the company will not be pursued."

But in Pavrides v. Jensen (7) Danckwerts J., after carefully examining previous cases, rejected this exception as not being borne out by the authorities. In that case the wrong to the company was allegedly done negligently, and not fraudulently.

It should be noted that the exception of fraud on the minority is fairly general, which together with the personal rights exception and statutory relief provides some degree of protection for the minority. Nevertheless, cases might arise where the act complained of can neither be classified as fraud on the minority nor personal rights; nor can the statutory protection of the minority be invoked. In these cases, it is submitted, that the courts should be able to admit this exception to the rule in Foss v. Harbottle. Thus while, on principle, the courts have jurisdiction to admit this exception to the majority rule, in practice it is difficult to establish a case for the admission of this remedial jurisdiction.

(7) [1956] Ch. 565; [1956] 3 W.L.R. 224; [1956] 2 All E.R. 518; 100 S.J. 452.

Minority Redress and Ratification

Most of the cases involving the Menier case principle concern a breach of duty of good faith of some directors who usually form the majority and ratification of that breach by the majority.

The power of ratification by the majority may be abused by the majority. And there seems to be no clear principle governing what breaches of duties may be ratified and what may not (8). It appears that the courts prefer to examine each case on its own facts and try to reconcile the voting right and majority rule with the principle of bona fides for the benefit of the company as a whole.

Gower (9) argues that where the directors appropriate the company's property, their action can be ratified by the majority if it can be shown positively that this was passed bona fide in the interests of the company. Where, however, the directors do not act bona fide in the interests of the company, their breaches cannot be ratified (10). Further, Gower argues that a resolution of a general meeting cannot, either prospectively or retrospectively, authorise the directors to act in fraud of the company, 'fraud' being used in a wider sense than deceit or dishonesty (1).

It is submitted that Gower's arguments about ratification of fraud on the company as stated immediately above also apply to ratification by the majority at general meeting of true fraud on the minority provided that if there is a prima facie case of discrimination by the majority against the minority, in practice the onus on the majority to prove bona fides in the interests of the company would be heavier.

(8) See below, pp.110-5

(9) Gower, p.619

(10) Ibid., p.619

(1) Ibid., p.619

It has been commonly (2) considered that North-West Transportation Co. v. Beatty (3) is authority for the proposition that a majority shareholder who is also a director can use his votes in general meeting to confirm or ratify an act or transaction which was not fraudulent or ultra vires, but was a breach of his duty as a director, in order to prevent a minority shareholder from bringing a derivative action. But Vinelott J. has a different view because he remarked in the recent case of Prudential Assurance Co. Ltd. v. Newman Industries Ltd. & Others (No.2) (4):

"As I see it all that Beatty's case shows is that a contract between a company and a majority shareholder which is authorised or ratified in general meeting, the resolution being passed by the use of the controlling shareholder's votes, will not be set aside unless it is shown to have been an improper one. That proposition follows from the principle that a majority shareholder in exercising his votes in general meeting in relation to a transaction in which he is involved does not owe any fiduciary duty to the company or to the other shareholders."

The Prudential case has also cast doubt on the view (5) held by some that in Regal (Hastings) Ltd. v. Gulliver (6) the House of Lords ruled that the directors would not have been liable to account had the transaction been ratified. Thus Vinelott J. commented (7):

"In Regal (Hastings) Ltd. v. Gulliver [1967] 2 A.C. 134 . . . Lord Russell of Killowen said, at p.150, that the directors "could, had they wished, have protected themselves by a resolution (either

(2) See K.W. Wedderburn (1981) 44 M.L.R. 202, 209.

(3) (1887) 12 App. Case. 589; 56 L.J.P.C. 102; 57 L.T. 426; 3 T.L.R. 789; 36 W.R. 647. See also below, pp.110-5

(4) [1980] 3 W.L.R. 543, 570. See also below p.111

(5) For example, See Gower, p.617.

(6) [1942] 1 All E.R. 378; [1967] 2 A.C. 134n.

(7) [1980] 3 W.L.R. 543, 568.

antecedent or subsequent) of the Regal shareholders in general meeting." It is suggested in the editor's note in the report at [1942] 1 All E.R. 378, 379, that the resolution "would have been a mere matter of form, since (the defendant directors) doubtless controlled the voting." I can see nothing in the report which indicates that the defendant directors controlled the voting and, as I understand this passage in the speech of Lord Russell of Killowen, he contemplated that the defendant directors might have protected themselves by a resolution in general meeting precisely because they had not control of the majority of the votes."

If Vinelott J. is right in his view on the Regal case, Regal (Hastings) Ltd. v. Gulliver would not be inconsistent with the decision of the Privy Council in Cook v. Deeks (8) about the effect of ratification of directors' breaches of duty as thought by some (9).

Although Vinelott J's illuminating judgement in the Prudential case is to be welcomed, it is perhaps important to note that his decision is one of first instance only and many of his statements concerning ratification by majority shareholders of directors' breaches of duty and fraud on the minority are merely obiter dicta.

Statutory Relief

To supplement the protection of minorities provided by common law and equity, the Companies Acts have provided some additional protection (10).

The Alternative Remedy

Under section 75 of the Companies Act 1980 replacing s.210 of

(8) [1916] 1 A.C. 554; 85 L.J.P.C. 161; 114 L.T. 636.

(9) E.g. see Gower, p.617.

(10) For Department of Trade Investigations, see below, pp.132-7

the Companies Act 1948 a member can petition the court for relief other than a winding-up order under certain circumstances to be discussed later in this Chapter (1).

Section 210 of the Companies Act 1948 provided that a member could petition the court for relief other than a winding-up order where any member complained that the affairs of the company were being conducted in a manner oppressive to some part of the members (including himself). The section was introduced to strengthen the position of the minority shareholders in private companies, but subsequent judicial decisions tended to limit its usefulness and scope (2).

As interpreted by the courts section 210 had the following weaknesses.

In a s.210 petition, the alleged conduct complained of must be "oppressive". Various definitions of this term were advanced, "the dictionary definition of burdensome, harsh and wrongful" (3), "a visible departure from the standards of fair dealing and a violation of the condition of fair play"(4), and "an element of lack of probity and fair dealing" (5).

An isolated act was not sufficient for section 210 to be invoked. Thus, if a director were to take excessive remuneration, this would not amount to oppressive conduct unless he used his position as a majority shareholder to retain that remuneration (6). Further a series of oppressive acts would not be sufficient unless they amounted to a chain of events which continued right up to the

(1) See also sections 5, 72, 164 and 172 of Companies Act 1948; T.E. Cain, Charlesworth & Cain's Company Law (11th ed.) p.382.

(2) See generally H. Rajak (1972) 35 M.L.R. 156.

(3) per Viscount Simonds in S.C.W.S. v. Meyer [1959] A.C. 324, 342.

(4) Lord Cooper in Elder v. Elder & Watson Ltd., 1952 S.C. 49, 55.

(5) Lord Keith in Eleer v. Eleer & Watson Ltd., 1952 S.C. 49, 60.

(6) Re Jermyn Street Turkish Baths Ltd. 1971 1 W.L.R. 1042.

presentation of the petition (7).

The section was not available where the allegations were about merely bad management and inefficiency. In Re Five Minute Car Wash Service Limited (8), some 15 allegations as to the continuous bad management of the managing director were insufficient to constitute oppression. There Buckley J. said at p.751:

"The mere fact that a member of a company has lost confidence in manner in which the company's affairs are conducted does not lead to the conclusion that he is oppressed; nor can resentment at being out-voted; nor mere dissatisfaction with or disapproval of the conduct of the company's affairs whether on grounds relating to policy or to efficiency, however well founded."

It was doubtful whether or not a personal representative or trustee in bankruptcy of a member of a company could bring a petition under section 210 where he had not been registered as a member (9).

The petitioner had to show also that the affairs of the company were being conducted in a manner oppressive to some part of the members, including himself (10). The oppression must be suffered by the petitioners as members, and not, e.g. by them as directors. Therefore s.210 could not be invoked to deal with one important kind of oppression, e.g. where the minority shareholder in a small private company had been removed from the board of directors unless there was also present oppression of him in his capacity as a member. Although this was not explicit in the section

(7) See above, p.31, n.(6).

(8) [1966] 1 All E.R. 242; [1966] 1 W.L.R. 745; 110 S.J. 347.

(9) See Re Jermyn Street Turkish Baths Ltd. [1970] 1 W.L.R. 1194. But cf. Re Meyer Douglas Pty Ltd. [1965] V.R. 638.

(10) Elder v. Elder & Watson 1952 S.C. 49; Re Lundie Bros. Ltd. [1965] 2 All E.R. 692; and Re Westbourne Galleries Ltd. [1970] 3 All E.R. 374.

itself, this additional requirement had been widely accepted.

Under section 210 the petitioner must not only show that there had been oppressive conduct but also that the facts would justify the making of a winding-up order on the ground that it was just and equitable (1).

Sometimes it is tempting to form the view that the judges have not appreciated the difficulty which the average shareholder experiences in finding out what is really happening to the company's business and that the proper motive of directors against frivolous enquiries and actions is too often operated to the shareholder's detriment. The courts ought, it is submitted, to be prepared to order the company to raise money so as to enable it to pay dividends with its profits and to order the personal attendance at court of directors to assist the court in its investigation. It is most unlikely that the courts would take so active a part in company's affairs. This raises the question whether it is advisable that conflicts between majority and minority shareholders should be resolved by the courts, which lack the necessary expertise and machinery for ensuring a just commercial settlement. Indeed Scrutton L.J. said in Shuttleworth v. Cox Brothers & Co. Ltd. (2):

"It is not the business of the court to manage the affairs of the company. That is for shareholders and directors . . . I should be sorry to see the courts go beyond this and take upon itself the management of concerns which others may understand far better than the court does."

(1) Re Bellador Silk Limited [1965] 1 All E.R. 667. See also Re Rica Gold Washing Co. (1879) 11 Ch. D. 43; Re Othery Construction Ltd. [1966] 1 All E.R. 145; Re Expanded Plugs Ltd. [1966] 1 All E.R. 887.

(2) [1927] 2 K.B. 9 at 23-4. But there is some indication that the courts have now taken a more protective attitude in favour of the minority. See e.g. Ebrahimi v. Westbourne Galleries Limited [1972] 2 All E.R. 492; [1973] A.C. 360; Prudential Assurance Co. Ltd. v. Newman Industries Ltd. & Others (No.2) [1980] 3 W.L.R. 543.

There were few instances in which section 210 was successfully invoked, indicating that there should be reform (3). Accordingly section 75 of the Companies Act 1980 was enacted to remove some of the weaknesses of section 210 (4).

Section 75 of the 1980 Act provides that any member of a company may apply to the court by petition for an order under the section on the ground that the affairs of the company are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (5) including an act or omission on its behalf) is or would be so prejudicial. Accordingly it is no longer necessary for the petitioner to show that the facts would justify the winding up of the company as a condition of intervention. Furthermore, the petitioner has now to show only that the affairs of the company are being, or have been, conducted in a manner which is "unfairly prejudicial" as opposed to "oppressive" to him. Thus the petitioner has not to show actual illegality or invasion of legal rights. Thirdly the petitioner can now complain a single actual or proposed prejudicial act or omission as well as a continuing course of conduct. Fourthly, it is now made clear that personal representatives and trustees in

(3) Petitioners succeeded in Scottish Cooperative Wholesale Society v. Meyer [1959] A.C. 324; [1958] 3 W.L.R. 404; 102 S.J. 617; [1958] 3 All E.R. 66 and Re H.R. Harmer Ltd. [1959] 1 W.L.R. 62; [1958] 3 All E.R. 689; 103 S.J. 73.

(4) With the enactment of s.75 the 'fraud on the minority' remedy may be much less used in future by minority shareholders.

(5) It is perhaps important to take note of certain remarks made by Walton J. in Northern Counties Securities Ltd. v. Jackson & Steeple Ltd. [1974] 1 W.L.R. 1133, 1144: ". . . although it is perfectly true that the act of the members, in passing certain special types of resolutions, binds the company, their acts are not the acts of the company . . . the decisions taken at such meetings and resolutions passed thereat are decisions taken by and resolutions passed by the members of the company and not by the company itself . . . The fact that the result of the voting at the meeting (or at a subsequent poll) will bind the company cannot affect the position that in voting (the shareholder) is voting simply in exercise of his own property rights." Although in many situations the members' resolutions will cause the company to act, or omit to act, there may be resolutions which do not result in any action being taken by or on behalf of the company itself.

bankruptcy who have not yet been registered as members of the company but to whom shares have been transferred or transmitted by operation of law may petition under the new section 75 of the 1980 Act. Fifthly, without prejudice to the court's general power to grant relief, and in addition to its continued powers to make orders regulating the future conduct of the company's affairs and requiring the purchase of the company's shares, the court may order the company to refrain from the act, or rectify the omission, complained of, and may authorise civil proceedings to be brought in the name of the company against a third party. This provision enables a minority, unable to comply with all the conditions for bringing a derivative action, instead to petition first under section 75 of the 1980 Act and to ask for an order authorising the minority to institute proceedings in the name and on behalf of the company. In this way, liability for costs of the subsequent action will fall on the company rather than on the minority. It will be interesting to see the extent to which the court will allow a minority shareholder to bring civil proceedings in the name and on behalf of the company and how the court would interpret the meaning of "unfairly prejudicial". When allowing a minority shareholder to bring legal proceedings under the section, it is submitted that the court should see to it that it should not omit an order that the shareholder bringing the legal proceedings be at liberty to discontinue or settle the same.

It seems that the section does not help where it is alleged that the directors of a company have grossly negligently sold the company's property at a wholly inadequate price (6) since the alleged conduct is prejudicial to all the members, not some part

(6) E.g. in a case like Pavlidis v. Jensen [1956] Ch. 565; [1956] 3 W.L.R. 224; [1956] 2 All E.R. 518; 100 S.J. 452

of the members. To invoke the section, the wrong has to be prejudicial to some part of the members (7).

It is regrettable that there is no express provision in section 75 of the 1980 Act to make relief available to a member against unfairly prejudicial conduct irrespective of the capacity as member, director, officer or creditor in which the member suffered from the conduct. In many family companies or small private companies, the shareholders look forward to remunerative employment rather than dividend payments. In those companies it is unrealistic to draw a distinction between the roles of members in their capacities as members, directors, and officers. The members or some of them are usually also directors and officers, and they themselves often act in several and overlapping capacities. Further, a member in a private company is usually more or less dependent for his living on his emoluments or fees as an officer or director. Typically, such a company pays no dividends; the members get their shares of profits in the form of salary. So if a shareholder is deprived of his salary, his investment in the company yields no return and he becomes vulnerable to exploitation.

It is to be hoped that there will not be judicial timidities over section 75 of the 1980 Act similar to those over section 210 of the 1948 Act. The courts retreated into a state of nervous immobility on being confronted with discretion under s.210 of the 1948 Act and the new section should be able to make clear to the

(7) Apart from cases such as Pavlidis v. Jensen [1956] Ch. 565; [1956] 3 W.L.R. 224; [1956] 2 All E.R. 518; 100 S.J. 452; it seems that the argument that a wrong harms not only 'some part' of the members but all members would not help the defendant. Such an argument did not help the defendants in Scottish Co-operative Wholesale Society v. Meyer [1959] A.C. 324; [1958] 3 W.L.R. 404; 102 S.J. 617; [1958] 3 All E.R. 66 and in Re Harmer (H.R.) Ltd. [1959] 1 W.L.R. 62; [1958] 3 All E.R. 689. where all members, qua members, suffered (though the wrongdoers benefited in another capacity). See Gower, Supplement to 4th ed., paragraph 670.

courts that they may be less timorous.

It is proposed for reform that:

1. As it is difficult to distinguish between the rights of a member as a shareholder and as a director, the court should be allowed to deal under the new section with unfairly prejudicial conduct suffered by a member in a capacity other than that of a member. Otherwise commercial reality in many cases would be overlooked. The new section should also be amended in such a way as to enable the court to have regard to all the circumstances of the particular case in the same way as the court is prepared to do under s.222(f) of the Companies Act 1948. Thus, in an appropriate case, where a director-shareholder is removed from the board of directors, the court would be able to impose a just settlement on the parties to the action without putting the company into liquidation. The court should have unfettered discretion.
2. Perhaps the new section should be amended to permit a petition to be brought by debenture holders which debentures are convertible into shares.
3. Consideration should be given to the proposition that disputes among shareholders in a small private company be subjected to compulsory arbitration.

Winding-up Remedy under Section 222(f)

An aggrieved minority shareholder may also have recourse to section 222(f) of the Companies Act 1948. (8) Under section 222(f) the courts may order the winding-up of a company where, in the opinion of the court, it is just and equitable that the company should be wound up. One line of cases where this has occurred are the so-called 'quasi-partnership' cases in which the courts have shown themselves ready to recognise that behind the company

(8) See generally M.R. Chesterman (1973) 36 M.L.R. 129; J. Birds (1975) 125 N.L.J. 786.

structure there exists what is, in substance, a partnership and have applied partnership principles in ordering their winding-up (9). Thus the exclusion of a member from participation in the management of the business has been held sufficient to justify the making of an order under s.222(f) of the 1948 Act. The leading authority is the House of Lords decision in Ebrahimi v. Westbourne Galleries Limited (10). If the petitioner can substantiate the existence of an agreement or understanding that he shall participate in the conduct of the business, the courts would make an order for the winding-up of the company. An agreement or understanding can arise because the parties had carried on business, before the company was incorporated, as partners with an equal share in management or it can be deduced from the conduct of the parties after the incorporation of the company. If such an agreement or understanding is found to exist, then the removal of the petitioner from the board of directors by the legally effective use of a power conferred by the articles of association or the Companies Act 1948 may justify the making of a winding-up order because the courts will subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights or exercise them in a particular way. It is not just legal rights to exclude a member from the running of the business that can be subjected to equitable considerations. It may be done in respect of other rights. Thus, if in a family

(9) See e.g. Yenidje Tobacco Co. Ltd. [1916] 2 Ch. 426; 86 L.J. Ch. 1; 115 L.T. 530; 32 T.L.R. 709; 60 S.J. 674

(10) [1972] 2 All E.R. 492; [1973] A.C. 360; [1972] 2 W.L.R. 1289; 116 S.J. 412. See also Re Lundie Bros. Ltd. [1965] 2 All E.R. 692 where it was held in relation to a three-man company that the unjustified exclusion of a member-director from management did not amount to oppression under section 210, but justified the making of an order under section 222(f).

company, the directors, acting in accordance with a particular provision in the articles, refuse to register as members those persons to whom the shares of a deceased member have been bequeathed and the circumstances suggest that their motive is to get those shares for themselves at a low price, a petition by the executors for a winding-up order may be successful (1).

Section 222(f) of the Companies Act 1948 has some practical importance as a shareholder's remedy not because its use will inevitably bring the company into winding-up, which indeed is usually the last thing that the petitioner wants, because winding-up would result in substantial losses for all including the petitioner; instead it is the threat of ruin for all that will often be effective in obtaining redress for an aggrieved shareholder. More often than not, the outcome as expected is simply a good price for the shares of the aggrieved shareholder - or else everyone, including the aggrieved shareholder himself, stands to lose a fortune in the near future.

Ebrahimi v. Westbourne Galleries Ltd. is not only important as a threat, a liberal interpretation of Westbourne Galleries principles would prove very useful in favour of minorities.

However, as rightly pointed out by Sullivan (2), Westbourne Galleries dealt with a petition to wind up a company on just and equitable grounds under s.222(f) of the 1948 Act, so there is good reason to think that its ratio is not of general application. Indeed in Bentley-Stevens v. Jones (3) Plowman J. refused to extend

(1) In Re Cuthbert Cooper & Sons Ltd. [1937] Ch. 392; [1937] 2 All E.R. 466; 106 L.J.Ch. 249; 157 L.T. 545, 53 T.L.R. 548 the court refused to grant a winding-up order in similar situation, but the decision was disapproved by Ebrahimi v. Westbourne Galleries Ltd.
(2) See G.R. Sullivan (1977) 41 Conv. (N.S.) 169 at 176.
(3) [1974] 1 W.L.R. 638; [1974] 2 All E.R. 653; 118 S.J. 345. See also D.D. Prentice (1976) 92 L.Q.R. 502.

Westbourne Galleries principles to a quasi-partnership company while the company was still a going concern with no petition for winding it up having been filed. Plowman J. sent away the plaintiff with such a statement:

"However, that still leaves the Westbourne Galleries point. But in my judgement there is nothing in that case which suggests that the plaintiff is entitled to an injunction to interfere with the defendant company's statutory right to remove the plaintiff from its board. What it does decide is that if the plaintiff is removed under a power valid in law, then he may, in appropriate circumstances, be entitled to a winding up order on the just and equitable ground." (4)

Although the plaintiff in Bentley-Stevens v. Jones failed to get an interlocutory injunction before Plowman J., elsewhere the plaintiffs met with more luck.

In Pennell, Sutton and Moraybell Securities Ltd. v. Venida Investments Ltd., Berry, Farr, McLelland, Macphail and Nationwide Homes Ltd. (5), Templeman J. (as he then was) applied the Westbourne Galleries principles to a company which was still a going concern, and not faced with a petition for winding up the company under s.222(f) of the Companies Act 1948 and granted interlocutory injunctions (6).

Furthermore, in Clemens v. Clemens Bros. Ltd. (7) Foster J. followed suit and extended Westbourne Galleries principles to another company which was still a going concern. In that case the plaintiff

(4) [1974] 1 W.L.R. 638 at p.641.

(5) July 25, 1974, so far unreported. For the facts thereof, see S.J. Burridge (1981) 44 M.L.R. 40.

(6) Unfortunately Bentley-Stevens v. Jones was not referred to Templeman J. Sir Sydney Templeman is now a Lord Justice of Appeal and accordingly the Pennell case may carry some weight.

(7) [1976] 2 All E.R. 268. See also V. Joffe (1977) 40 M.L.R. 71.

and her aunt were the sole shareholders holding shares in the ratio of 45 to 55 per cent. The plaintiff had resigned from her post as a director. Although the aunt was still a director, she left the management to four non-shareholding directors. At an extraordinary general meeting, the board put forward proposals to increase the share capital by issuing 200 shares to each of the four non-shareholding directors and 850 shares to a trust for the company's employees and three resolutions were passed. Under the company's article (Article 6), members of the company had a right of pre-emption if another member wished to transfer his shares, and the proposals would result in the plaintiff losing her right to veto a special or extraordinary resolution and affect her existing right to purchase the aunt's shares under Article 6. The plaintiff sued for an order setting the three resolutions aside. In granting the order, Foster J. said after referring to Ebrahimi v. Westbourne Galleries Ltd.:

"I think that one thing which emerges from the cases to which I have referred is that in such a case as the present Miss Clemens is not entitled to exercise her majority vote in whatever way she pleases." (8)

With Templeman J's and Foster J's judgements against Plowman J's judgement (9), it seems that the weight of judicial opinion supports the possibility of extending Westbourne Galleries principles to companies where no petition has been presented under s.222(f) of the 1948 Act. It remains to be seen how wide the application will be (10).

(8) Bentley-Stevens v. Jones was not referred to Foster J.

(9) Ebrahimi v. Westbourne Galleries Ltd. was also applied in Re A & BC Chewing Gum Ltd. [1975] 1 All E.R. 1017; [1975] 1 W.L.R. 579; (1974) 119 S.J. 233.

(10) See also B.A.K. Rider (1979) 38 C.L.J. 148.

Costs and the Minority Shareholder

In another direction, the Court of Appeal decision in Wallersteiner v. Moir (No.2) (1) may encourage more litigation by minority shareholders because of its ruling on costs. In that case the court ruled that it is open to the court in a minority shareholder's action to order that the company concerned should indemnify the plaintiff against the costs incurred in the action if it is reasonable and prudent in the company's interest for the plaintiff to bring the action and it is brought by him in good faith.

Contingency Fees

In Wallersteiner v. Moir (No.2) the plaintiff, who was a minority shareholder, had exhausted his funds and the contributions made by other minority shareholders and yet the litigation seemed far from near the end. Seeing this, Lord Denning agreed that an exception in the case of minority shareholders had been made out (2) although he was still of the opinion that generally contingency fees should still be prohibited as against public policy.

On the disadvantages of contingency fees, Lord Denning pointed out that the system 'may stimulate lawyers to take on unworthy claims, or to use unfair means to achieve success.' (3)

But Lord Denning felt that 'these disadvantages are believed to be outweighed by the advantage that legitimate claims are enforced which would otherwise have to be abandoned by reason of the

(1) [1975] 1 All E.R. 849; [1975] Q.B. 373; [1975] 2 W.L.R. 389; 119 S.J. 97. See also H. Rajak (1975) 125 N.L.J. 1109; A.J. Boyle (1976) J.B.L. 18.

(2) Lord Denning was in a minority with Buckley and Scarman LJJ dissenting on this point.

(3) [1975] 1 All E.R. 849, p.861.

poverty of the claimant.' (4)

It seems that Lord Denning based his disapproval of use of contingent fees generally on his opinion that the present system of legal aid in the United Kingdom is comprehensive (5).

It is submitted that as the present system of legal aid stands, there are many people whose resources are beyond the financial limits for legal aid, yet they are without sufficient money to fight a long legal action (6).

It must be remembered that Article 6 of the European Convention on Human Rights, which applies to the United Kingdom, provides that 'In the determination of his civil rights and obligations . . . everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law.'

But there may not be few people like the plaintiff in Wallersteiner v. Moir (No.2) for whom legal aid is not available. To these people may be added those attempting to bring a test case on some novel or uncertain principles but who nonetheless are without sufficient money to retain a lawyer on the usual fee paying basis. For the minority shareholder (as well as the other people mentioned), the availability of a contingent fee would be a powerful weapon in combatting an oppressive (or unfair) or fraudulent majority.

One of the reasons opposing contingency fees might be the supposed immoralities of commercial life as well as the belief that contingent fees will bring harmful effects upon lawyers, clients and courts.

(4) Ibid. p.861.

(5) Ibid. p.861.

(6) See M. Sander, Lawyers and the Public Interest (1968) at 115-20.

But any attempt to deny the commercial aspects of the practice of law in 1981 must be unreal; few would still consider that legal fees are mere honoraria for a service to justice nowadays.

Of course the use of contingent fees would need to be safeguarded both as to the amount of fees and merits of claims. But it is submitted that these matters can be controlled by the governing bodies of the two branches of the legal profession and along the safeguards as suggested by Lord Denning in Wallersteiner v. Moir (No.2).

In the United Kingdom litigation is considered as socially disruptive and so should be used as a last resort (7). But attention should be drawn to the United States where litigation is seen as a socially useful device. That the contingent fee system is used successfully in the United States and other countries and the principle of equality of access to the courts justify further study into the contingent fee system.

It may be that the non-introduction of the contingent fee system is due to shortage of parliamentary time. Indeed in Wallersteiner v. Moir (No.2) Scarman L.J., who had been chairman of the Law Commission in 1966, complained with the following words:

"Although I could have wished to have seen by now some results from the 'further study' of contingency fees which the Law Commission recommended (para. 20), the delay in the matter (which may or may not be inevitable, I do not know) is no excuse for the court attempting to do the work of the legislature." (8)

It is proposed that there should be introduction of some form of contingent fee system. Such a system could be of particular use to minority shareholders as well as middle income groups.

(7) Indeed disincentives exist because the loser has to pay the winner's costs.

(8) [1975] 1 All E.R. 849, at 873.

Finally it is perhaps important to emphasise the practical difficulties involved in detecting fraud, self-serving negligence and other breaches of duty in the first place and then substantiating them. More often than not breaches of duty are only detected when the company reaches the point of going into liquidation. At this point in time the personal fortunes including insurance money of the directors in default are likely to be insufficient to provide for compensation for the wrongs or breaches of duty that may have been committed. Where a company is negligently or incompetently run, the resultant economic and social harm may be very great. Bad and incompetent management places shareholders, creditors, employees, consumers and suppliers at risk of loss, and as can be seen from above, the law as it now stands can only have a limited role to play (9).

Therefore it is submitted that of far greater practical significance in the future should be the continuing improvement of managerial education in its many varieties of form and the creation of external mechanisms and internal mechanisms within the company to improve supervision of management. In this connection the watching committee or the use of outside directors on a non-executive basis, who have something definite to offer other than mere social graces, which will be more particularly described in Chapter 3 herein, has a major role to play as does employee participation, which will be more particularly described in Chapter 2 herein.

(9) See, e.g. Wallersteiner v. Moir (No.2) [1975] 1 All E.R. 849; [1975] Q.B. 373; [1975] 2 W.L.R. 389 although recently the courts have been more ready to intervene to correct abuse of majority power and unfairness.

CHAPTER 2 EMPLOYEE PARTICIPATION

Until recently company law did not set out to recognise the interests of the employee. It took care of directors, shareholders, creditors, auditors, but not employees. Thus Plowman J. said in Parke v. Daily News (1):

"The view that directors in having regard to the question what is in the best interests of their company are entitled to take into account the interests of the employees irrespective of any consequential benefit to the company is one which may be widely held . . . But . . . in my judgement such is not the law . . . the defendants were prompted by motives which however laudable and however enlightened from the point of view of industrial relations were such as the law does not recognise as sufficient justification. The essence of the matter is this, that the directors of the defendant company are proposing that a very large part of its funds should be given to its former employees in order to benefit those employees rather than the company."

Section 46 of the Companies Act 1980, which came into force on the 23rd June, 1980, provides that the matters to which the directors of the company are to have regard in the performance of their functions shall include the interests of the company's employees in general as well as the interests of its members. But this duty is to be owed by the directors to the company alone and is enforceable in the same way as any other fiduciary duty owed to the company by its directors. The employees are not given any collective right of enforcement. Therefore this provision will not as such directly benefit employees who would require to be shareholders (2) to take action and will presumably come within

(1) [1962] Ch. 927; [1962] 3 W.L.R. 566; [1962] 2 All E.R. 929; 106 S.J. 704.

(2) But, of course, the trade unions may buy shares in companies employing their members so that they can sue qua members on behalf of the companies when that is allowed. See also post, p.89.

the rule in Foss v. Harbottle (3). So little is changed and the provision is probably only declaratory of the law as it stood before this provision was brought into force. Section 47 of the Companies Act 1980, however, provides that directors who are empowered (4) so to do may make provision for employees in the event of a cessation or transfer of business even though the exercise of the power may not be in the best interests of the company, thus reversing Parke v. Daily News (5)

Pressures for Change and the Arguments

In the last twenty years or so the whole scale of business organisation has significantly increased. New forms of trading have created vast industrial empires. It has been said that the rise of the modern corporation with concentration of economic power behind it can compete on equal terms with the modern state. If its own interests are affected, it even attempts to dominate the state. To some extent, then, the law of corporation can be considered as an aspect of the constitutional law of the modern state and increasing recognition is being taken of the political and social influence of their decisions (6).

The large company today has a large influence on market conditions and consumer demands. Sometimes to get the largest profits for its shareholders seems not to be its first goal; it concentrates on growth of size and power as the first objective (7).

(3) (1843) 2 Hare 261.

(4) The power must be exercised by the general meeting unless the directors are authorised by the memorandum or articles (s.74(3) of the Companies Act 1980). Steps are, however, taken to ensure that this is not used to the detriment of creditors; provision may be made only out of profits available for dividend or, if the company is in liquidation, available for distribution to the members (s.74(6) of the 1980 Act).

(5) Ante, p.46

(6) Cf. Gower, pp.58-9

(7) Cf. Gower, p.59

A further consequence of the growth of giant commercial enterprises is that many of them have ceased to owe allegiance to one country only. Our world is now one where the giant company has already assumed international proportions, either by way of trading agreements or mergers with foreign companies or by operating subsidiary companies or branches in other countries (8). In 1968, a Minister told the House of Commons, "As the international companies develop, National Governments including our own, will be reduced to the status of parish councils in dealing with the large corporations which will span the world."

The current development of international mergers has caused alarm. If two companies merge, there is no need for two personnel, marketing or accounting departments.

Furthermore Britain and many developed nations are on their way to becoming an automated society. As technology is so sophisticated, more and more tasks can be done by machines and jobs are lost.

In the last half of the 1980s Western Europe began to experience levels of unemployment unknown for forty years. By 1978 Britain's unemployment rate of over 6 per cent was nearly three times greater than the politically acceptable level of the mid 1950s; yet it is going and expected to continue to go up. Unemployment creates a lot of economic and social difficulties. Together with inflation, unemployment is the greatest economic stimulant for political discontent. Our traditional system of moral principles requires that people work for a living and the head of the household, usually the husband, is expected to keep those who are too young to work. A man who is out of work cannot fulfil this requirement of society, and is looked down upon because

(8) Gower, p.61.

(9) A.W. Benn, Minister of Technology: Official Report (H.C. 1968, Col. 491).

he is considered not capable of supporting his family. This may have a bad psychological effect. A long period of unemployment can destroy a man's pride and eventually remove his mental and physical ability to work. There are cases where men pretend to go to work to prevent their children from finding the truth. Unemployment amongst young people is even worse. The youngsters may have a feeling that they are being rejected by adult society and they have no source of income. Because they have nothing meaningful to do, some youngsters turn to vandalism and crime (10). It is believed, however, that the unemployment rate will fall if there are better industrial relations and revitalisation of British industry.

Recently educational opportunities have expanded, a phenomenon which will accelerate with the raising of the school leaving age and an increase in further education facilities (1). The new opportunities raise the aspirations of young people and educational advancement is producing a society where younger people are against authoritarianism in a positive way; they are urging that man should have a greater say in his destiny. Such ideas have permeated into the work environment (2).

"Not only must workers have the right to determine their economic environment by participating in a widening range of decisions within management but the recognition of that right and measures to secure it are matters of urgency." (3)

The need for employee participation on the board has partly arisen out of fear of unemployment and redundancies resulting from mergers and conventional firms going bankrupt.

(10) See generally Bullock Report, Cmnd 6706, Chapter 3.

(1) See W.B. Creighton (1977) 4 Brit. J.L. & Soc. 1, 6.

(2) See Bullock Report, para. 3.7.

(3) Labour Party document on Industrial Democracy 1967.

Another base for advocating employee participation is that the employees of a big company in fact make a greater continuing and practical contribution to the success and profitability of its business than shareholders and investors. It is true that shareholders contributed some initial or new capital, but they play no active or continuing part in running it. Therefore employees ought to be entitled to rights at least as great as those of shareholders both in controlling the activities of management and in participating in profits. Since employees' ties to the company last longer than those of shareholders, employees should be entitled to sharing control over it. Indeed it may be argued that the power to control management is probably more important for employees than for shareholders, since a shareholder may sever his relationship with a company by selling his shares, whereas an employee may have much to lose by leaving the company. The shareholders, it is submitted, should be entitled to a reasonable return by way of interest on the capital invested and some profit for the risk of making investment. Any profit remaining after paying these sums should be shared by the shareholders and employees equally or in proportion to their notional contribution as the case may be. We live in an era that questions the sanctity of profit and restricts the pursuit of self interest. A company should be a meeting place for capital, management, employees, suppliers, consumers, and the public together. All these interests should have a status in company law. Ownership involves not only rights but responsibilities as well. This requires company directors on behalf of shareholders to discharge their social responsibilities as well as to protect their legitimate interests as investors.

There are other reasons for demanding employee participation. It is argued that the new system will end the exploitation of human

beings. It is alleged that some employees have been treated as objects. This is contrary to their natural rights and should be stopped. It is said that there are unfair inequalities in income between employees and employers and many would like to see the end of such phenomenon. It is further said that employee participation would involve more people in the production of wealth and check the concentration of capital into fewer and fewer hands (4). It has also been said to provide for more responsible citizenship by providing for more industrial democracy.

However it may be argued that the employee directors would be inexperienced and unable to effectively assist in making decisions at board level. Without the necessary training employee directors would find it difficult to understand corporate policies and management would have to spend more time explaining policies to them and through them to their constituents or those they represent and decision-taking might be further slowed down because the employee directors would feel obliged to report back and consult their constituents or those they represent before committing themselves (5).

On the other hand, it is argued that employee participation on boards would bring about an optimum combination of capitalism and socialism. Conflicting interests at crucial stages in policy formation would be solved at an early stage. The employees will be able to express their opinions before a decision is taken, to point out the implications of a proposal for the interests of employees, to question management on what they are proposing and to suggest alternatives or alterations, and in so doing the workforce will commit themselves more to the company. A joint decision can usually be carried out without costly industrial disputes and loss of production. Although initially it may take longer time to

(4) See W.B. Creighton (1977) 4 Brit. J.L. & Soc. 1,6.

(5) Bullock Report, para. 6.27.

formulate corporate policy, once the consent of employees has been obtained, decisions will be easier and quicker to implement. This will more than make up for the loss of time in discussing corporate policy at the beginning (6).

Concern has been expressed over that the new system of employee participation might have a bad effect on foreign investment, which plays an important part in the British economy, and fewer international companies would set up businesses in the United Kingdom because of the uncertainty that the instructions of the foreign parents would be carried out by the board of a subsidiary company in the United Kingdom which is subject to the new proposed rule of co-determination. Bullock (7) considered that at first foreign investment would decline (8) because foreigners might make investments elsewhere. But once it was proved that the new system would increase the efficiency of companies, improve industrial relations and make the companies more profitable, there would be an increase of foreign investment in the United Kingdom. Furthermore foreign investors would eventually become accustomed to the new system, especially when so many countries in Europe have adopted the German model of co-determination in some form (9).

Some attention has been drawn to that board representation might conflict with the traditional role of collective bargaining, which is seen as one of opposing management, not collaborating with it. There may then be contradiction between the objectives of board level representation and collective bargaining (10). But it is

(6) Cf. Bullock Report, paras. 6.28, 6.29.

(7) See Bullock Report, paras. 6.33 to 6.41.

(8) It was thought that employee participation was only one of many economic and political reasons that would affect foreign investment, so it would be very difficult to estimate its actual effect on investment. See Bullock Report, para. 6.36.

(9) Foreign interests have adapted to employee representation in West Germany and to some extent Yugoslavia. See Bullock Report, para. 6.41.

(10) Bullock Report, para. 5.18.

argued that board level representation and collective bargaining are not incompatible because both processes serve the same purpose of enabling employees to take part in decision-making in the company in which they work. The two processes are similar and assist each other. No new issues of principle are raised by board level representation. There are some matters which collective bargaining alone is unable to handle and employee participation may be used as an additional means to cope with those matters (1).

Bullock's main Proposals

In response to the increasing demand for some sort of legislative action the Government set up a committee known as the Committee of Inquiry on Industrial Democracy (2) under Sir Alan (later Lord) Bullock. This marked the first real move by the Government towards statutory regulation of employee participation. The Bullock Committee, however, could not reach a unanimous decision. Two reports were issued, a Main Report signed by seven members including the academic and trade union members and a Minority Report signed by the remaining three members who were all industrialists.

Bullock (3) proposed a reconstituted board of directors for companies employing 2,000 or more employees (4), envisaging the possibility of lowering the number from 2,000 to 1,000 in due course(5).

(1) Ibid. para. 10.54.

(2) Cmnd 6706. The terms of the Bullock Committee were as follows: "Accepting the need for a radical extension of industrial democracy in the control of companies by means of representation on boards of directors, and accepting the essential role of trade union organisations in this process, to consider how such an extension can best be achieved, taking into account in particular the proposals of the Trades Union Congress report on industrial democracy . . ." The terms of reference of the Committee have been criticised since the terms recognised the essential role of trade unions in the new system. Furthermore Bullock did not consider the alternative of extending public ownership by government.

(3) Bullock Report, para. 11.4. See also generally O. Kahn-Freund (1977) 6 I.L.J. 65. Except where indicated Bullock's majority proposals are referred to as Bullock.

(4) As to groups of companies, see below pp.80-1

(5) Bullock Report, para. 11.5. The new system would affect for the time being some 738 enterprises employing 6 or 7 million people in the United Kingdom (one third of total private sector workforce).

The new board would consist of equal numbers of shareholder directors and employee directors with a minimum of four in either case and a third group of directors (the so-called 2X + Y formula). The third group directors would be co-opted jointly by the shareholders and employees and would be chosen for their expertise and experience (6). In case of disagreement as to who should be co-opted, an independent commission to be called Industrial Democracy Commission would try to conciliate. If conciliation failed as well, the Commission would impose a binding solution upon both sides (7). The number of Y members should be an odd number and more than one (8), but should be smaller than the number of either the shareholder directors or employee directors (which are to be equal of course). Bullock rejected the introduction of a two-tier system and proposed that the existing unitary board structure as restructured as aforesaid be introduced because, inter alia, they felt that a two-tier system would be inconsistent with the traditional flexibility of British company law and there might be friction between the supervisory board and the management board in the two-tier system.

When considering the question of channel of representation, Bullock pointed that union membership was high (on average about 70% of the total workforce) in large companies with 2,000 employees or more. Furthermore, in spite of increase of unemployment union membership was still going up (9).

The Trades Union Congress strongly argued that in order to avoid the possibility of conflict between the processes of employee participation on the board and collective bargaining, the channel for the appointment of employee directors should be the same machinery as was established for collective bargaining (10).

(6) Ibid., paras. 9.13, 9.14 and 9.19.

(7) Ibid., para. 9.43.

(8) It was so proposed as to prevent a deadlock from arising.

(9) Bullock Report, para. 2.9 to para. 2.17.

(10) Ibid., para. 4.4.

Bullock agreed to the view of the Trades Union Congress and suggested that employee participation on the board should be based on a single channel of representation through trade union machinery (1). Any other method would be contrary to the established published policy of encouraging and strengthening collective bargaining (2) and would also be strongly opposed by the trade unions, which would see it as an attack on their established interests. There would be great dangers in proceeding with industrial democracy without the support of the trade unions and Bullock felt it impractical to propose a system of representation on the board which was not supported by the trade unions (3). A further justification was that the unions could reasonably be expected to possess the necessary expertise and independent strength effectively to run a system of employee participation on the board and would be able to establish procedures to avoid conflict with collective bargaining (4). Bullock recommended that the shop stewards and other key representatives of the various trade unions who had members in the company should set up a committee to be called the Joint Representation Committee (JRC) and suggested that the choice of the representatives should lie with JRC. The JRC would also be responsible for arranging discussions between the employee directors and collective bargaining union representatives to decide how different kinds of questions should be solved, for example whether the questions should be raised at meetings of board of directors or through collective bargaining machinery.

Bullock also recommended that the process of reconstituting the board should be "triggered" by the request of the one or more trade unions recognised for collective bargaining representing at

(1) Ibid., para. 10.8.

(2) Ibid., para. 10.6.

(3) Ibid., para. 10.5.

(4) Bullock Report, para. 10.7.

least a fifth of the total workforce. Bullock nevertheless took into account to some degree the position of non-union members by suggesting that there should be a requirement of a ballot of all employees before the system could be triggered in any given company. Bullock proposed that if a majority equal to one-third of those eligible to vote casted affirmative votes then the board would be reconstituted. It is submitted that Bullock failed to guarantee employee participation on the board to non-union employees. Although about 70 per cent. of the workforce in the companies covered by the Bullock proposals are trade union members, there seem to be no good reason for confining representation to trade union employees. Indeed it can be argued that by excluding some 30 per cent. of the workforce, the proposed system of industrial democracy is no so 'democratic' as the name suggests.(5). Bullock (6) considered it unlikely that employees would wish to discontinue the new system of board representation once it was started. However, to allow for such possibility Bullock proposed that after five years a union or unions representing 20 per cent. of the workforce should be allowed to request a ballot to decide upon the continuance of the new system, and for it to be discontinued there should be a simple majority of one third of those eligible to vote against continuance.

Bullock also recommended that there should be better trade union education so that employee directors would be properly equipped for their tasks. The purpose of such education was to " . . . equip the employee representatives with the necessary ability to take part in the more technical aspects of the board's work. For

(5) The Bullock Committee was to some extent restricted by its terms of reference. The Minority Report, however, suggested that employee directors should be elected by all the employees, and the institution linking the employee directors and the workforce should be an employee or company council, which council would be a consultative body separate from the recognised trade unions.

(6) Bullock Report, para. 10.21.

this, some acquaintance is needed with the presentation of financial information, basic economics, management information and control systems, some aspects of company law and so on." (7)

Fifth Directive

The Labour Party is committed to the Bullock Report. However, the present Government is opposed to any compulsory introduction of employee participation (8), but events are not entirely in its own hands. The accession of the United Kingdom to the European Economic Communities required Britain to harmonise British company law with those of other member states (9). Initially the European Commission proposed the introduction of the German two-tier model in all EEC countries (10). But after a series of negotiations and consultation, in 1975 the European Commission recommended "a framework which provides for the objectives to be reached in a way which leaves discretion to the member states as to the precise models which they may adopt." (1) and in March 1981 the Legal Affairs Committee of the European Assembly suggested the following alternatives to the European Commission (2):-

(7) Ibid., para.12.22.

(8) The Liberals and Social Democrats approve of the Fifth Directive.

(9) See also the Draft Statute on the European Company.

(10) Draft Fifth Directive to harmonise Company Law in Member States (1972).

(1) EEC Commission, Employee Participation and Company Structure (1975).

(2) The Fifth Directive is scheduled to be finalised by the Council of Ministers in September 1981. The present Government is opposed to any compulsory introduction. The Fifth Directive derives its legal force from Art. 54(3)(g) of the Treaty of Rome the relevant terms of which read as follows: ". . . co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by member states of companies or firms . . . with a view to making such safeguards equivalent throughout the Community." It is debatable whether the question of industrial democracy fits comfortably within the Article. If the final version of the Fifth Directive is unacceptable to and forced upon the United Kingdom, the United Kingdom would be entitled to challenge any contentious articles in the Fifth Directive as ultra vires. See also W. Däubler (1977) 14 C.M.L. Rev. 457.

(i) A supervisory and management board with employees slightly under half of the directors of the supervisory board. OR

(ii) A unitary board which is obliged from time to time to consult with a consultative council on which employees are represented. OR

(iii) A consultation system derived through a system of collective bargaining but which must involve a secret ballot when choosing the employee representatives.

What final version the Fifth Directive would be is conjectural, but the pressure from the EEC has been the principal reason for Government action in discussing introduction of some form of board level employee participation in large companies (3).

The Choices

A view has been put forward that the interests of employees are best represented by the development of existing structures for collective bargaining or consultation (4). It is pointed out that one should not lose sight of that making comparisons in employee participation in different countries is both difficult and dangerous (5) because, among other things, one cannot usefully examine any particular aspect of law of a country apart from its institutional and social context including in the case of employee participation the practical operation of collective bargaining, other forms of worker representation, the structure and functions of unions and employer associations, the political situation and the role of government, and the impact of social practices, attitudes and values and because it is so easy to fail to recognize or correctly interpret important elements of the context, and one may particularly

(3) See Hadden, p.447.

(4) See generally S. Simitis (1975) 38 M.L.R. 1.

(5) See also Bullock Report, para. 6.48.

fail to sense deeply-rooted but unarticulated assumptions or attitudes in an unfamiliar society. Making comparisons only helps us better understand our own system by seeing it from a different perspective so that we may become conscious of gaps and weaknesses of our system which familiarity has led us to overlook and one should bear this in mind when one advocates the introduction of the German model to our country, although with modifications to suit the particular needs and conditions of our society.

Accordingly that the German system seems to have been a success in Germany does not necessarily mean the German model would work well in the United Kingdom because there are sufficient differences in the patterns of industrial and trade union organization in Germany to make any direct transfer of the German model to other countries impractical. Co-determination in Germany is based on a long-established and precise division of power between a supervisory and an executive board (6). On the contrary the most significant feature of labour relations in Britain is that there has generally been a preference for collective bargaining between trade unions and employers over legal solution as a method of regulating jobs. The traditional reliance upon collective bargaining does not rest upon some philosophical basis, such as 'the abstention of the law' but simply on practical experience. During the critical periods of their development British trade unions have found that they could win more economic gains through collective industrial strength than through reliance upon the law. Historically the workers were antagonistic towards the judiciary. The justices of the peace, who fixed wages for nearly 500 years and fined and imprisoned workers for breach of contract until 1875, were nearly always landowners

(6) Hadden, p.448.

and employers. The social origins and judicial attitudes of the High Court were also perceived as being fundamentally anti-trade union. The common law rules laid down by the judges did little to redress the basic inequality of the individual employment relationship, in which the property rights of the employer far outweigh the bargaining power of the individual worker. This hostility to the ordinary courts is reflected, even nowadays, in the establishment of tripartite industrial tribunals, consisting of a lawyer, an employer and a trade unionist, to deal with legal disputes in this field (7).

It is argued that it is better to use traditional means for dealing with industrial conflicts because experience shows that collective agreements appear to be an adequate means for introducing participation. It is easier to extend the jurisdiction of an already existing body than to introduce and enforce new structures. Besides there are difficulties. As the law now stands, all directors (which would include employee directors) should take the prosperity of the company into account and consider always the company's best interests irrespectively of any possibly conflicting particular interests. Employees may thus elect representatives; nevertheless they cannot expect them to follow their instructions or wishes. It is up to the representatives to decide whether the expectations of the employees who elected them are compatible with the company's best interests or not. Furthermore, companies the policy of which is determined by employers' and employees' representatives jointly may gradually tend to act outside the collective bargaining system (8). They will try to fix their own wages. Board representation thus

(7) For collective bargaining, see generally C.D. Drake, *Labour Law* (2nd ed.) pp.273-276; Cronin and Grime, *Labour Law* (1970) pp.303-318.

(8) S. Simitis (1975) 38 M.L.R. 1, 20.

leads to self-governing corporate wage policy. Some employees may welcome such phenomenon, but such companies will gradually be isolated. As a result they risk preventing trade unions, in the long run, from defending a branch, regional or even national wage policy. Therefore any form of board representation would challenge collective bargaining. The right to strike is also affected. In fact, it is argued, if board representation is treated not only as a right to take part in making board decisions but also as a duty to accept and defend board decisions, strike activities may become increasingly dubious. The ultimate sanction behind the collective bargaining machinery is the threat and exercise of the right to strike (9) and any suggestion which takes away this sanction leads therefore to a reconsideration of the mechanisms offered by labour law. It is suggested (10) that board representation should be seen as an auxiliary or a secondary mechanism, but collective agreements and not employee participation schemes determine the position of the employees. Hence it is also up to these agreements to control corporate planning in favour of employees. Consequently it is not necessary to resort to employee participation schemes except in connection with matters which evidently cannot be coped with by collective agreements. It is argued (1) that the usefulness of collective bargaining has been under-estimated. The larger therefore is the area of collective bargaining, the less necessary will be the introduction of auxiliary means.

It is, however, accepted that collective bargaining is at present inadequate to cover the process of corporate planning. It is by and large confined to the traditional wages and hours issues of

(9) W.B. Creighton (1977) 4 Brit. J.L. & Soc. 1, 14.

(10) S. Simitis (1975) 38 M.L.R. 1, 21.

(1) S. Simitis (1975) 38 M.L.R. 1, 21.

industrial relations and only exceptionally extends to cover issues such as investment and pricing policy.

It is observed that the public corporations of nationalised industry are all under legal obligations to seek negotiations with trade unions, but these duties are, for various reasons, scarcely enforceable in the courts. So if industrial democracy is effected through extended collective bargaining, it is proposed that it is not enough to just seek negotiations; the law should specify that there is a duty to bargain and consult with employee representatives. Besides this, the law should also set out the areas or topics on which consultation or bargaining must take place. The areas or topics should include new working methods, dismissals, employees' pension rights, substantial closures and changes in the plant, redundancy etc. The appropriate Minister should be given power to vary, after consultations, the list of required topics or areas. In order to help extend the proposed range of areas covered in the present forms of collective bargaining, the law should recognise and enforce the right of employees and of their representatives to information about the proposed particular areas or topics from employers. Those who sell labour to the company are entitled to know about its affairs. If the creditor who lends money to the company is entitled to disclosure, so is the employee who brings his labour to the company. The list of compulsory disclosure should include, inter alia, labour cost against output, the number and type of employees employed, payroll, etc.

In the United Kingdom those who seek industrial democracy through an extension of collective bargaining and a greater compulsory disclosure of information advocate either joint decision-making with employees represented solely by trade unions or extension of consultative machinery, e.g. through works councils representing all

employees rather than through trade unions (2).

Another view (3) is that employee participation is more likely to be achieved by giving employee representatives effective powers of supervision and veto on specific and limited issues rather than by pursuing the more attractive goal of joint employee/management control on all issues at board level.

A third alternative of employee participation would be representation of employees on the board. It is argued that, besides the social responsibility argument, industrial relations would improve and that productivity would increase as a result (4). Employee representation on the board would not only improve efficiency but are indeed essential to developing new forms of co-operation between labour and capital, which are needed if Britain is to overcome its current industrial and economic difficulties. Board representation must not necessarily conflict with collective bargaining; the proposed change would be in the interests of the efficiency of companies (5) and the economy and of the satisfaction of employees (and gradually the community). At present it is believed that much industrial unrest is caused by the lack of communication between employees and management. Decisions are arrived at without consultation of employees' representatives, and are frequently announced without any attempt to explain what were the considerations which led to those decisions. Once a decision has been reached, it is difficult for trade unions to persuade employers to reconsider in the light of the employees' interests, unless there is a work to rule, a strike or similar industrial action to produce a direct

(2) See Gower, p.69.

(3) E.g. see Hadden, p.484.

(4) Ibid., p.160.

(5) Ibid.

confrontation. The employees might be more willing to co-operate with management if they knew that their interests had been seriously considered by the board of directors at the time when the decisions were made. British industrial relations have a long history, but many of their historic features have proved unworkable in our modern society.

The Trades Union Congress put forward another proposal. They suggest that representation of employees on the board be a legal right which a recognised and independent trade union may demand but selection of representatives must be through trade union machinery (6).

European Experience

In the United Kingdom there has been little legal progress towards giving employees any right to participate in management or decision making (7).

In other countries more progress has been made. Co-determination in West Germany has reached the most sophisticated level and is imposed through two and sometimes three separate institutions. A Works Council (8) is required in each company employing more than 5 persons. This Council must meet management monthly to discuss problems and the Council makes reports to employees regularly. The Council has the right to veto over a wide range of management actions ranging from pay and holidays to health and safety precautions and the engagement of new staff.

(6) Bullock Report, para. 4.3.

(7) There has been much activity but little progress regarding the Fifth Directive, and in Cmnd. 7654 (1979) the government states that no useful purpose would be served by introducing legislation requiring the inclusion of detailed employment and other non-financial information in company accounts. The government is now considering a draft report prepared by the Dutch rappporteur (Geurtsen).

(8) See generally Hadden, pp.474-6.

In case of disagreement there is provision for arbitration. Further topics require discussion; these include dismissal. Where the company employs more than 100, a permanent economic committee of between 3 and 7 employees must be formed. The employer participates in the proceedings but is not a member. This committee must agree with any proposed change in the economic circumstances of the plant such as its sale or closure. Once again they go to arbitration in case of disagreement. Third form which co-determination takes is through the supervisory board of the company. Where a company has more than 2,000 employees or is engaged in the mining or iron and steel industries, it must have a supervisory board. Where such a board is obligatory, then half of the members are appointed by the shareholders and the other half by the employees. The function of such a board is to supervise and appoint the management which is carried out through a management board. Where a company employs 500 to 2,000 employees, one third co-determination is required with one third of the members of the supervisory board appointed by the employees and two thirds by the shareholders. In practice workers tend not to be represented by the direct election of their own representatives and the unions usually appoint semi-professional supervisory directors (9).

Numerous surveys and reports (10) in Germany have reported as follows:

Most German workers are happy with the German system. The formal structures for co-determination have resulted in the development of a much more extensive informal network of communi-

(9) See generally H. Wiedemann (1980) Am. J. Comp. L. 79; Mertens And Schanze (1979) 2 J. Comp. Corp. L. & Secs. Regs. 75.

(10) Hadden, pp.455-7.

cation between management and employee representatives at all levels of the company. The requirement of joint discussion on formally constituted bodies appears to have given way, both at the supervisory board and the works council level, to an informal search for consensus or compromise between the leaders on each side, with the result that proceedings at the meetings themselves have become less significant. The success of co-operation results from the receipt of comprehensive information by the plant representatives and in the opportunity to discuss with management at the earliest possible stage all problems of the plant and the company. Most of the decisions at supervisory board level are unanimous, largely as a result of prior negotiation between the parties.

It is also reported that in some cases the system has led to delays in decision-making while the representations of employee representatives are dealt with and some directors have greater problems in preparing major investment plans (1). While this may be looked at as some defect, on the other hand this is exactly what the system is for. Management plans should be subjected to more scrutiny as to their impact on the workforce and a balance has to be struck between technical and economic considerations and the demands and expectations of employees.

Although it cannot be proved that co-determination as such has been any direct contribution to the success of the German economy, but it is difficult to deny the implication that it has played some part and that it is a more effective method of dealing with the inherent conflicts within an enterprise than the British model of arms-length collective bargaining. It appears

(1) Hadden, p.456.

that the German system has operated successfully for about thirty years (2).

The German system has been widely followed, though with variations. Holland in 1971 introduced a system whereby the supervisory boards of its larger companies will eventually be made up of members approved both by the shareholders and by the employees acting through the works councils. The object of this was to avoid the divisive effect thought to be characteristic of the German model (3).

France, in 1966, introduced an option for companies to adopt a two-tier structure, but it is learned that few have done so. Proposals were made in 1975 for a wide variety of corporate forms so as to facilitate employee representation at various levels. But a formal two-tier board is not an essential precondition for employee directors (4).

The Netherlands has revised their company law so as to distinguish large companies from small ones. Their co-determination rules are different from the German rules in some important ways. Any corporation which has at least 100 employees must have a Works Council which must be consulted on plans affecting employment in a general way, such as mergers, closures, expansion etc. The prior consent of the Works Council must be obtained in the field of working conditions, including health and safety. If, in addition to employing 100 people the company has net assets of £1¼ million, then it must have a supervisory board. The duties of this board correspond with the German position but there is an interesting difference in the way the board is appointed. Initially the board is appointed by the shareholders

(2) Hadden, p.447.

(3) Gower, p.70.

(4) Ibid.

and replacements are appointed by the Board itself. Both the shareholders and the works council, however, have the right to make and veto nominations.

Sweden has recently provided for minority representation of employees on the unitary boards of its larger companies (5).

Denmark has introduced a system which is half-way between the unitary and the two-tier (6).

Proposed Form of Participation

It is unlikely that the interest in the idea of employee participation will go away because the United Kingdom have joined the EEC and most countries in Western Europe have some form of industrial democracy (7). It is unlikely that a German Works Council or its equivalent in countries adopting the German model would permit a substantial employing company to merge with, or be acquired by a United Kingdom company unless the United Kingdom company was prepared to grant co-determination rights. An example of this actually happening was the Royal Dutch Steelworks merger where the German side forced the Dutch to set up co-determination in the Dutch parent company even though it took place before the introduction of co-determination into Dutch law.

As to the choice between a two-tier and a unitary board, Holland, Belgium, Sweden and Denmark (8) have based their introduction of employee representatives on the German model. But in each case, there have been substantial modifications to the formal two-tier German structure to reflect the current practice and organization of management and unions. Under the two-tier

(5) Gower, p.70.

(6) Ibid.

(7) See W. B. Creighton (1977) 4 Brit. J. L. & Soc. 1, 1-2; Bullock Report, para. 3.13 and Conclusion, para. 8.

(8) Hadden, p.458.

structure, day-to-day management is vested in an executive or management board which is appointed by, and responsible to, a supervisory board which also determines matters of fundamental policy. The supervisory board consists of representatives of the shareholders and employees. The Fifth Draft Directives (9) suggest a catalogue of measures on which the executive board is bound to consult and obtain the authorisation of the supervisory board. The catalogue includes (i) the closure or transfer of the undertaking or of a substantial part of it; (ii) substantial curtailment or extension of the activities of the undertaking; (iii) substantial organisational changes within the undertaking; and (iv) establishment of long-term co-operation with other undertakings or the termination thereof.

It can be argued that the unitary board system in the United Kingdom was created at a time when directors were normally entrepreneurs and were interested basically only in profits for themselves. It is not suitable for non-executive directors, particularly for employee directors. It has been argued that the unitary board rejects the logic of modern organisation. The dissociation of the overall objectives, policies and control affords a clearer check and enables non-executive directors, whether employees or not, to make a more meaningful contribution than when debating day-to-day problems with executive directors who have spent hours or days on the problems and the background. The minority Bullock report considered that the introduction of employee directors on to the main board of a company would lead to the dilution of management expertise and the confusion of objectives. Their recommendation was that any employee

(9) See C. M. Schmitthoff (1973) J.B.L. 312, 320.

representation should be on a supervisory board. Such a supervisory board, where established, would not involve itself with detailed decision making of existing boards of directors, but should be primarily concerned with the quality of the management of the company and its capacity to run the company profitably and competitively (10).

The majority Bullock report (1) considered that it was not practical to introduce the two-tier system into the United Kingdom. It felt that employee directors on a supervisory board had little real power and proposed that representation should be on the existing company board.

The White Paper (2) stated that the two-tier board structure had certain advantages over a unitary board. In particular the division of responsibility between a management board responsible for the day-to-day affairs of the company and an independent supervisory policy board as a watchdog overseeing the management board was seen as a desirable split of function.

The boards of large British companies have traditionally combined both executive and supervisory functions and it seems better to leave the precise allocation of responsibility for executive and supervisory functions to each individual company because there is such a wide range of different managerial structures in companies and groups in various sectors of the society. The German system achieves a clearer allocation of powers. The present British system is more flexible. It is hard to say which system is the better one, so there are no compelling reasons for changing the present British system. It is better

(10) See Bullock Report, p.167. Professor Schmitthoff also favoured the two-tier board. See his article, New Concepts in Company Law (1973) J.B.L. 312, 320.

(1) Bullock Report, Cmnd. 6706 (1977). See above, p.54.

(2) Industrial Democracy, Cmnd. 7231 (1978). See Gower, p.75.

to let things as they are, and therefore it is proposed (3) that for every public company or large unquoted company or alternatively for every company employing more than 50 employees there should be a reconstituted unitary board with an equal number of shareholder and employee directors and a third group from professionals recognised by the government for that purpose. The employee directors may be elected by the employees themselves or their unions. There should not be a single channel of representation through trade unions. Manual workers, salaried employees, executives, etc. will be entitled to representation according to their numbers in the company, but at least one representative of each class should appear on the board. The participation of the third group is necessary because the part-time or full-time employee directors may not be a match for full-time professional shareholder director/managers. The third group may be in a position to help the employee directors understand or clarify for the sake of the shareholder directors effective managerial planning and office practice; they also act as an independent watchdog and check the activities of management. It is also proposed that for the companies under discussion, apart from employee directors, there should be an evolution of a managerial profession. The third group are expected to keep an eye on the conduct of the company's affairs at least as well as many of the investment institutions or unit trusts are at present doing on behalf of their investor-clients. Most of these institutions maintain a staff of skilled investment analysts each; they are competent to monitor, question and scrutinize the management

(3) See generally N. Martin-Kaye (1976) J.B.L. 235; N.M. Hunnings (1976) J.B.L. 377; C.M. Schmitthoff (1975) J.B.L. 265; C.M. Schmitthoff (1973) J.B.L. 312; C.W. Summers (1980) 28 Am. J. Comp. L. 367; P.L. Davies (1975) 38 M.L.R. 254.

of any company and may at any time attend company meetings as part of their job. Alternatively the third group should be similar in nature to the watching committees to be discussed in Chapter 3 herein (4).

While a statutory right of board level representation may prove in due course insufficient to secure a real extension of industrial democracy, it is at least an essential prerequisite to the joint regulation of major policy decisions and is more likely than any other legislative measure to improve existing forms of industrial democracy below board level. The presence of employee directors on the board as of right and access to documents would help to ensure that important issues of industrial relations are not left out of account in the preparation and discussion of company policies, to say nothing of the impartiality and assistance of the neutral third group, those from professionals recognised by the government.

It is submitted that changes at board level are not by themselves sufficient to ensure an extension of industrial democracy. What is needed is an inter-related structure of participation or joint regulation at all levels of the company, or at least at plant level to start with, and a sufficiently well developed structure of participation below the board is important. Therefore it is further proposed (5) that the law should require a works council for every public company or large unquoted company or alternatively for every company employing more than 50 employees. The number of members of the works council should depend on the number of employees, say roughly 1 to 2 in every 100 to 200 employees, with a minimum of 3 members. It should represent manual

(4) See post, pp. 137-8

(5) See ante, p.71, n.(3).

workers, white collar employees, etc. in proportion to their numbers. The works council may also form other committees to perform specialised functions. If there are several independent plants, there should be a corresponding number of works council, and they may form a joint works council. Where there are more than 5 employees of less than 18 years of age, there should be established a youth council to take care of the special interests of juvenile employees, e.g. career training. The following should be within the scope of the work of the works council, the determination of hours and days of work, the determination of the place, time and method of payment of wages and salaries, questions involving holidays, the determination of matters relating to the system of remuneration, the establishment of piece rates and overtime, the formulation of regulations relating to prevention of industrial accidents and diseases, the conduct of the employees in the plant, and matters in connection with the introduction of improvement. In case of disagreement between the management and the works council, they should go to arbitration. There should be a legal duty on both the employer and the works council, unlike the trade unions, that they must refrain from doing any act which might have a harmful effect on production or the working peace of the plant. Both the employer and the works council must also ensure the legal and fair treatment of all persons employed within the plant, and the absence of discrimination against any of them. Members of the works council should not be interfered with or disturbed in the exercise of their functions, and may not be discriminated against by reason of their activities.

The last but not the least, as an alternative or ancillary reform, is the development of the concept by way of education and

professional conduct in relevant professional bodies (6) that a company is for both investors and employees equally, and indeed for the consumer and the community at large as well. Much existing management training is concerned with maximization of profits for shareholders and creating higher standards of management within the organisation. A new system should supplement this by exploring the crucial factors affecting the long-term success and status of industry and commerce and their relationships to society (7). The task of management is to strike a fair balance between reasonable dividends to shareholders, good wages for employees and fair prices to consumers after the primary requirements of the company itself by way of expansion and reinvestment have been met. The duty should extend to making provision for the welfare and recreation of the employees including their families and for reasonable contributions to local and national charities. These are the modern conditions appropriate in our society on which private capital in a mixed economy can be allowed the privilege of incorporation with limited liability. In order to introduce meaningful participation in any depth, it is necessary to create a change in peoples' whole philosophy to management and the purposes of work. These types of concept may be argued as foreign to practical company law, but it is submitted that if a modern theory of enterprise is to be stable and respected, it must provide an up-to-date philosophy of ethics and social aspirations (8). The way to reform

(6) Cf. Hadden, p.484. See also M.P. Fogarty, Company and Corporation - One Law? (1965) pp.12-17.

(7) See Charles de Houghton, the Company (1970) p.29.

(8) See also EEC Commission's Green Paper on Employee Participation and Company Structure E.C. Bull. Supp. 8/75: "Company laws of the traditional pattern have not contained such provisions in the past precisely because they were based on economic and social policies which saw employees' relationships with companies as essentially contractual. In so far as economic and social policies come to regard the company as an enterprise where labour and capital combine in their own society's interest, then the laws relating to companies will sooner or later have to reflect this change of underlying philosophy and include provisions expressly dealing with relationships between the providers of capital, the management and the employees irrespective of whether they are formally deemed to be 'company law'"

does not lie in law alone; management education is of paramount and parallel importance too. Business education helps to encourage corporate responsibility. As an academic discipline, it defines its objectives around the concept of an enlightened businessman; by this standard, the educated businessman will have learned to think of himself in the perspective of the total social and business system. Such a role requires an understanding of the various institutions that a company encounters in the course of its operations, and of the inter-relationships between such institutions. It enables directors and managers to examine the principles, concepts and responsibilities underlying business decisions.

Implications of Employee Participation on Company Law

An aspect of company law which will be materially affected by the implementation of any proposals on co-determination is that relating to directors' duties.

Under the existing law, directors are required to conduct the company's business for the benefit of the company (including the employees) as a whole (9). Thus directors are required to take a detached view of the interests of any particular group of persons, whether shareholders, employees or otherwise, and this would make it very difficult, in certain situations, for employee representatives to pursue the interests of those whom they represent. For example on redundancy it seems most likely that an employee director has to vote for redundancy if he is to do his duty as a director, but such an act would easily be misrepresented by those electing him.

(9) See Report of the Inspector of June 14, 1954 in the second Savoy Hotel Investigation (HMSO); Gaiman v. National Association for Mental Health [1971] Ch. 317; [1970] 3 W.L.R. 42; [1970] 2 All E.R. 362; 114 S.J. 416; Greenhalgh v. Arderne Cinemas Ltd. [1951] Ch. 286; [1950] 2 All E.R. 1120; 94 S.J. 855; Section 46 of Companies Act 1980; below pp.88-9

One may note that under s.448 of the Companies Act 1948 the Court is empowered to relieve, either wholly or partly and on such terms as it thinks fit, a director from liability for negligence, default, breach of duty or breach of trust. The Court must be satisfied that the director concerned has acted honestly and reasonably and that having regard for all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused. The Court could, of course, use this power in a case involving an employee director, but it is doubtful whether or not the Court would consider that an employee director had acted reasonably if he had, for example, considered only the interests of the employees.

Bullock (10) proposed that in principle all directors including employee directors should be under the same legal duties and liabilities. Codification of two standards for employee directors and shareholder directors respectively would not promote cooperation between employee and shareholder directors on the board (1); nor would people have confidence in the new system of board level representation. But the law should provide that this should not impede employee directors from arguing specifically from an employee's viewpoint at board meetings (2). The special status of employee directors should be recognised in order to take proper account of their responsibility to their constituents or those they represent, but employee directors should not be allowed to be instructed to vote in a particular way on a particular issue. An employee director must be a representative. He should be free to form and express his view, weigh up the various interests in the company and reach his own conclusions about which policies will work for the greater

(10) Bullock Report, para.8.37.

(1) Ibid.

(2) Bullock Report, para. 8.40.

good of the company. The emphasis should be on the benefit of the company as a whole. An employee director should not be a delegate (3). This is to ensure that all directors should look to the long-term interests of the company and are free from external pressure. In other words, all directors will be required to act on their own authority and responsibility but must keep in touch with the opinion of those they represent. They have to take into account the differing and conflicting interests in the company in order to reach decisions which they genuinely believe to be in the company's overall best interest as a whole. Bullock (4) also proposed that directors should be entitled to take account of the interests of shareholders and employees in subsidiary companies. As members of the board, all directors should, of course, have total access to information. But how can the employee representative's duty to report back to his constituent or those he represents be reconciled with his duty as a director not to disclose confidential information? Three observations can be made on this. First, it would not usually be necessary to disclose confidential information in order to make an effective report. Secondly, there is little reason to suppose that employee representatives are more likely than other directors to disclose their company's trade secrets or to use confidential information which might be detrimental to the company for personal gain. Thirdly, many trade union representatives and officials have already had access to, and have dealt with, confidential information for many years without any particular difficulties appearing to have arisen. But the real problem arises when an employee director obtains confidential information which places him in a position where his responsibility to the company

(3) Ibid.

(4) Ibid., para. 8.38.

comes into direct conflict with his responsibility to those he represents. For example, the company may be formulating long-term plans which would seriously affect the workforce but which, for business reasons, the management may wish to keep secret until they are finalised. Where the directors are in breach of their fiduciary duties, the shareholders in general meeting can, after full and frank disclosure, ratify their actions by ordinary resolution. The effect of such a resolution is, in most cases, to absolve the directors from liability (5). However if an employee director were in breach of his duty because he completely subordinated the interests of the company to those of the employees, it would be most unlikely that such an act would be ratified by the shareholders. Bullock (6) thought that the problem of confidentiality of information had been overstated and was reluctant to see a statutory redefinition of confidentiality. It is conceivable that in the absence of such redefinition, a disgruntled shareholder may in some cases bring a derivative action to complain of a breach of duty by an employee director in releasing confidential information, to harass him or otherwise, and the employee director might just as well be advised to ask the board to agree on what information is confidential. Where the board has agreed on the disclosure of certain information, it is doubtful if the courts would allow a derivative action against the employee director concerned for disclosing the information.

As the law now stands, a director is not obliged to give continuous attention to the company's affairs. If any change of the law requires a higher standard of such duty and the directorship of employee directors is part-time, this may provide some shareholders

(5) See, e.g. Bamford v. Bamford [1969] 1 All E.R. 969; [1970] Ch. 212; [1969] 2 W.L.R. 1107; 113 S.J. 123.

(6) Bullock Report, para. 8.54.

with an opportunity to harass an employee director, unless a distinction is made between the duties of a shareholder representative and an employee representative (7).

An effective sharing of power by employee directors will necessitate the severe curtailment of the ownership rights of shareholders. Therefore the relationship between the new board and the shareholders has to be adjusted in order to ensure that employee directors on the board have a real say in decision making on fundamental questions like winding-up. It would be frustrating and illogical to the true objective of industrial democracy to put employee directors on the board and then allow the shareholders the power to retain control of all major decisions.

Bullock (8) proposed that in connection with certain 'attributed functions' the board should have the exclusive right to submit a resolution for consideration to the shareholders in general meeting. These attributed functions affect the present powers of shareholders in five important areas: changing the company's memorandum and articles of association, winding-up, changes in the company's capital structure, the fixing of dividends, and the disposals of a substantial part of the undertaking. These matters are directly related to the employees' future employment and income but are generally subject to shareholders' power of initiative by requisitioning an extra-ordinary general meeting pursuant to section 132 of the Companies Act 1948, apart from retaining ultimate control by approving or rejecting proposals put to them by the board. The new law should give the board of directors the exclusive right to initiate proposals for approval or veto at the shareholders' meeting.

(7) But this would violate the principle all directors should have the same legal duties and liabilities.

(8) Bullock Report, para. 8.27.

Thus, in effect, the shareholders have only a power of veto.

As to the right to dispose of a substantial part of the undertaking, which would be affected by the Bullock proposals, it is perhaps of importance to note that in some cases the meaning of 'substantial part' may cause difficulty and unreasonably delay the sale (and purchase) of chattels and machinery. The words 'substantial part' should be well defined to avoid any ambiguity.

It may be argued that it would be unfair to bar the shareholders to initiate proposals in respect of the attributed functions altogether, and therefore it is proposed that as an alternative solution to the Bullock's proposals, the shareholders may still requisition an extraordinary general meeting in respect of the attributed functions, but their resolution need to be approved by the new proposed board to be effective.

The proposed introduction of employee directors creates special problems in the case of groups of companies, whether on a national or multi-national basis (9). Bullock proposed that employee participation on the board should apply both to the holding company in a group where the group employ 2,000 or more in total in the United Kingdom and to any subsidiary company in the group which subsidiary alone has 2,000 or more employees in the United Kingdom. To ensure power of holding companies to control the activities of their subsidiaries, Bullock recommended that the parent of a British-based group should be entitled to appoint the neutral members of the board in any subsidiary within which there has been a vote for board level

(9) See generally Hadden, pp.466-7; D.D. Prentice (1978) 56 Can. B. Rev. 277, 293-5; D.B. Broadhurst (1978) 128 N.L.J. 1227, 1228; Lewis and Clark (1977) 40 M.L.R. 323, 337.

representation. In the case of an English subsidiary of a foreign parent Bullock proposed that the ultimate right to appoint the neutral members to the board should be with the Industrial Democracy Commission in case of deadlock, but suggested that such an appointment should only be made after consultation by the Industrial Democracy Commission with the foreign parent and with the Secretary of State for Industry (10). As regards subsidiaries of foreign-based multi-nations which have not been actually incorporated in the United Kingdom, Bullock proposed that the subsidiaries should be required to be incorporated in the United Kingdom if the necessary majority in favour of employee representation is obtained (1). Bullock recognised that in the case of foreign-based multi-nationals it is unavoidable that major decisions are often made outside the United Kingdom and the board of a British subsidiary will have little say in the decisions. A situation which is readily conceivable is where the foreign parent recommends the distribution as dividend of a great portion of profits made by a British subsidiary instead of plowing back the profits into the business in the United Kingdom while the British subsidiary wishes to make use of the profits for expansion of the business in the United Kingdom. But unless there were international agreements on the matter, Bullock felt that their proposals were the best that could be devised in the circumstances.

Another problem concerning groups of companies arises in the case of takeovers. Since by virtue of the residual power for holding

(10) Bullock Report, para. 11.59. The Minority Bullock Report was against employee participation on the boards of subsidiary companies. If legislation was insisted upon, it recommended that then the other supervisory boards should have more power than the supervisory board of a subsidiary company. In any event it proposed that subsidiaries of foreign companies should be exempted; otherwise there would be a deleterious effect on inward investment by foreigners, which plays an important part in the economy of the United Kingdom.

(1) Bullock Report, para. 11.52.

companies, an intending holding company would be able not only to control the shareholder directors on the board of the taken-over company but also replace the co-opted directors of the latter company, the benefits of employee participation might be destroyed if the intending holding company held objectives different from those of the taken-over company. Bullock (2) proposed that the definition of 'subsidiary' in section 154(1) of the Companies Act 1948 should be amended so that a taken-over company would only become a subsidiary if an additional requirement is complied with, namely the registration with the Registrar of Companies of an agreed "instrument of control". (3) Bullock was able to point to similar methods in other legal systems. The new definition would apply to all companies whether or not there is employee participation on the board. With this new system the employee directors and the co-opted directors would be able to demand undertakings of importance to the workforce such as security of jobs and investment before the instrument of control is signed by the board of the taken-over company. It is submitted that while such a proposal would curtail the power of capital, this would act as a disincentive to the takeover of a failing business.

There are some companies whose articles preclude directors from voting on matters in which they have a personal interest. And Bullock proposed that the new law should provide that employee directors should not be affected by these articles or provisions simply

(2) Bullock Report, paras. 11.37 to 11.44.

(3) The instrument of control might be cancelled later on by agreement between the holding company and subsidiary. But the expected opposition by the employee directors of the subsidiary to any attempt by the holding company to bring about such cancellation without the real consent of the subsidiary was thought to be a serious check of such attempt. See Bullock Report, para. 11.44.

because they take part in board decisions concerned with industrial relations or collective bargaining (4).

Under the present law an employee director would always be liable to removal from the board by ordinary resolution under section 184 of the Companies Act 1948 before the expiration of his period of office, notwithstanding anything in its articles or in any agreement between it and him, and accordingly s.184 should be amended so as to curtail the shareholders' right of removal in the case of an employee director.

The pressure for employee participation has been growing, and the Bullock Report constitutes by far one of the most thorough and thoughtful examinations of the impact of employee participation on the customary rules of company law. Implementation of proposals to give an effective voice to employees in corporate management will bring in its train a host of significant changes in company law, especially the rights of shareholders and directors' duties.

(4) Bullock Report, para. 10.58.

CHAPTER 3 DIRECTORS' DUTIES

The effective legal control of limited companies requires the imposition on directors of suitably stringent duties which are readily enforceable. So it is of importance to see what duties are owed by directors and managers in the exercise of their powers in those areas which have been subjects of debate or which have caused some difficulties and to discuss the enforcement of directors' duties.

The powers and duties of a company director are derived primarily from the company's memorandum and articles of association. The Companies Acts provide little guidance on the nature of a director's duties, apart from the formal requirements as to the holding of periodic meetings, etc. When a person accepts the office of a director, he accepts with it certain duties towards the company. These duties are partly dependent on the law of agents and persons in a fiduciary position, partly statutory, and partly regulatory (1). Such duties vary from company to company, and within any given company the directors may have different responsibilities. Breach of these duties or negligence in performing them on the part of a director gives the company, and, in its winding up, the liquidator, rights and remedies against him for any damage which has been suffered by the company as a result of the breach or negligence (2).

Directors are agents of a company. As agents they stand in a fiduciary relationship to their principal, the company. The duties of good faith which this fiduciary relationship imposes are very similar to those imposed on trustees, and to this extent directors can be regarded as trustees (3). But the position of a director differs considerably from that of an ordinary trustee. The duty of

(1) See Palmer's Company Law, Vol. 1, p.684.

(2) Ibid., Vol. 1, p.684.

(3) Gower, p.572.

the trustees of a settlement or will is to be careful and to avoid risks to the capital of the trust (4), but taking risks seems to be inevitable in running a company, which would not be legally permissible for a trustee. A businessman seeking profit is entirely different from a trustee, and it would not be realistic to subject the former to the same rules.

"It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company, the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it is wholly misleading. It is indeed impossible to describe the duties of directors in general terms, whether by way of analogy or otherwise. The position of the director carrying on a small retail business is very different from that of a director of a railway company."

(per Romer J., at p.426) (5)

In Smith v. Anderson (6), James, L.J. had this to say:

"A trustee is a man who is the owner of property and deals with it as principal, as owner, and as master, subject only to an equitable obligation to account to some persons to whom he stands in the relation of trustee . . . The office of a director is that of a paid servant of the company. A director never enters into a contract for himself, but for his principal . . . he cannot sue on such contracts, nor be sued on them."

Further, the provisions of the Trustee Act 1925 including section 61 (the relief provision) do not apply to directors, and a similarly worded relief provision (section 448) has to be provided

(4) Gower, p.572,

(5) In re City Equitable Fire Insurance Co. [1925] 1 Ch. 407.

(6) (1880) 15 Ch. D. 247; 50 L.J.Ch. 39; 43 L.T. 329; 29 W.R. 21.

by the Companies Act 1948.

It is convenient to discuss the duties of directors (7) under two headings: (A) fiduciary duties of loyalty and good faith, and (B) duties of care diligence and skill.

(A) Fiduciary Duties

As fiduciaries, directors must display the utmost good faith towards the company in their dealings with it or on its behalf. Before proceeding further, it is useful to emphasize certain points.

First, each director owes his duties of good faith individually.

Secondly, the duties are owed to the company and to the company alone. This principle is regarded as established by the decision in Percival v. Wright (8) where a director bought some shares in the company from a member who wished to sell them. The director knew at the time that negotiations were in progress for a sale of all the company's shares at a higher price than he was paying, but he did not disclose this fact to the seller. It was held that the sale should not be set aside because the director owed no duty to that individual member.

Sometimes, however, the directors are in the position of agents of the shareholders as well. This can arise where the shareholders expressly appoint them to act as their agents, Briess v. Woolley (9), or where by their own behaviour they render themselves agents for the shareholders, Allen v. Hyatt (10). But this is not the normal legal position and only arises in

(7) Gower, p.572.

(8) [1902] 2 Ch. 421; 71 L.J.Ch. 846; 18 T.L.R. 697; 9 Mans. 443.

(9) [1954] A.C. 333; [1954] 2 W.L.R. 832; [1954] 1 All E.R. 909; 98 S.J. 286.

(10) (1914) 30 T.L.R. 444.

exceptional circumstances (1).

Thirdly the fiduciary duties are imposed on directors because of the nature of the work they perform. It is for this reason that the same duties (although less rigorous depending on the particular circumstances of the case) apply to any officials (other than directors in the usual sense) of the company who are authorised to act on its behalf, particularly to those in a managerial capacity at the material time (2).

As Professor Gower has stated (3), the fact that directors are fiduciaries imposes on them (i) subjective duties of honesty and good faith, and (ii) objective duties not to place themselves in a position where their duties might conflict with their private interests.

In practice, it is convenient to break down each of these into three subheadings for purposes of analysis (although in practice they tend to blend together). First, the directors must act bona fide, that is in what they believe to be the best interests of the company. Secondly, they must exercise their powers for the particular purpose for which they were conferred and not for some extraneous purpose (4). Thirdly, the directors must not, without the consent of the company, place themselves in a position in which there is a conflict between their duties and their personal interests (5).

1. Bona Fides

It has been stated by Lord Green (6) that "(the directors)

(1) See for example Coleman v. Myers [1977] 2 N.Z.L.R. 255.

(2) See Gower, p.574.

(3) Gower, p.576.

(4) Ibid.

(5) Gower, pp.576-7.

(6) See Re Smith & Fawcett Ltd. [1942] 1 All E.R. 542; [1942] Ch. 304; 111 L.J.Ch. 265; 166 L.T. 279.

must exercise their discretion bona fide in what they consider — not what a court may consider — to be in the interests of the company, and not for any collateral purpose."

A question is sometimes asked whether or not the expression 'the company' means all the shareholders, or the majority shareholders, or the company as a business concern, or the sum total of the proprietary, employees' and public interests as represented by the shareholders, the company's employees, and the consumers or public at large.

Megarry J. was of the view that 'the company' does not mean the sectional interest of some of the present members, but of present and future members of the company and that a long-term view has to be balanced against short-time interests of present members. Thus he remarked in Gaiman v. National Association for Mental Health (7):

"The interests of some particular section or sections of the company cannot be equated with those of the company, and I would accept the interests of both present and future members of the company, as a whole, as being a helpful expression of a human equivalent."

And Lord Diplock was of the opinion that 'the company' may cover creditors. Thus he commented in Lonrho Ltd. v. Shell Petroleum (8):

"it is the duty of the board to consider...the best interests of the company. These are not exclusively those of its shareholders but may include those of its creditors"

The expression 'the company' now includes the employees

(7) [1971] Ch. 317 at 330. But cf. Hogg v. Cramphorn [1967] Ch. 254; [1966] 3 W.L.R. 995; 110 S.J. 887; [1966] 3 All E.R. 420. See also above p.75.

(8) [1980] 1 W.L.R. 627, 634.

because the directors have now to regard their interests in general as well as the interests of the members of the company (9).

2. Proper Purpose

If directors do not exercise their powers for purposes for which they are conferred, they have exceeded their authority and are liable accordingly. The rule, known as the proper purpose rule (10), is generally applicable in cases in which directors have used their powers as directors for an ulterior purpose other than, or in addition to, their apparent or professed purpose. It is specially relevant in cases where directors misuse their powers to protect their position as directors in the face of a take-over threat. Like any other power vested in the directors, this power must be exercised in the best interests of the company as a whole, as opposed to those of individual directors.

In Hogg v. Cramphorn (1), the directors wished to get control in order to forestall a take-over bid, and therefore transferred unissued shares in the company to trustees to be held for the benefit of the employees. The shares were paid for by the trustees out of an interest-free loan from the company. It was held by Buckley J. that that was a wrongful exercise of the directors' fiduciary power. In reaching his decision, Buckley J. was influenced by the directors taking into account the staff's interests. Thus he said:

"I am satisfied that Mr. Baxter's offer, when it became known to the company's staff, had an unsettling effect on them. I am

(9) Section 46 of Companies Act 1980. See also above, pp.46-7 and below, p.92

(10) See generally Gower, pp.580-2; Hadden, pp.245-8; Pennington, Company Law (4th ed.) pp.538-42.

(1) [1967] Ch. 254; [1966] 3 W.L.R. 995; [1966] 3 All E.R. 420; 110 S.J. 887. See also L.S. Sealy (1967) C.L.J. 33; K.W. Wedderburn (1967) 30 M.L.R. 77; (1968) 31 M.L.R. 688.

also satisfied that the directors and the trustees of the trust deed genuinely considered that to give the staff through the trustees a sizeable, though indirect, voice in the affairs of the company would benefit both the staff and the company. I am sure that Colonel Cramphorn and also probably his fellow directors firmly believed that to keep the management of the company's affairs in the hands of the existing board would be more advantageous to the shareholders, the company's staff and its customers than if it were committed to a board selected by Mr. Baxter."

However Buckley J. took the view that the directors had no right to exercise their power to issue shares, in order to defeat an attempt to secure control of the company, even if they considered that in doing so they were acting in the company's best interests.

Buckley J's view about the directors taking into account the staff's interests was not shared by his counterpart in Canada because in Teck Corporation v. Millar (2) Berger J. refused to follow Hogg v. Cramphorn Ltd. Thus he commented:

"In defining the fiduciary duties of directors, the law ought to take into account the fact that the corporation provides the legal framework for the development of resources and the generation of wealth in the private sector of the Canadian economy. A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences

(2) (1972) 33 D.L.R. (3d) 288, a decision from Supreme Court of British Columbia. See also B.V. Slutsky (1974) 37 M.L.R. 457; M.E. Bennun (1975) 24 I.C.L.Q. 359.

to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders. I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company." (3)

The Teck case was approved by the Privy Council in Howard Smith Ltd. v. Ampol Petroleum Ltd. (4), another take-over battle case, Lord Wilberforce commenting:

"(Berger J's) decision upholding the agreement with Canex on this basis appears to be in line with the English and Australian authorities to which reference has been made." (5)

It is of importance to note the approach Berger J. used in the Teck case. The rule he used seemed to be whether the directors had reasonable grounds for their belief (6) not whether their

(3) Berger J. was of the view that Hogg v. Cramphorn [1967] Ch. 254; [1966] 3 W.L.R. 995; [1966] 3 All E.R. 420; 110 S.J. 887 was inconsistent with the view of the law taken in Re Smith and Fawcett Ltd. [1942] 1 All E.R. 542 to the effect that the directors must exercise their discretion bona fide in what they, and not the court, consider to be the interests of the company and for no collateral purpose. He tried to distinguish Hogg case from the case before him by stating that in Hogg case the directors were seeking to retain control of their company while he was concerned with a case where their primary purpose was to make the best contract for the company that they could, not being motivated primarily by a desire to retain control.

(4) [1974] A.C. 821; [1974] 2 W.L.R. 689; [1974] 1 All E.R. 1126. See also J.R. Birds (1974) 37 M.L.R. 580; M.E. Bennun (1975) 24 I.C.L.Q. 359.

(5) It is interesting to note that the Privy Council appears to have simultaneously approved both Hogg v. Cramphorn and Teck case although the two cases are inconsistent with each other.

(6) (1973) 33 D.L.R. (3d) at 315-6.

belief was correct. He was apparently trying to establish not what the reasonable director ought to do under a given set of circumstances but what the reasonable director might do. Thus he remarked:

"My own view, is that the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorised as improper...It is no part of this court's function to decide what contract Afton should have made or whom it should have made it with."

On the other hand the Privy Council adopted a more objective test in the Howard Smith case. Thus Lord Wilberforce said:

"...the Court...is entitled to look at the situation objectively in order to estimate how critical or pressing, or substantial, or per contra, insubstantial an alleged requirement may have been. If it finds that a particular requirement, though real, was not urgent, or critical, at the relevant time, it may have reason to doubt, or discount, the assertion of individuals that they acted solely in order to deal with it, particularly when the action they took was unusual or even extreme." (7)

Section 46 of the Companies Act 1980 (8) has now come to the aid of directors who take into account employees' interests in the performance of their functions, and it is doubtful whether, if similar facts arose today, the court would decide in the same manner as Buckley J. did in the Hogg case. Indeed it looks likely

(7) [1974] 1 All E.R. 1126 at 1131-2.

(8) See also above, pp.46-7.

that the court would give a judgment in favour of the directors.

It is not very clear whether the proper purpose doctrine is a director's fiduciary duty or a mere rule of interpretation of the articles so that it can be excluded by appropriate drafting (9).

The view that the proper purpose duty can be excluded is founded on Re Smith & Fawcett (10) where the articles gave the directors an uncontrolled discretion to refuse to register a transfer. A, as executor of his father, claimed to be put on the register in respect of 4,001 shares held by his father. The directors refused to put A on the register unless he sold 2,000 shares to a director, in which case they would register A in respect of 2,001 shares. A challenged the refusal.

The Court of Appeal held that as the directors were acting in the best interests of the company as they saw them the directors' discretion was unlimited. Further, no mala fides had been shown and the refusal to register the transfer was allowed to stand.

Lord Green, M.R. commented:

"...this type of article is one which is for the most part confined to private companies. Private companies are, of course, separate entities in law just as much as are public companies, but from the business and personal point of view they are much more analogous to partnerships than to public corporations. Accordingly, it is to be expected that, in the articles of such a company, the control of the directors over the membership may

(9) See J.R. Birds (1974) 37 M.L.R. 580; B.V. Slutsky (1974) 37 M.L.R. 457, 460; D.D. Prentice (1970) 33 M.L.R. at 703. See also D.D. Prentice's modified views in his article (1977) 40 M.L.R. 589. Gower on Modern Company Law, 3rd ed., stated at p.524, "it is for the court to decide on a true interpretation of the articles what the purpose was for which the power was conferred but it appears that he has not referred to any interpretation of articles in the Section on Proper Purpose (p.580) in his 4th edition.

(10) [1942] 1 All E.R. 542; [1942] Ch. 304; 111 L.J.Ch. 265; 166 L.T. 279.

be very strict indeed. There are very good business reasons, or there may be very good business reasons, why those who bring such companies into existence should give them a constitution which gives to the directors powers of the widest description. In the present case the article is as follows: "The directors may at any time in their absolute and uncontrolled discretion refuse to register any transfer of shares." As I have said, it is beyond question that that is a fiduciary power, and the directors must exercise it bona fide in what they consider to be the interests of the company. The language of the article does not point to any particular matter as being the only matter to which the directors are to pay attention in deciding whether or not they will allow the transfer to be registered . . . In cases where articles are framed with some such limitation on the discretionary power of refusal as . . . it follows on plain principle that, if they go outside the matters which the articles say are to be the only matters to which they are to have regard, the directors will have exceeded their powers."

From the case it seems that the court dealt with the interpretation of a relevant article at greater length than the bona fides of directors.

In recent years there has been a growth of school of thought in the Commonwealth (1) regarding the 'proper purposes' as merely one aspect of the much wider duty requiring a director to act bona fide in the best interests of the company as a whole (2).

For example in Teck Corporation Ltd. v. Millar (3) it was held that the 'proper purpose rule' is merely an aspect of the broader

(1) See B.V. Slutsky (1974) 37 M.L.R. 457; S.J. Burridge (1981) 44 M.L.R. 40 at 44.

(2) See also Sealy's Cases and Materials on Company Law (2nd ed.) pp.468-70.

(3) (1972) 33 D.L.R. (3d) 288.

principle that directors must act bona fide in the best interests of the company as a whole. Thus Berger J. remarked there:

"The cases decided in the United Kingdom make it plain that directors, in the exercise of their powers, must act in what they bona fide consider to be the best interests of the company. If they issue shares to retain control for themselves, that is an improper purpose . . . Lord Green M.R., expressed the general rule in this way in Re Smith & Fawcett Ltd., [1942] Ch.304 at p.306: "They (the directors) must exercise their discretion bona fide in what they consider - not what a court may consider - is in the interests of the company, and not for any collateral purpose." Yet, if Hogg v. Cramphorn Ltd., supra, is right, directors may not allot shares to frustrate an attempt to obtain control of the company, even if they believe that it is the best interests of the company to do so. This is inconsistent with the law as laid down in Re Smith & Fawcett Ltd. How can it be said that directors have the right to consider the interests of the company, and to exercise their powers accordingly, but that there is an exception when it comes to the power to issue shares, and that in the exercise of such power the directors cannot in any circumstances issue shares to defeat an attempt to gain control of the company? It seems to me this is what Hogg v. Cramphorn Ltd. says. If the general rule is to be infringed here, will it not be infringed elsewhere? If the directors, even when they believe they are serving the best interests of the company, cannot issue shares to defeat an attempt to obtain control, then presumably they cannot exercise any other of their powers to defeat the claims of the majority or, for that matter, to deprive the majority of the advantages of control. I do not think the power to issue shares can be segregated, on the basis that the rule in Hogg v. Cramphorn

Ltd. applies only in a case of an allotment of shares."

And in the Pennell case Templeman J. (as he then was) seemingly favoured this school of thought (4).

As the case law now stands (5), the operation of the proper purpose doctrine remains some kind of guesswork for those concerned and it is to be hoped that in the next Companies Act it will expressly be stated whether or not the proper purpose duty has been or should be regarded as a fiduciary duty. It should be noted that the application of the proper purpose doctrine is not confined to a power to issue shares and it is as well that in the next proposal to govern-ment the Department of Trade should recognise that instead of providing for a general statement of the duties of directors in statute law, there should be detailed stated statutory duties of directors.

3. Conflict of Duty and Interest

As fiduciaries, directors must not place themselves in a position in which there is a conflict between their duties to the company and their personal interests.

For purposes of analysis it is convenient to break this down into two subheadings, namely (a) contracts with the company and (b) use of corporate property, information or opportunity.

(a) Contracts with the Company

Directors have been entering into transactions with their companies. Commonly such transactions are in the form of a sale to the company by the director of assets in which he is interested,

(4) See S.J. Burridge (1981) 44 M.L.R. 40 at 50.

(5) See, e.g., Piercy v. S. Mills & Co., Ltd. [1920] 1 Ch. 77 where a company was in no further need of capital, but the directors used their powers to issue shares by allotting some to themselves solely in order to acquire the majority of the voting power, and to defeat the wishes of the existing majority shareholders; Punt v. Symons & Co., Ltd. [1903] 2 Ch. 506 where the directors issued shares with the sole object and intention of creating voting power to carry out a proposed alteration in the articles; Gaiman v. National Association of Mental Health [1970] 2 All E.R. 362.

or a purchase of property from the company by the director. As aforesaid, as fiduciaries, directors must not place themselves in a position in which there is a conflict between their duties to the company and their personal interests. So a contract or transaction which produces such a conflict is liable to be rescinded or avoided by the company. The authority for this proposition is founded in Aberdeen Railway v. Blaikie (6) where Lord Cranworth L.C. had this to say:

"A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal. And it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect . . . So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into."

It is not surprising that this strict rule was not acceptable to the business community and it soon became the practice to ensure that the company waived it. Prior to 1929 it was established that articles could effectively exempt from liability except for breaches which were fraudulent. Thus in Re City Equitable Fire Insurance Co. (7) a petition was filed for the winding-up of an insurance company at one time doing a large business, owing to losses caused by the fraud and misappropriation of the managing director, and it

(6) (1854) 1 Macq. 461.

(7) [1925] 1 Ch.407; 94 L.J.Ch. 445; 133 L.T. 520; 40 T.L.R. 853; [1925] B. & C.R. 109. See also the cases referred to therein and Re Brazilia Rubber Plantations and Estates Ltd. [1911] 1 Ch. 425.

was discovered that there was a deficit of about £1,200,000 in the funds which the company should have possessed. The balance sheets showed large trading profits, and the loss was due to depreciation of industrial securities in which the company's money had been invested, and to allowing the company's manager and their stock-brokers, of which firm their managing director was senior partner, to become possessed of very large sums of money properly belonging to the company, which were entirely lost. The official receiver, as liquidator, took out a misfeasance summons alleging misfeasance, negligence, breach of trust, and breach of duty against the directors. It was held that in certain particulars the directors had failed in their full duty to the company, but were excused from liability by article 150 of the company's articles, which provided: "None of the directors . . . should be answerable for the acts, receipts, neglects, or defaults of the others of them, or for any bankers or other persons with whom any moneys or effects belonging to the company should be lodged for safe custody, or for insufficiency or deficiency of any security upon which any moneys of the company should be invested, or for any other loss, misfortune, or damage in relation thereto, unless the same should happen by or through their own wilful neglect or default."

As a consequence of this decision, the Greene Committee Report(8) recommended that such articles should be forbidden. This recommendation was duly enacted in the Companies Act of 1929 and subsequently reenacted as section 205 of the Companies Act 1948.

Section 205 of the Companies act 1948 provides as follows:

". . . any provision, whether contained in the articles of a company or in any contract with the company or otherwise, for exempting any officer . . . from . . . any liability which by

(8) Cmd. 2657.

virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relating to the company shall be void."

All this causes no difficulty, and no possibility of doubt as to the meaning of s.205 of the 1948 Act could have arisen if it had not been for the fact that Article 84(3) of Table A, which is contained in the very same 1948 Act as is s.205 of the 1948 Act, appears on the face of it to relieve directors from the consequences of a breach of duty which takes the form of having an interest in any contract to which the company is a party. Article 84(3) reads as follows:

". . . nor shall . . . any contract entered into by or on behalf of the company in which any director is in any way interested, be liable to be avoided, nor shall any director so contracting or being so interested be liable to account to the company for any profit realised by any such contract or arrangement by reason of such director holding that office or of the fiduciary relation thereby established."

If such an article had not appeared in Table A of the Companies Act 1948, it would not have been doubted that it contravened s.205 of the 1948 Act and was therefore void.

What is even worse is that some companies adopt articles in terms similar to the following instead of adopting article 84(2) of Table A, which prohibits a director from voting on a contract in which he has an interest or being counted in the quorum at the board meeting at which the board of directors decides that the company should enter into such a contract:

"A director may vote in regard to any contract or arrangement in which he is interested or upon any matter arising thereout and if he shall so vote his vote shall be counted and he shall be reckoned in estimating the quorum present."

Such an article seems to be in more flagrant breach of section 205 of the Companies Act 1948, yet it appears that articles in this form are adopted by some private companies.

One school of thought is of the opinion that the effect of s.205 of the 1948 Act is that liability for breach of duty cannot be excluded by the articles, but that the scope of the duty can still be determined by the articles, subject to the general principle that no clause can protect the directors against the consequences of their own fraud (9).

Construed literally, section 205 of the 1948 Act does refer only to restrictions on liability, not on the scope of any particular duty. But the difficulty is this. Although such a submission has some merit, it would permit articles to release directors from nearly all duties so long as one remained because it could still be argued that not all the duty had been excluded; it had merely been restricted.

Birds (10) argues that despite that, literally construed, section 205 of the 1948 Act refers only to exclusion of liability, articles purporting to exclude any duty which the general law casts upon a company director, other than the proper purposes doctrine, are void under section 205 of the 1948 Act. Sometimes it is true that these duties can be modified to certain extent, but the position is not clear as to the extent of such modification. It is unfortunate that there are some Articles in Table A which seem to exclude a duty of directors. But they are best treated to be exceptional for their validity relies on their inclusion in an Act.

(9) E.g. Gower and Gore-Browne. In 4th edn. of Principles of Modern Company Law, Gower argues (in addition) at p.586 that just as the normal obligations of trustees can be waived or modified by express provisions in the trust deed under which they were appointed, so (within limits) can the normal fiduciary duties of directors be modified by express provision in the company's constitution.

(10) See J.R. Birds (1976) 39 M.L.R. 394, 399.

It seems that the special article allowing a director to vote in regard to contracts in which he is interested quoted to be used in lieu of Article 84(2) of Table A, although in the opinion of the writer a breach of s.205 of the 1948 Act, is fair and reasonable in the case of a small private company, but not so for a company with minority shareholders or a public company. It goes to show that the perplexities in this field of company law arise out of that one set of company law has to cater for companies of a vastly different character and form. It is high time that there should be separate rules of directors' duties for public (or large) companies, medium (or medium unquoted) companies and small companies respectively (1).

The law on waiver clauses in articles is thus confused. But it is inevitable that companies will wish and need to enter into contracts with their directors, and it is therefore necessary that they may be able to do so. Some form of solution to the problem of the resulting conflict of duty and interest has therefore to be found, and it is submitted that a more effective safeguard for a director who desires to protect himself against the possibility of rescission in these circumstances (instead of relying on some sort of exclusion clause) is to fully disclose his interest to the shareholders of the company and to have the contract entered into or ratified by the company in general meeting or, if the articles of association contain an appropriate provision, to the board of directors (2).

(1) See below, p.123.

(2) Hely-Hutchinson v. Brayhead Ltd. [1968] 1 Q.B. 549; [1967] 3 W.L.R. 1408; [1967] 3 All E.R. 98; 111 S.J. 830. Disclosure to directors is ineffective even if the interested directors refrain from attending and voting leaving an independent quorum to decide, for the company has a right to the unbiased voice and advice of every director. Bensor v. Heathorn (1842) 1 Y. & C.C.C. 326, per Knight-Bruce V.-C. at pp.341-342, and Imperial Mercantile Credit Association v. Coleman (1871) L.R. 6 Ch. App. 558, per Hatherley L.C. at pp.567-568. But cf. Queensland Mines Ltd. v. Hudson (1978) 52 A.L.J.R. 399. For comments on Queensland Mines Ltd. v. Hudson, see G.R. Sullivan (1979) M.L.R. 711 and Gower, Supplement to 4th ed. para. 598.



A director who makes proper disclosure of his interest to the shareholders is entitled to participate in and vote upon the necessary resolution approving the transaction because on the authority of North-West Transportation Co. Ltd. v. Beatty (3) votes are proprietary rights, to the same extent as any other incidents of the shares, which the holder may exercise in his own interests even if these are opposed to other holders' interests.

It may not be considered as a very good solution of the problem, but it is submitted that this solution is safer than one relying upon waiver clauses. It need only be added that instances of serious abuse, for example company purchases at gross over-value, are within the scope of minority protection under section 75 of the Companies Act 1980.

Particular Transactions giving Rise to a Conflict of Interest

The Companies Act 1980 has recently extended the regulation of particular transactions in which there is likely to be a conflict of interests (4).

Under section 47 of the Companies Act 1980, the consent of the general meeting is required for any term whereby a director's employment cannot be terminated by the company by notice (or by notice only in specified circumstances) for a period exceeding five years. If no consent is obtained, the term in question will be void and the employment is deemed to be determinable by the company on reasonable notice being given. The section is an attempt to protect companies against the abuse whereby directors, possibly in anticipation of attempt to dismiss them under s.184 of the Companies Act

(3) (1887) 12 App. Cas. 589; 56 L.J.P.C. 102; 57 L.T. 426; 3 T.L.R. 789; 36 W.R. 647. See also Burland v. Earle [1902] A.C. 83 and Dominion Cotten Mills Co. Ltd. v. Amyot [1912] A.C. 546. But see also Prudential Assurance Co. Ltd. v. Newman Industries Ltd. And Others (No.2) [1980] 3 W.L.R. 543; above pp.29-30; below pp.111-5
(4) See generally Gower, Supplement to 4th ed., para.589-592.

1948, enters into long term service contracts so that they cannot be dismissed except on payment of heavy compensation payments for wrongful dismissal. Section 54 of the 1980 Act requires disclosure of such agreements in the accounts. And section 61 of the 1980 Act extends s.26 of the Companies Act 1967 in respect of directors' service contracts being open to inspection by members of the company.

Section 48 of the 1980 Act provides that the consent of the general meeting is required if a company is to enter into an arrangement with a director whereby the company is to acquire from him or to dispose of to him one or more non-cash assets of the "requisite value", i.e. worth £50,000 or 10 per cent (minimum £1,000) of the company's assets. The section extends to dealings with directors of holding companies and to dealings with persons connected with directors. A person connected with a director is defined as the director's spouse, including a separated but not a divorced spouse; his children under 18, including stepchildren and illegitimate children; an associated body corporate in which the director and any person connected with him together are interested in more than one-fifth of the equity share capital or control more than one-fifth of the voting power; and any trustee for or partner of the director or his spouse, children or associated body corporate. Any arrangement entered into in contravention of the section is avoidable by the company unless affirmed by the company within a reasonable time. The rights of an innocent third party are protected, but the offending director, connected person and any directors who authorised the transaction are liable to restore their gains and to indemnify the company against any loss, subject to a limited right to relief.

Under section 49 of the 1980 Act, prima facie all types of company are prohibited from making loans, or guaranteeing or providing security for loans made by others, to their directors or the directors of their holding companies. In relation to relevant

companies there are similar prohibitions in relation to quasi-loans and credit transactions both to directors and to those connected with them. A relevant company is defined as a public company and company forming part of a group containing a public company. A quasi-loan is a transaction between the company and the director or connected person whereby the company pays, or promises to pay, a third party on terms that the director (or person on his behalf) will reimburse the company. A credit transaction is one which involves the supply or lease of goods, services or land by a relevant company on deferred terms. These wide prohibitions cover the use of credit cards by directors and connected persons where the company is the cardholder and the provision of goods and services on the understanding that payment will be made later. In the case of non-relevant companies, there is a straight prohibition of loans to directors and directors of holding companies, but the provisions relating to quasi-loans, credit transactions, and loans to connected persons do not apply.

Section 50 of the 1980 Act sets out exceptions to the prohibitions in section 49 of the 1980 Act; these include loans, quasi-loans and credit transactions with a holding company, the provision of funds to enable a director to perform his duties properly (in the case of a relevant company there is a ceiling of £10,000), subject to various conditions, and loans and quasi-loans by money lending companies in the ordinary course of business on normal terms.

Section 52 of the 1980 Act confers on a company making a loan in contravention of s.49 of the 1980 Act a right to avoid the transaction and recover the property. The director or connected person benefiting, and any director who authorised the transaction, may be liable to account for resulting losses and gains. Section 53 of the 1980 Act imposes criminal sanctions.

Sections 54 to 60 of the 1980 Act make new provisions for

disclosure of transactions involving directors, replacing section 197 of the Companies Act 1948 and section 16(1)(c) of the Companies Act 1967. In particular, accounts will have to disclose (i) any transaction or arrangement of a kind described by section 49 of the 1980 Act (thus even though loans to connected persons are not prohibited in the case of private companies, they will have to be disclosed) and (ii) any other transaction or arrangement with the company or with a subsidiary in which a director of the company or its holding company or a person connected with him had directly or indirectly a material interest. Heading (ii) is deliberately vague so that disclosure will be required in the accounts of (a) the substantial property transactions described in s.48 of the 1980 Act; (b) consultancy and other contracts for services not disclosed as contracts of employment under s.26 of the Companies Act 1967; and (c) transactions falling outside ss. 48 and 49 of the 1980 Act because they are made to persons other than the specified range of connected persons to catch a situation where, say, a director might have a material interest in a transaction between his company and a company run by his father. A director involved is under a duty to consult with his fellow directors and the board of directors excluding the director concerned may decide that his interest is not material.

Various minor transactions involving deferred payment by directors are excluded from the disclosure provisions of s.54 of the 1980 Act.

(b) Use of Corporate Property, Information or Opportunity

Because the powers and duties of directors are fiduciary in nature, fundamental principles of equity preclude a director from deriving personal profit or benefit (as opposed to directors' fees or remuneration) from his office. Any profit so received is recoverable by the company in proceedings against the director concerned.

The leading case is Regal (Hastings) Ltd. v. Gulliver (5). In that case the appellant company were the owners of a cinema in Hastings. With a view to the sale of the property as a going concern they were anxious to acquire two other cinemas in Hastings. To do this a subsidiary company was formed to buy the two cinemas. In order to meet various demands the paid-up capital of the company had to be £5,000 but unfortunately the total cash available to the appellant company was only £2,000. One of the methods used to find the extra capital was for the directors each to take 500 £1 shares in the subsidiary company (the appellant company took 2,000 shares). This arrangement was agreed upon at a board meeting of both the appellant and the subsidiary company. As events turned out, the sale of all three properties was effected by the sale of the shares held in the two companies. The shares sold by the directors were sold at a profit of £2 ls. 6d. per share. It was found as a fact that all the transactions were bona fide and was held that the directors were in a fiduciary position towards the company and were bound to pay to the company the profits made out of this position. On that occasion Viscount Sankey said:

"At all material times they were directors and in a fiduciary position, and they used and acted upon their exclusive knowledge acquired as such directors. They framed resolutions by which they made a profit for themselves. They sought no authority from the company to do so, and, by reason of their position and actions, they made large profits for which, in my view, they are liable to account to the company."

while Lord Russell of Killowen commented:

"The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that

(5) [1942] 1 All E.R. 378; [1967] 2 A.C. 134n.

profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances been made. The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account."

It was clear that the directors in the Regal case had not deprived the company of any of its property (unless information can be regarded as property), or, seemingly, robbed it of an opportunity which it might have exercised for its own advantage; the 3,000 shares in the subsidiary had never been the company's property and, on the facts as found, the company could not have availed itself of the opportunity to acquire them. But it exemplifies the high standards of detachment which the law requires of anyone who adopts the status of trustee.

Recently a greater degree of the fiduciary obligation of directors has been required by the courts in Canada. Thus in Canadian Aero Services Limited v. O'Malley (6) Laskin J. (as he then was) said:

". . . what these decisions indicate is an updating of the equitable principle whose roots lie in the general standards that I have already mentioned, namely, loyalty, good faith and avoidance of a conflict of duty and self-interest. Strict application against directors and senior management officials is simply recognition of

(6) (1973) 40 D.L.R. (3d.) 371. See also S.M. Beck (1975) 53 Can. B. Rev. 771; M. Iacono (1975) 21 McGill L.J. 445.

the degree of control which their positions give them in corporate operations, a control which rises above day-to-day accountability to owning shareholders and which comes under some scrutiny only at annual general or at special meetings. It is a necessary supplement, in the public interest, of statutory regulation and accountability which themselves are, at one and the same time, an acknowledgment of the importance of the corporation in the life of the community and of the need to compel obedience by it and by its promoters, directors and managers to norms of exemplary behaviour."

The Canadian Aero case exemplifies those cases within the doctrine of corporate opportunity (7) which deal with directors who take for themselves opportunities that first came to them while acting, and because they were so acting, as directors. The case establishes a more flexible rule than the narrower test thought to be established by some by the Regal case which narrower test requires that the benefit or advantage must be obtained by reason and in course of their office of directors (8). In the Canadian Aero case the directors had not obtained a relevant contract in the course of their duties as directors. They competed with the plaintiff company after resignation from their positions with the plaintiff and succeeded in bidding for the contract. They did not use any confidential information in obtaining the contract. But there Laskin J. observed:

". . . the fiduciary relationship goes at least this far: a director or a senior officer . . . is precluded from obtaining for himself, either secretly or without the approval of the company (which would have to be properly manifested upon full disclosure of the facts), any property or business advantage either belonging to the

(7) See generally D.D. Prentice (1974) 37 M.L.R. 464.

(8) (1973) 40 D.L.R. (3d) 371, 386 per Lord Russell.

company or for which it has been negotiating; and especially is this so where the director or officer is a participant in the negotiations on behalf of the company . . . In my opinion this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to be prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired."

As we have seen, the rules concerning directors' duties of loyalty are very strict, and before we leave the topic on fiduciary duties, it is convenient to discuss briefly again the extent to which duties which the law would otherwise cast upon directors could be lessened or excluded by appropriate drafting of the articles and the extent to which liability of directors for breaches of duties of good faith could be released by ratification in general meeting.

1. Exempting by Drafting

It may be thought a convenient way of lessening or even getting rid of the duties which the law would otherwise cast upon directors that appropriate clauses be inserted in the articles. For example article 78 in Table A of the Companies Act 1948 provides:

"A director of the company may be or become a director or other officer of, or otherwise interested in, any company promoted by the company or in which the company may be interested as shareholder or otherwise, and no director shall be accountable to the company for any remuneration or other benefits received by him as a director or officer of, or from his interest in, such other company unless the company otherwise directs."

May articles be drafted so as to purport to relieve the director in all circumstances from the duty, for example, not to make a secret profit?

As submitted before, articles purporting to exclude any duty which the general law casts upon a director, other than the proper purposes doctrine (9), are void under section 205 of the Companies Act 1948. However, sometimes it is possible to alter these duties to some extent. It is better to treat the articles in Table A that appear to exclude a duty as exceptional; they are valid because of the very fact that they are contained in an Act.

As far as contracts between the company and its directors or contracts of the company in which they are indirectly interested are concerned, some waiver clauses have been helpful to remove the sting from the general equitable principle of good faith. It has not been the practice to insert waiver clauses excluding liability to account to the company for profits directors obtain in some other way as a result of their position in the company (10); and it is submitted that such waiver clauses would be void.

2. Ratification in General Meeting

Some breaches of fiduciary duty by directors can be ratified by the shareholders in general meeting and some cannot, and the traditional test (1) is that ratification is disallowed where the directors act mala fide or where some "property" (legal or equitable) of the company has been misappropriated directly or indirectly.

(9) There is a growth of school of thought regarding the 'proper purposes' as merely one aspect of the much wider duty requiring a director to act bona fide in the best interests of the company as a whole. See above, pp.94-6; Teck Corp. v. Millar (1972) 33 D.L.R. (3d) 288

(10) Gower, p.591.

(1) See K.W. Wedderburn (1981) 44 M.L.R. 202, 206. In his article, Professor Wedderburn strongly disagrees to Vinelott J.'s test about ratification in general meeting.

In Prudential Assurance Ltd. v. Newman Industries Ltd. (No.2)(2)

Vinelott J. remarked that directors in default who are also shareholders can vote in general meeting, but it is "unconscionable" for the majority to "use their voting power in general meeting to prevent an action being brought against them. The fraud lies in their use of their voting power not in the character of the act or transaction giving rise to the cause of action." (3)

Wedderburn strongly disagrees with Vinelott J. on this point, but Vinelott J. may be right on his interpretation of North-West Transportation Company v. Beatty (4). In that case, Sir Richard Baggallay held that the director's breaches of duty could be confirmed:

". . . provided such affirmance or adoption is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards those shareholders who oppose it." (5)

It should be noted that the uncontradicted evidence was that it was essential to the company's business to buy another boat, that the boat concerned was suitable, that no other equally suitable boat was available, and that the price was neither excessive nor unreasonable (6). If any of the uncontradicted facts had been different, it might be that the transaction would not have been capable of confirmation.

Further support can be found in Sir Richard Baggallay's remarks in that case:

"The only unfairness or impropriety which, consistently with the admitted and established facts, could be suggested, arises out of

(2) [1980] 3 W.L.R. 543; [1980] 2 All E.R. 841. See also above, pp.29-30.

(3) [1980] 2 All E.R. 841, 862.

(4) (1887) 12 App. Cas. 589; 56 L.J.P.C. 102; 57 L.T. 426; 3 T.L.R. 789; 36 W.R. 647.

(5) (1887) 12 App. Cas. 589, 594.

(6) (1887) 12 App. Cas. 589, 594.

the fact that the defendant J. H. Beatty possessed a voting power...

It may be quite right that, in such a case, the opposing minority should be able, in a suit like this, to challenge the transaction, and to show that it is an improper one, and to be freed from the objection that a suit with such an object can only be maintained by the company itself.

But the constitution of the company enabled the defendant J. H. Beatty to acquire this voting power...he had a perfect right...to exercise his voting power in such a manner as to secure the election of directors whose views upon policy agreed with his own, and to support those views at any shareholders' meeting; the acquisition of the United Empire was a pure question of policy, as to which it might be expected that there would be differences of opinion, and upon which the voice of the majority ought to prevail; to reject the votes of the defendant upon the question of the adoption of the byelaw would be to give effect to the views of the minority, and to disregard those of the majority."

Their Lordships were of the opinion that the judges of the Canadian Supreme Court appeared to have regarded the exercise by the defendant of his voting power as of so oppressive a character as to invalidate the adoption of the buy-law, but they were unable to adopt such a view.

Beatty's case may also be interpreted to mean that the case decided that "the resolution in general meeting superseded the resolution of the directors and there was, therefore, no question of the majority using their votes to prevent an action being brought to set aside a transaction between the board of

directors and one of their number." (7) In other words, there was no confirmation of the transaction between the board of directors and one of them. Such confirmation was not necessary because, it may be argued, there was a new contract in terms of the old contract which new contract was concluded at the meeting of the shareholders.

With great respect to Professor Wedderburn, it is submitted that Vinelott J.'s interpretation of Beatty's case is the correct one; Beatty's case is not authority for the proposition that a majority shareholder who is also a director can use his votes in general meeting to confirm or ratify an act or transaction which was not fraudulent or ultra vires, but was a breach of his duty as a director, in order to prevent a minority shareholder from bringing a derivative action (8).

Vinelott J. (9) does not agree that the best way to define the limit of the exception to the rule in Foss v. Harbottle is by reference to any category of acts or transactions which are incapable of being authorised or ratified by the majority in general meeting. A relevant transaction may be fraudulent, but the law should not impose a limit to the power of the majority to resolve in general meeting to forget about the injury done to the company and not to take any action. If the majority at general meeting so wish, under certain circumstances a fraudulent transaction should be allowed to be ratified and legal action allowed not to be taken. There may be good reasons for the majority so deciding because, e.g., the reputation (10) of the company might be injured by the proposed legal action;

(7) Prudential v. Newman (No.2) [1980] 3 W.L.R. 543, 570 per Vinelott J.

(8) See also above, p.29.

(9) Prudential v. Newman (No.2) [1980] 3 W.L.R. 543, 568.

(10) Ibid. at p.568.

the outcome of the litigation may be uncertain; the business would be disrupted by discovery of documents, preparation for trial and attendance at court to give evidence; legal costs may prove to be irrecoverable; there may be damage to the company greater than any benefits to be obtained from the action, etc. The emphasis should be on 'the benefit of the company as a whole' or whether it is truly in the interests of the company that proceedings should be brought (1). A better test would therefore be whether or not the wrongdoers use their voting power (2) or some improper means such as manipulation of their position in the company in general meeting to prevent an action being brought against them.

Vinelott J. sought to support his new test of 'use of voting power' by citing (3) two decisions of Sir William Page Wood V.-C. in Atwood v. Merryweather (4) and said:

"The contrast between Page Wood V.-C.'s two decisions is important. The first shows...The second shows that the use of a wrongdoer's votes to prevent proceedings being taken by a company to remedy a wrong done to it may justify a minority shareholder bringing a derivative action." (5)

Professor Wedderburn has raised some questions on Vinelott J.'s new principles such as: What are votes "capable of being cast"? (6) How is the "conflict" to be judged? (7) When do shareholders' interests "conflict" with those of the company? (8) Would we always need to inquire into the subjective motives of

(1) Prudential v. Newman (No.2) [1980] 3 W.L.R. 543, 583.

(2) Ibid. at p.568.

(3) Ibid. at p.577.

(4) (1868) L.R. 5 Eq. 464.

(5) [1980] 3 W.L.R. 543, 579.

(6) (1981) 44 M.L.R. 202 at 208.

(7) Ibid. at 208.

(8) Ibid. at 211.

each of the shareholders voting? (9)

It is submitted that in practice there is no need to inquire into the motives of disinterested shareholders, a common sense test should be applied to determine what is good for the company as a whole (10) and a reasonableness test should be applied to determine the conflict between shareholders themselves and between shareholders and the company as a whole.

Vinelott J. tries to reconcile Regal v. Gulliver with Cook v. Deeks by remarking that he could see nothing in the report which indicated that the defendant directors in the Regal case controlled the voting (1). Professor Wedderburn disagrees, (2), but he has not been able to point to anything in the relevant report which so indicated.

If one favours the traditional test, one has to face the difficulty of explaining "advantages", "opportunities" or "information" as the company's "property". The word "property" may cover many, many things. It may be said that the directors in the Regal case used corporate "information" in some sense to make a profit, and those favouring the traditional test would find it difficult to explain why the directors' breach could have been validated by ratification. On the contrary Vinelott J. has suggested a way to reconcile the Cook case with the Regal case and North-West Transportation Company v. Beatty.

Insider Dealing

Before we pass on to the topic "Duties of Care Diligence and Skill" it is perhaps of importance to note one particular aspect

(9) (1981) 44 M.L.R. 202 at 211.

(10) See also above, p.17-8.

(1) In any event, it is submitted that it is reasonable to forbid ratification in the Cook case and to allow it in the Regal case because in the former the directors had profited at the company's expense while in the latter the directors had profited without doing any harm to the company.

(2) (1981) 44 M.L.R. 202, 210.

of directors' duties, namely the vexed question of insider dealing(3).

The ideal of Stock Market trading is based on a philosophy that all investors should have relatively equal access to material information, and dealings in corporate securities where one party has and the other party does not have access to confidential information which has a substantial bearing on the value of those securities are considered to be wrong.

The use of confidential information can lead to a profit in the hands of the insider which if he were an outsider, he would be unable to obtain. This profit may either be in the form of a positive gain or avoiding a loss, but in both cases unjust enrichment.

Part V of the Companies Act 1980 now makes insider dealing a criminal offence.

An individual may not deal in securities of the company with which he is connected if he is, or at any time in the previous six months has been, knowingly connected with the company; if he has information which he holds by virtue of being connected with the company; if it would be reasonable to expect a person so connected and in the position by virtue of which he is so connected not to disclose that information except for the proper performance of the functions attaching to that position; if he knows that information is unpublished price-sensitive information in relation to those securities (4). An individual may only be connected with a company in the following ways: as a director of that company or of a related company, which means a subsidiary of a holding company; as an officer or employee of that company or of a related company; as a person

(3) This duty is also imposed on officers and members of a company and others when dealing in the company's securities with inside information which affects their value. See generally L. Loss (1970) 33 M.L.R. 34; N. Spinks (1973) 123 N.L.J. 779; N. Spinks (1973) 123 N.L.J. 809; T.M. Ashe (1973) 123 N.L.J. 216.

(4) s.68(1) of Companies Act 1980.

occupying a position involving a professional or business relationship between himself or his employer or a company of which he is a director and the company or a related company which in either case may reasonably be expected to give him access to information which in relation to securities of either company, is unpublished price-sensitive information, and which it would be reasonable to expect a person in his position not to disclose except for the proper performance of his functions (5).

The prohibitions also apply in the case of information about takeover bids by an individual or group of individuals (6) and information obtained by Crown servants (7) in their official capacity.

A tippee from connected persons must not deal where he has information which he knowingly obtained directly or indirectly from an individual connected (or who within six months previously was connected) with a particular company; he knows or has reasonable cause to believe that the connected person held the information by being so connected; and the tippee knows or has reasonable cause to believe that because of the latter's connection and position, it would be reasonable to expect him not to disclose the information save for the proper performance of functions attaching to that position (8). The tippee must also know that the information is unpublished price-sensitive information in relation to the particular securities. A similar prohibition applies to tippees of Crown servants (9) and to an individual who has knowingly obtained directly or indirectly unpublished price-sensitive information from an individual who is contemplating or who has contemplated a takeover offer (10).

(5) s.73(1) of Companies Act 1980.

(6) s.68 of 1980 Act.

(7) s.69 of 1980 Act.

(8) s.68(3) of 1980 Act.

(9) s.69 of 1980 Act.

(10) s.68(5) of 1980 Act.

To be caught as a tippee by the Companies Act 1980, an individual has knowingly to have obtained certain information directly or indirectly from the persons mentioned. Accordingly there will be some persons who receive information from tippees to whom the legislation will apply, but such a sub-tippee, to fall within the prohibitions will have to be an individual who, for example, will have had to knowingly obtain indirectly information from a connected individual and know that because of that individual's connection it would be reasonable for him not to breach his confidence and that the information is price-sensitive. It seems that most sub-tippees would be unlikely to be convicted on the wording of this legislation.

'Unpublished price-sensitive information' is defined in the 1980 Act as information which relates to specific matters relating or of concern directly or indirectly to that company and is not generally known to those persons who are accustomed or would be likely to deal in those securities but which would if it were generally known to them be likely materially to affect the price of those securities (1).

It is provided that the information is that which relates to a specific matter relating etc. to the company, not to a matter which relates etc. specifically to the company. Accordingly information of matters outside the company will be unpublished price-sensitive information if they are specific matters, of concern directly or indirectly or relate to the company, are not generally known to the market, affect materially the price of the securities. In practice, however, it is internal matters which are more likely to be unpublished price-sensitive information.

On the construction of 'materiality', U.S. judges have said:

"the basic test of materiality is whether a reasonable man would

(1) s.73(2) of Companies Act 1980.

attach importance in determining his choice of action in the transaction in question" (2) and "material facts include not only information disclosing the earnings and distributions of a company but also those facts which may affect the desire of investors to buy sell or hold the company's securities." (3)

The prohibitions apply to dealing on a recognised Stock Exchange, counselling or procuring someone else to deal or passing on the information when subsequent dealing is likely and to off market deals in advertised securities through or by professional dealers making a market in the securities.

There is an exception to the prohibitions if the thing is done otherwise than with a view to the making of a profit or avoidance of a loss by the use of the information. There are also various other defences including defences under certain circumstances for liquidators, receivers, trustees in bankruptcy and jobbers.

Proceedings in England and Wales can only be brought by the Secretary of State or by or with the consent of the Director of Public Prosecutions. The 1980 Act does not confer a civil remedy on a victim of insider dealing on a stock exchange. It is deplorable that the victim should be denied a civil remedy, but probably it is due to that matching-up of particular transactions is almost impossible in the case of a normal transaction on the stock exchange.

(B) Duties of Care Diligence and Skill

Having discussed the fiduciary duties of directors, let us see what are their duties of care diligence and skill at law.

A director may reasonably rely on his co-directors and officers of the company. Thus it is the duty of the general manager to go

(2) See List v. Fashion Park Inc., 340 F2d 457 per Waterman Circ J.

(3) SEC v. Texas Gulf Sulphur Co. 40a F2d 833 at 849 per Waterman Circ. J.

carefully through the returns and to bring before the board any matter requiring the consideration of the other directors and a director is not guilty of negligence in not examining them for himself, notwithstanding that they are laid on the table of the board for reference (4).

On the other hand a director who signs a cheque cannot claim that he did so as a mere ministerial act. If he neglects inquiry, trusting in his co-directors or one of the company's officers, he will be himself liable to the company if the cheque is not authorised by the board or if it is an improper payment (5),.

In both the Denham case and Joint Stock case, the defendants trusted their co-directors (although in the Denham case, the co-director was the chairman of directors) the defendant in the former case was held not liable whereas the defendant in the latter case was held liable.

In Ramskill v. Edwards (6) where a director was not present at the board meeting when a loan was authorised, and had no part in the making of it, it was held that the director was under no liability in respect of the loan.

But where an ultra vires act was decided at a board meeting, a director who was not present but adopted it at a subsequent meeting was held liable as if he had been an original party (7).

There is no real duty for a director to attend board meetings(8).

In Marquis of Bute's Case (9) where there were fifty trustees

(4) Re Denham & Co. (1883) 25 Ch. D. 752; 50 L.T. 523; 32 W.R. 487.

(5) Joint Stock Discount Co. v. Brown (1869) L.R. 8 Eq. 381. See also Coats v. Crossland (1904) 20 T.L.R. 88;

(6) (1885) 31 Ch. D. 100; 55 L.J.Ch. 81; 53 L.T. 949; 34 W.R. 97; 2 T.L.R. 37.

(7) Re Lands Allotment Co. [1894] 1 Ch. 616; 63 L.J.Ch. 29; 70 L.T. 286; 10 T.L.R. 234; 1 Mans. 107; 7 R. 115; 42 W.R. 404.

(8) In Re Denham & Company (1883) 25 Ch. D. 752; 50 L.T. 523; 32 W.R. 487.

(9) [1892] 2 Ch. 100.

(namely persons in the position of directors) of a savings bank, a "trustee" who attended no meetings for a number of years was held not liable for the misconduct of his "co-trustees."

But Lord Hardwicke said in Charitable Corporation v. Sutton(10) that continuous non-attendance at meetings might render a director guilty of the breaches of trust which were committed by others.

In that case it was the responsibility of a warehouse-keeper of a chartered corporation to make loans to poor people on the security of suitable pledges and fifty committeemen of the corporation were held liable for losses resulting from their failure to ensure that the activities of the warehouse-keeper were adequately supervised. While delivering the judgement, Lord Hardwicke commented:

"In this respect (directors) may be guilty of acts of commission or omission, of malfeasance or non-feasance . . . By accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely honorary . . ."

And in Re Forest of Dean Co. (1) Jessel M.R. said:

". . . (Directors are) to use reasonable diligence having regard to their position, though probably an ordinary director, who only attends at the board occasionally, cannot be expected to devote as much time and attention to the business as the sole managing partner of an ordinary partnership, but they are bound to use fair and reasonable diligence in the management of their company's affairs, and to act honestly."

A director is not expected to exercise skill which he does not possess. Thus in Re Brazilian Rubber Plantations & Estates Ltd. (2)

(10) (1742) 2 Atk. 400, 405.

(1) (1878) 10 Ch. D. 450, 452.

(2) [1911] 1 Ch. 425; 80 L.J.Ch. 221; 103 L.T. 697; 27 T.L.R. 109.

Neville J. remarked:

"(A director) is, I think not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance." (3)

In that case three defendants were held not liable for losses resulting from a ruinous speculation in rubber plantations, and Neville J. had this to comment:

"The directors of the company . . . were all induced to become directors by Harboard . . . Sir Arthus Aylmer was absolutely ignorant of business. He only consented to act because he was told the office would give him a little pleasant employment without his incurring any responsibility. H.W. Tugwell was partner in a firm of bankers in a good position in Bath; he was seventy-five years of age and very deaf; he was induced to join the board by representations made to him in January, 1906. Barber was a rubber broker and was told that all he would have to do would be to give an opinion as to the value of rubber when it arrived in England. Hancock was a man of business who said he was induced to join by seeing the names of Tugwell and Barber, whom he considered good men." (4)

And in Re Denham & Co. (5) a director was held not liable for not detecting the frauds of the chairman of directors because he was "a country gentleman and not a skilled accountant." (6)

From the above cases, it is fairly clear that (in contrast to directors' very strict duties of loyalty) directors' duties of care,

(3) [1911] 1 Ch. 425 at 437.

(4) [1911] 1 Ch. 425, 437.

(5) (1883) 25 Ch. D. 752.

(6) Ibid. at p.767, per Chitty J.

diligence and skill are lax or far from rigorous. Beyond that, it is difficult to deal in general propositions. There are some inconsistencies; in the words of Romer J. in Re City Equitable Fire Insurance Co. (7) "to the question of what is the particular degree of skill and diligence required of (a director), the authorities do not, I think, give any very clear answer." (8)

A Case for differentiating Companies

Part of the difficulty which the courts have had in this respect can be attributed to the fact that while the judges are well competent to adjudicate on questions of good faith and loyalty, they feel not sure when they are confronted with complicated problems of business administration, economics and trading, resulting in their reluctance to interfere with the directors' business judgement (9). In setting out standards of conduct applicable to businesses of all sizes and kinds, the courts have required little more than honesty and effort so as to attract men of sound business acumen to the commercial world.

It is submitted that another reason for inconsistency of case law is the courts' failure to distinguish from one another the positions of directors in different classes of companies, which, it is submitted, may be classified into three groups as a rough guide, namely large companies (public or large unquoted companies) (Class I companies); medium companies (medium unquoted or large family companies) (Class II companies); and small companies (partnership companies) (Class III companies). (10)

(7) [1925] Ch. 407; 94 L.J.Ch.445; 133 L.T. 520; 40 T.L.R. 853; [1925] B. & C.R. 109.

(8) [1925] Ch. 407, 427. Romer J. also said in that case: "There are, in addition, one or two other general propositions that seem to be warranted by the reported cases: (1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."

(9) See Gower, p.603.

(10) On partnership companies, see generally Morse & Tedd (1971) J.B.L. 261. Cf. Hadden, P.239.

The differentiating mark of large companies (public or large unquoted companies) (Class I companies) is the separation of ownership and control among shareholders, management and directors. Roughly they are the companies as distinguished from nineteenth-century middle-class family-owned personal companies. Included in this class would be those huge companies which are at present characterised by a large number of shareholders, in many cases more shareholders than employees; by professional management teams; and by boards of directors, sometimes selected from outstanding names and owning minor or negligible percentages of total shares. Examples of these huge companies are dominant controlling groups and foreign interest.

Class I companies should also include those large-sized companies outside the heavy sector of industrial activity, companies of the service type, companies representing light or new industries, and companies dominant in their particular fields which have recently moved out of the private sector.

It is proposed that all public companies irrespective of the number of their employees and all limited companies employing 2,000 employees or more should be registered as Class I companies. All enterprises within a group should be treated as an entity for the purpose of classification.

Class I companies would be those companies in whose executive decision-making the question of social responsibility should weigh heavily. The criterion of profit ability should not be their sole test of good business performance. And because they should have criteria other than profit, it is in these companies that one is more likely to find attention given to such issues as patronage of arts and sciences. These companies are those which would be under a duty to provide and stabilise employment.

It is proposed that the general fiduciary duty of directors should be the same for directors of all three classes.

It is further proposed that a director should observe the utmost good faith towards his company in all of his actions and to act honestly in the exercise of the powers and in the discharge of the duties of his office.

A director should not do anything or omit to do anything if the doing of that thing or the omission to do it, as the case may be, gives rise to a conflict, or might reasonably be expected to give rise to a conflict, between his private interests and the duties of his office. In particular a director should not make use of any money or property belonging to his company to benefit himself; nor of any relevant information acquired by him or relevant opportunity afforded to him by virtue of his position as a director of a company, if by doing so he gains an advantage for himself where there may be a conflict with the interests of the company.

The expression 'relevant information' should mean any information which a director obtained while a director or other officer of the company and which it was reasonable to expect him to disclose to the company or not to disclose to persons unconnected with the company.

The expression 'relevant opportunity' should mean an opportunity which a director had while a director or other officer of the company and which he had (i) by virtue of his position as a director or other officer of the company; or (ii) in circumstances in which it was reasonable to expect him to disclose the fact that he had that opportunity to the company.

However, it is proposed that a director should not be liable in manner aforesaid for any act or omission which is duly authorised or ratified.

'Proper purposes' should be merely one aspect of the wider duty requiring a director to act bona fide in the best interests of the company as a whole.

As to the degree of care, diligence and skill of directors in Class I companies, it is submitted that the degree should be rather high. The old rule that company directors are not bound to do more than act honestly and to the best of their ability in whatever they actually do is clearly inadequate. Current commercial attitude (1) is certainly more demanding. It is recognised, however, that it is unreasonable to expect every director to have equal knowledge and experience of every aspect of the business of the company (2). Therefore, it is proposed that in the case of Class I companies' directors, with the exception of employee directors, within the field of professed or inferred competence of each director there should be imposed an objective standard of care, diligence and skill so that defences such as lack of knowledge or lack of experience will not help the director concerned. In the said field the director should conform to professional standards much as lawyers, accountants, architects, engineers, doctors, etc. Outside the said field it is proposed that a director in Class I companies should not be required to exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.

In the case of an employee director in Class I companies, it is proposed that he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. However, if he is professionally qualified, he should be dealt with exactly as a non-employee

(1) Hadden, p.322.

(2) For example in a building construction company, one director may have expertise in finance and another in construction engineering.

director.

It is also proposed that in the case of Class I companies' directors, with the exception of employee directors, there should be an evolution of managerial profession. It is high time that, apart from employee directors, company management in the case of large (Class I) companies be a recognised profession with objective professional standards. Persons eligible to be such directors would be professional managers, business consultants, management specialists, accountants, lawyers, economists, social scientists, engineers, architects etc. It is not proposed that the management profession need be a graduate profession. The reason for requiring a managerial profession is that in order to maintain its members' reputation and standing and to gain and retain public confidence in their abilities, a developed profession usually lays down and maintains standards of ethical conduct beyond those required of the ordinary citizen by law, and by requiring a director and or executive and or manager to be a member of a recognised profession, it would be safeguarded to a reasonably good extent that those controlling companies are imposed by rules of professional conduct which can satisfy the needs of modern society. The sanction or possibility thereof of disciplinary proceedings or suspension or removal of membership from a recognised profession would operate to a great extent to deter directors from pursuing fraudulent or negligent courses of conduct. Moreover, business education and professional training help to encourage corporate responsibility.

Small companies (partnership companies) (Class III companies) would be those companies which are in essence incorporated partnerships

or sole traders nowadays (3). They would include those companies which have been registered to take over businesses or professional practices previously carried on by partnerships. Usually in these companies the shareholders wish to jointly take part in management and regard themselves for practical purposes as partners in the company. They have been incorporated principally to obtain the advantage of limited liability or tax advantage or other advantages which flow from incorporation. The present Companies Acts are ill-adapted for regulating the relationship within a group of persons who consider themselves as partners in a small company and wish to have the same freedom in the running of its business and in the regulation of their internal legal relationships as would be available to them under a partnership regime (4). There should be a greater degree of flexibility in the rules governing the external and internal relations of such companies to meet the varying requirements of the entrepreneurs. These problems cannot satisfactorily be met by amendments within the framework of the existing Companies Acts, but call for a new legislative approach.

It is proposed that the business relationship between the shareholders should be governed by such simple assumptions as good faith, mutual trust, and unanimity in reaching decisions of basic

(3) The laws of many countries draw a clear distinction between joint stock companies and other companies, e.g. in France the société anonyme and the société à responsabilité limitée and in Germany the Aktiengesellschaft and the Gesellschaft mit beschränkter Haftung. In U.S. some state legislatures have passed laws specifically regulating close companies. Brightman J. once attempted to define a partnership company; see his judgement in Re Leadenhall General Hardware Stores Ltd. (1971) 115 S.J. 202.

(4) The difficulties caused by partnership companies are well illustrated by Re Westbourne Galleries Ltd. [1970] 3 All E.R. 374; [1971] 1 All E.R. 56. Although the case asserts the ability of the courts to act on equitable grounds in compulsory winding up, this remedy may in many cases be worse than the disease. It is submitted that it is desirable to have a new set of statutory rules regulating their internal relationships according to their own intentions. See also above, pp.37-8.

importance and similar partnership rules under the Partnership Act. There should also be an easy registration procedure and a simplified constitution - perhaps a set of partnership articles instead of the memorandum and articles of association, primarily as a guide for ordinary Class III companies but which could, like Table A under the Companies Act 1948, be adopted in whole or in part. Of course the set of partnership articles may be modified in writing by a supplemental agreement, but such a supplemental agreement, if it is proposed, need not be filed on a public register.

It is proposed that only those intending companies that employ not more than 50 people may be registered as Class III companies. Again, all enterprises within a group are treated as an entity for the purpose of classification.

As aforesaid (5), the general fiduciary duty of directors of Class III companies should be the same as that of directors of Class I companies.

As to the degree of diligence and care of directors of Class III companies, it is proposed that it should be settled by agreement so that the parties concerned can agree on the amount of time to be devoted by each party to the business, but in the absence of any contrary agreement, each director should attend diligently and exclusively to the management of the business.

As regards the degree of skill, it is proposed that each director of a Class III company should exercise the degree of skill which may reasonably be expected of a person of his knowledge and experience.

Limited companies which do not fall within Class I companies and Class III companies should be registered as medium companies (medium unquoted or large family companies) (Class II companies). The characteristics of Class II companies are that there is no such

(5) See above, pp.125-6.

separation of ownership and control as is evident in Class I companies. The ownership, the direction and the management are all much more coincident. But they are larger than Class III companies. Some of these companies do have professional managers and directors; while others have several outside minority shareholders. Together with Class III companies they are the true private capitalism of the nineteenth-century type. But on the whole Class II companies are more ambitious than Class III companies. In some of these Class II companies one sees the ferment of private capitalism. Here is the field for bold exercise of intuition, for adventurousness and for agility. Risks are recognised and undertaken with the aim of becoming bigger, stronger and finding a firm position in the industrial structure either through growth or combination. Some of these companies are divisions of the great institutional organisations (Class I companies) but, for one reason or another, have not moved into their areas.

It is in respect of Class II companies that comparatively the question of protection of minorities arises more frequently.

As aforesaid (6), the general fiduciary duty of directors of Class II companies should be the same as that of directors of Class I companies.

However, as to the degree of care, diligence and skill, a director of Class II companies should be required to exercise that degree of care and diligence that a reasonably prudent person would exercise in comparable circumstances and the degree of skill which may reasonably be expected of a person of his knowledge and experience.

It is perhaps not out of place to note certain comment given by Lord Macnaghten in Dovey v. Cory (7):

(6) See above, pp. 125-6.

(7) [1901] A.C. 477 at 488.

"I do not think it desirable for any tribunal to do that which Parliament has abstained from doing - that is, to formulate precise rules for the guidance or embarrassment of businessmen in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances; and, speaking for myself, I rather doubt the wisdom of attempting to do more."

But are not directors, executives, and their advisors entitled to demand from the law some reasonably certain rules of permissible conduct? When laws become outmoded in society, when they do not reflect the way in which people live, then serious consideration should be given to their modification or abolition. There should be a sane rationalisation and codification of the law relating to company directors.

As to the problem of enforcement of directors' duties, the law should be amended so that it is a condition of the receipt of certain subsidies or licences granted by government that the new proposed reform in these three Chapters and or certain duties be observed. Other sanctions may be suspension, temporarily or permanently, from practice as a professional director, manager or executive, assuming the law is amended so as to require that a director of a large company should be a member of a relevant professional body; a compulsory winding up of the companies concerned; striking from the register of the companies concerned; a declaration that the director concerned be barred from being employed as director by anyone or any company for a number of years from the date of court order (8). Provisions should also be made to allow employees,

(8) Cf. Companies Act 1948, s.188(1); Insolvency Act 1976, s.9; Companies (No.2) Bill 1981 (As Amended in Committee), clause 61.

unions or shareholders to take directors including employee directors to court for incompetence or failure to observe directors' duties and to allow the courts to suspend or replace the directors in default.

Enforcement of Corporate Duties

In order to make the duties of directors more effective, it is important to have a good system of enforcement of corporate duties.

There are several ways of enforcing corporate duties.

First, the company may bring an action against its director(s) for breaches of duties of loyalty, care, diligence or skill.

Secondly, there are the derivative action, personal action, alternative remedy under section 75 of the Companies Act 1980 and winding up under s.222(f) of the Companies Act 1948, all of which were discussed in Chapter 1 herein.

Two other means of enforcement (one of which is proposed) namely department of trade investigations and watching committees remain to be discussed, and to these we shall now turn.

1. Department of Trade Investigations

The Department of Trade now have extensive powers to investigate companies (9), and the existence of these powers is important both as a remedy against unfair treatment and as a preliminary to civil or criminal proceedings against the wrongdoers. Until 1967 these powers were exercisable only by the formal appointment of an inspector to investigate the company's affairs and they were rarely exercised owing to the overlap in the functions of various government

(9) The Government's Companies (No.2) Bill 1981 (As Amended in Committee) proposes that the classes of persons who may be required to give evidence in the course of investigations should be extended and proposes to provide inspectors with power to examine directors' bank accounts. See clauses 57 and 59. See also clauses 56, 58 and 60 thereof.

authorities in the affairs of public companies and the absence of any clearly defined responsibility within the Board of Trade, the predecessor of the Department of Trade, for the oversight of the market. They took the view that if an appointment was made before it was absolutely necessary, especially in the case of a public company, irreparable damage might be occasioned to the company if the allegations made against it were proved to be frivolous, false or incorrect. This difficulty has been removed by the grant to the Department of new powers of preliminary enquiry, by virtue of which it may demand the production of documents and accounts from any company without necessarily conducting a full inspection (10). To save costs and increase manpower, after 1967 a corps of inspecting officers was established on a full time basis to undertake the more routine inspections which would not merit the appointment of eminent professional lawyers and accountants.

There are three types of investigation which can be carried out by the Department, namely an investigation of the company's affairs, of the company's ownership and of share dealings.

The Department may appoint inspectors to investigate and report on a company's affairs on the application of at least 200 members or members holding at least one-tenth of the shares issued in the case of a company having a share capital and on the application of at least one-fifth of the members in the case of a company having no share capital (1).

The Department may appoint inspectors to investigate the company's affairs if it appears (i) that the business is being or has been conducted with intent to defraud creditors, for a fraudulent or unlawful purpose, in a manner which is oppressive to any of its

(10) Section 109 of Companies Act 1967.

(1) Section 164(1) of Companies Act 1948.

members, or that the business was formed for a fraudulent or unlawful purpose, or (ii) that the persons concerned with formation or management have been guilty of fraud, misfeasance or other misconduct towards the company or the members. The Department may also appoint inspectors if it appears that the members of a company have not been given all the information about its affairs which they might reasonably expect (2). In this way the Department may not only help the members to get information to which they were already legally entitled; they add somewhat to their legal entitlement. This benefit is sometimes very useful to establish that the member's rights have been infringed. One of the great weaknesses of an aggrieved shareholder who has been oppressed by the directors is that he is not entitled to access to the company's books and records whereas the directors have such access.

If an inspector thinks it necessary, he may also investigate the affairs of related companies (3).

All officers and agents of the company (and an auditor is an agent for this purpose) must attend before the inspectors when required and give all the assistance that they can (4). In so doing, they are not entitled to make stipulations, or require assurances from the inspectors, as to the procedure to be followed. This is an explicit duty on the officers or agents who are being investigated to attend before the inspectors if required to do so, and they cannot use excuses not to attend in order to avoid being questioned. A refusal to attend before inspectors when required to do so is a ground for bringing an officer or an agent before

(2) Section 165(b) of 1948 as amended by section 38 of 1967 Act.

(3) Section 166 of 1948 Act.

(4) Section 167(1) of 1948 Act as amended by section 39 of 1967 Act.

the court, and if they still refuse to produce the books, this would be a contempt of court.

The inspector may examine the officers or agents on oath (5) and may apply to the court for an order for the examination before it on oath of any other persons whom he thinks it necessary to examine (6).

Section 41 of the Companies Act 1967 empowers the inspector at any time in the course of his investigation to inform the Department of matters tending to show the commission of an offence, without the necessity of making an interim report. It had been found that the information obtained by inspectors was sometimes confidential and could be made available to the Board of Trade only by means of a formal interim report or a formal final report. This section removes the difficulty over confidentiality and the inspectors may inform anytime now.

If it appears to the Department from any inspector's report or from any information or document obtained under s.109 of the 1967 Act that it is expedient in the public interest that the company should be wound up, it may, unless the company is already being wound up by the court, present a petition for it to be so wound up if the court thinks it just and equitable.

If it appears to the Department from any inspector's report or from any information or document obtained under s.109 of the 1967 Act that the company's business is being conducted or has been conducted in a manner unfairly prejudicial to any part of its members, it may, as well as or instead of presenting a winding up petition, present a petition for an order under section 75 of the Companies Act 1980.

The Department may itself bring civil proceedings in the name of any company wherever it appears in the public interest to do so.

(5) Section 167(2) of 1948 Act.

(6) Section 167(4) of 1948 Act.

It is advantageous to make a complaint to the Department with a view to their exercising their powers. Like a petition by a member for winding up or the alternative remedy it can be made by a single member without regard to the rule in Foss v. Harbottle, but, unlike those remedies, it may lead to a successful conclusion entirely without expense or trouble to the complainant. Moreover, the Department in exercising their follow-up powers may be in a stronger position than the member, for on a petition to wind up they, unlike him, will not have to show that there will be something left in the company for the members (7). The Department's inquisitorial powers may prevent oppression from occurring at all if exercised in good time.

An inspection is usually conducted together with an Official Receiver's or Fraud Squad investigations. This had caused delays in some cases, esp. where a detailed scrutiny of the company's books of account is necessary because contact is necessary between them. Another reason for the delays is that eminent non-official inspectors work only part-time.

It is submitted that the functions of the Department of Trade and its inspectors, the Official Receiver, the Director of Public Prosecutions and the Police Fraud Squad in this field should be brought together and exercised by a single company law enforcement unit so that there is independence of action which the relevant authorities at present lack individually. There should be a body of skilled and experienced investigators in such a unit with its own legal and accounting advisers, who under the existing arrangements are not easily available at short notice. Much time can thus be saved in investigating and reporting on individual cases. It is important that our system of investigation and enforcement should

(7) See Gower, p.679.

be flexible with extensive statutory power for investigation and enforcement.

2. Watching Committees

The position of the minority shareholder has always been unenviable, as is evident from a passage in the judgement in Wallersteiner v. Moir (No.2) (8).

"This case has brought to light a serious defect in the administration of justice . . . (Mr. Moir) applied many times to the Department of Trade to appoint an inspector, but that department put him off . . . He applied to the ombudsman, but he could do nothing. He raised the matter at shareholders' meetings, but was abruptly cut off. The only way in which he has been able to have his complaint investigated is by action in these courts. And here he has come to the end of his tether. He has fought this case for over ten years on his own. He has expended all his financial resources on it and all his time and labour. He has received contributions from other shareholders but these are now exhausted."

Crusading plaintiffs in derivative actions are very few and far between. In the ten years or so of hazards and complications of litigation there must have been many times when Mr. Moir was close to abandoning the action. There are not many dedicated, determined and resourceful minority shareholders as Mr. Moir, and it pays to prevent corporate abuses arising in the first place rather than to cure them after the event. It is true that criminal proceedings and Department of Trade investigations for corporate malpractice are not infrequent today, but they are usually taken when the worst has happened (9), as a result of which the interests of shareholders,

(8) [1975] 1 All E.R. 849 at p.846 per Lord Denning M.R.

(9) See Mr. Moir's example in Wallersteiner v. Moir (No.2)

employees, creditors, consumers etc. have already been severely damaged (10).

The preventive measure takes the form of internal self-regulation, and it is proposed that for every public company or large unquoted company, watching committees (1) be set up. These committees should be composed entirely of the company's outside directors. Their function is to supervise management and company operations generally, and in particular to examine the adequacy of accounting procedures, to analyse the overall financial position and to select the company's auditors. The watching committee should have its own small independent staff which is only answerable to the non-executive directors and totally independent of management control. Further, the committee should be authorised to hire skilled consultants to advise it and provide an independent source of expertise. Any person who is an executive of the company, or who has a professional relationship or material business dealings with the company, and any close relatives of such persons should be disqualified from being appointed as a committee member. The committee members should preferably be drawn from professional managers, business consultants, management specialists, accountants, lawyers, economists or social scientists, but only those with an enquiring mind and strength of character. The committee members should no longer be honorary or ornamental and should be amply rewarded. In order to ensure that the committee members have sufficient time and energy to do their work properly, it is proposed that a person should not hold more than three such committee memberships at any given time.

(10) See also above, p.45.

(1) Cf. A.J. Boyle (1978) 27 I.C.L.Q. 487.

CONCLUSIONS

Recently the courts have been more ready to intervene to correct abuse of majority power and unfairness, which they should be able to do still more effectively under the newly improved remedy alternative to winding up.

It is to be hoped that the courts will adopt a much more liberal attitude to the question of the minority shareholders' locus standi in derivative actions so as to remove any need to categorise types or degrees of breach of duty by directors in terms of their being either ratifiable or non-ratifiable and or the law will be changed by legislation to give the courts an explicit discretion to permit a derivative suit for any breach of duty including perhaps that of care diligence and skill too, and whether or not the wrongdoers are in control.

It is submitted that there are still some weaknesses of the newly enacted section 75 of the Companies Act 1980, and it is proposed that the courts should be allowed to deal under the new section with unfairly prejudicial conduct suffered by a member in a capacity other than that of a member or by a debenture holder whose debentures are convertible into shares; the court should have unfettered discretion.

As to the proposal that it might be better to introduce employee representatives directly into the supervisory and or managing organs of companies, it is submitted that the time has now come to introduce employee participation at board level. It is proposed that for every public company or large unquoted company or alternatively for every company employing more than 50 employees there should be a reconstituted unitary board with an equal number of shareholder and employee directors and an independent third group from professionals. In order to ensure an extension of industrial

democracy sufficiently, works councils should also be required. The management and the workforce should be taught and made to act on the principle that a company is for both investors and employees equally and there is a duty upon employees to work, upon employers to provide work, and upon both to co-operate at work. It is submitted that the essence of success in achieving unity is not pluralistic bargaining or compromise, but co-operation.

An examination of the case law about directors' duties seems to show that there are some inconsistencies in their duties of care and diligence. Roughly their duties of loyalty are very strict. On the other hand their duties of care diligence and skill are quite lax. The reason for the latter might be that many directors worked and work part time and company management is up to date not a recognised profession with professional standards. Current commercial attitude is now more demanding, and it is proposed that in the case of public or large unquoted companies, with the exception of employee directors, the law should require a director to possess a professional qualification. Another reason for the inconsistency of case law is the courts' failure to distinguish from one another the positions of directors in small companies, medium companies and large companies respectively. Accordingly it is proposed that all companies should be classified into three groups and there should be a codification of the law relating to directors' duties for each of the three classes of companies. It is also proposed that for every public or large unquoted company there be set up a watching committee consisting of independent outside directors who should preferably be professionals. The third group of directors proposed to be required for certain companies mentioned earlier is meant to be the same as these watching committees.

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