An analysis of corporate legal structure and the evolution of an alternative ownership-control system.

by

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I hereby certify that this material which I now submit for assessment on the programme of study leading to the award of Doctor of Philosophy, is entirely my own work and has not been taken from the work of others save and to the extent that such work has been cited and acknowledged within the text of my work.

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ABSTRACT

Chapter one is divided in two parts. Part 1 examines the component elements of the model company. Part 2 examines the way in which the model company hypothesized in Part 1 has been eroded. The chapter concludes that a combination of judicial interpretation and statutory intervention regarding the elements of the model has made it unworkable. Chapter two focuses on the model legal control element of the company, the board of directors. It examines firstly the model function of the board. It then examines how the exercise of the directors' managerial discretion can be interfered with by the members. It concludes that the board has been degraded to a secondary organ. Chapter three examines the effect of the institutional investor on the degraded model legal structure. It concludes that the presence of a large shareholder within the company with interests other than those of the company to pursue, has a further degrading effect on the model legal structure of incorporated companies. Chapter four focuses on the directors duty to act "bona fide in the interests of the company" and finds that the judicial definition of that duty has considered the shareholders interest as paramount. Here the directors' discretion within this duty to make decisions based on the long term or future interests of the shareholders has been eroded by remuneration schemes designed to create a concurrence of interests between the shareholders and the directors. Thus the directors have a duty to act in the interest of the shareholders, the majority of whom, within public limited companies, are institutional. Chapter five considers the conclusions from each of the above chapters and examines one particular example where the eroded model can be clearly seen. This chapter recommends regulating private and public companies separately and suggests some potential answers to the eroded model legal structure.

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CHAPTER ONE: THE EROSION OF THE MODEL LEGAL COMPANY.

Part 1.

1.0 The Model Legal Company.

This chapter describes a model of the limited company. To do so the chapter is divided into two parts. In Part 1 the thesis describes the component elements of the model company. In Part 2 the thesis examines the way the component elements of the model have been eroded to the point that the basic model hypothesized in Part 1 no longer exists. Part 2 concludes that the model company is now unworkable.

The thesis turns to examine three aspects of the model company. It begins with the decision of the House of Lords in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) where the company was held to be a legal entity, separate and distinct from its members. Thus once the requirements of the Companies Acts with regard to incorporation are complied with, a separate legal entity comes into existence.

The second element of the model company consists of the constitution of the company, the memorandum and articles of association. The memorandum provides the legal entity with its purpose through the objects clause. The articles of association provide the ownership and control structure of the company (the board of directors and general meeting), they regulate the interaction of those organs of the company, as well as providing a statement of the rights and obligations of the members and the company to each other.

The third element of the model arises from the decision in FOSS V HARBOTTLE (1843) 2 Hare 461. There it was held that the only the company could maintain proceedings in respect of wrongs done to it. Thus FOSS V HARBOTTLE (1843) 2 Hare 461, sustains and compliments both the decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.), and the ownership and control mechanisms in the articles of association by placing the cause of action in the company. Thus if the organs of the company do not instigate an action for a wrong to the company as a legal entity, no action can be brought.

1.1 The Decision in SALOMON V SALOMON.

The facts of the case were as follows. Salomon carried on a business as a leather merchant. In 1892 he formed the company Salomon & Co. Ltd. Salomon, his wife and five of his children were the members. The members of the family apparently holding the shares as nominees for Salomon. Salomon was also the managing director. The newly incorporated company purchased the leather business and the company immediately ran into difficulties. One year later the company was in liquidation and its assets were insufficient to discharge its liabilities to its unsecured creditors. The liquidator, on behalf of the unsecured creditors, brought an action alleging that the company was but a sham and a mere "alias" for Salomon. The Court of Appeal upheld this claim in doing so they looked at the motives of the promoters and members of the company, and as such Salomon was liable to indemnify the company against its trading debts.

The House of Lords unanimously reversed that decision. It held that the company was validly formed according to the Joint Stock Companies Act 1844, which only required that there be seven members, holding one share each. The business thus belonged to the company and not to Salomon. Salomon was an agent of the company, not the company his agent. Lord Halsbury L.C. stated at p.31:-

> [e]ither the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not.

The decision established that the company was a legal entity which was at law a different person altogether from the members. It has therefore a definable interest which is separate from its members.[1]

[1] On the issue of the separate legal personality of the company, see Ussher (1986: pp.16-57) and Pennington (1985: pp.46-52).

In giving his reasons for overturning the decision of the Court of Appeal, Lord Macnaghten stated:-

> [t]he company is at law a different person altogether from the subscribers ...; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers, as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

The importance of the case lies in the consequence which flow from the decision.

They can be articulated as follows: the fact that some of the subscribers to the memorandum and articles are mere nominees is irrelevant; the machinery of the Companies Acts may be used by an individual to carry on what is in economic reality his business; the company formed in compliance with the regulations of the Companies Acts is a separate person and not per se the agent or trustee of its' controller.

The application of the judgment can be seen in the following cases.

In MACAURA V NORTHERN ASSURANCE CO. [1925] A.C. 619 the appellant sold all the timber on his estate to a company in return for the issue to him of the whole share capital of the company. The appellant then later insured the timber with a policy taken out in his own name. The timber was destroyed by fire some time later. The insurance company contended that he had no insurable interest in the timber. Lord Wrenbury agreeing with the insurance company's contention, stated that a member:-

> even if he holds all the shares is not the corporation and.....neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation.

In BATTLE V IRISH ART PROMOTION CENTRE LTD. [1968] I.R. 252 the defendant company was being sued but had no assets with which to defend the action. The managing director, who was also the major shareholder, wished to conduct the defence of the company. He maintained that a judgment in default against the company would reflect on his standing and reputation in the business community. The court considered this. O'Dalaigh C.J. dismissed the request stating:-

> [t]his is an infirmity of the company which derives from its own very nature. The creation of the company is the act of its subscribers; the subscribers, in discarding their own personae for the persona of the company, doubtless did so for the advantages which incorporation offers to traders. In seeking incorporation they thereby lose the right of audience which they would have as individuals; but the choice has been their own...[He] cannot as major shareholder and managing director now substitute his persona for that of the company.[2]

Thus, as in PEARLBERG AND O'BRIEN [1982] Crim. L.R. 829, it is possible for a member to steal from his own

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[2] See also GENERAL ACCIDENT CORPORATION V MIDLAND BANK LTD. [1940] 3 ALL E.R. 252.

company.[3]

The principle that the company is a separate legal entity lies at the heart of the model company. It impacts on the other elements of the model and must be kept in mind as the thesis now turns to consider the second constituent of the model company.

1.2 The Memorandum, Articles of Association and Section 25.

The Memorandum.

The model company constitution is contained in the Companies Act 1963 in the form of the memorandum (sections 5-10) and also the articles of association (sections 11-15) which creates a management and ownership structure and regulates the behaviour of the organs.

It is from the memorandum of association, after the registration procedure is complied with, that the company defines its existence as a separate legal entity.[4]

More specifically section 5 (1) of the 1963 Act, states that:-

> any seven or more persons or, where the company to be formed will be a private company, any two or more persons associated for any lawful

[3] See ATT-GEN. REFERENCE (NO.2 OF 1982) [1984] 2 W.L.R. 447; and RE SULLIVAN [1984] Crim. L.R. 405. For an analysis of the difficulties surrounding this type of corporate theft, see Jefferson (1993: pp.180-181) and Virgo (1991: pp.464-489).

[4] SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.).

> purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of this Act relating to registration, form an incorporated company, with or without liability.

The act of association is formalised and acknowledged legally through the subscription to the memorandum and compliance with the registration procedure.

The requirements as to the content of the memorandum are set out in section 6:-

> [t]he memorandum of every company must state--
> (a) in the case of a public limited company, the name of the company, with 'public limited company' or 'cuideachta phoibli theoranta' as the last words of the name;.....
> (c) the objects of the company.

Section 6 (2) states, that if the company is limited by shares the memorandum must also state that the liability of its members is limited.

Where a company has a share capital section 6 (4) states:-

> the memorandum must also, unless the company is an unlimited company, state the amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount;

The subscribers to the memorandum must take at least one share each, (section 6 (4) (b)) and must write opposite to his name the number of shares he takes, (section 6 (4) (c)).

The Companies Act 1963 places the control over the alteration of the company's constitutional document (the memorandum) in the hands of the members. Section 10 (1) states:-

> [s]ubject to subsection (2) [an application to court to cancel an alteration of the memorandum], a company may, by special resolution, alter the provisions of its memorandum abandoning, restricting or amending any existing object or adopting a new object and any alteration so made shall be valid as if originally contained therein, and be subject to alteration in like manner.

The legal entity has thus a purpose to pursue, defined in the objects clause. If the company trades outside of the objects clause, the transaction will be ultra vires and void.[5] Thus in RE JON BEAUFORTE (LONDON) LTD. [1953] Ch. 131 the company was established to manufacture costumes and gowns. It traded as a manufacturer of veneer panels. No change had been made to the objects clause. The note-paper of the company described the company as a veneer panel manufacturer. The company went into liquidation and the trade creditors of the company sought to be paid for goods and services supplied to the company. They were met with the argument that the transactions were outside the objects and therefore void. It was held that the trade creditors were not entitled to be paid. They had actual notice of the business being carried on (the note-paper) and constructive notice that the business was not within the

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[5] Or if as in RE GERMAN DATE COFFEE CO. (1882) 20 Ch. D. 169, (C.A.) the objects of the company can no longer be obtained, the company must be wound up.

company's objects.[6] Thus once the company goes beyond its defined objects the transaction will be ultra vires and void.[7]

The Articles of Association.

Another part of the second element of the model company is the articles of association which regulates the internal administration of the company. Here the thesis examines three aspects of the articles. The separation of ownership and control, the regulation of the interaction of the organs and the residual function of the general meeting.

Section 11 of the Companies Act 1963 (as amended by section 2 of the Companies (Amendment) Act 1982) provides for the registration of articles of association with the memorandum, "signed by the subscribers to the memorandum and prescribing regulations for the company."

The Companies Act 1963 contains a model set of regulations and provides in section 13 (1) that "[a]rticles of association may adopt all or any of the regulations contained in Table A." Further to this section 13 (2) provides that:-

> [i]n the case of a company limited by shares and registered after the operative date, if articles are not registered or, if articles are

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[6] See also RE INTRODUCTIONS LTD. [1970] Ch. 199 (C.A).

[7] For an examination of the history and nature of the ultra vires rule, see Mac Cann (1992: pp.79-86).

registered, in so far as the articles do not exclude or modify the regulations contained in Table A, those regulations shall, so far as applicable, be the regulations of the company in the same manner and to the same extent as if they were contained in duly registered articles.

The articles must comply with section 14 of the 1963 Act and "be signed by each subscriber to the memorandum in the presence of at least one witness who must attest the signature." Section 15 (1) places the control of the internal regulations in the hands of the general meeting in that it states "a company may by special resolution alter or add to its articles".

Incorporation has a critical effect on the contractual nexus of the members and the company. This is set out in section 18 (2):-

[f]rom the date of incorporation mentioned in the certificate of incorporation, the subscribers of the memorandum, together with such other persons as may from time to time become members of the company, shall be a body corporate with the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this Act.

Thus the 1963 Act details the model company's legal personality as defined by SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.). Once the incorporation procedure is complied with the company is a separate legal entity.

The Separation of Ownership and Control.

One aspect of the model that is significant, is contained within the articles of association.[8] This is the separation of the ownership and control powers.[9]

The model company has two organs, the members in general meeting and the board of directors. The management powers are delegated to the board by the members, but with some functions reserved by the members in general meeting.[10] Thus management can operate the day to day function of the company subject to the continuing approval of the members.

The Irish Table A articles were substantially adopted from the Table A articles contained in the U.K Companies Act 1948. The Table A articles in the U.K Act constructed a model along the lines of the neo-classical theory of the firm, where the company is a "black box" owned by the shareholders and managed on their behalf by directors who take various factors of production, combine them and create new products (Tomlinson (1986: p.220)).

The primary feature of the Irish Table A is that it maintains this neo-classical model by creating through Article 80, a company which consists of two organs, the general meeting and the board of directors.[11] The

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[8] See the Companies Act 1963, Table A.

[9] Article 80.

[10] See below at p.18, The Residual Function of the General Meeting.

[11] Article 80.

managerial power which is inherent in the ownership rights of the members, is delegated upwards from the general meeting to the board of directors, residual power residing in the organ of the general meeting.

It should be noted that a company limited by shares is not required to register articles on formation.[12] It is, though, almost invariably the case that a company will register articles upon formation. If the company does not register a set of articles on formation then it is deemed to have adopted Table A.[13] Even where a company does register articles on formation, it is deemed, as provided in section 13, to adopt Table A anyhow, except where modified or excluded. It is normal in practice for most companies to adopt Table A with some amendments. In all cases the articles contain a separation of ownership and control.[14]

The importance of Table A in shaping the law with regard to companies is best put by Ussher when he states:-

> [m]ost of the regulations in Table A have a long history, going back to the 1908 [Companies (consolidation)] Act and beyond, and therefore,

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[12] Companies Act 1963, section 11 (as amended by section 2 of the Companies (Amendment) Act 1982).

[13] Companies Act 1963, section 13.

[14] The Council of The Stock Exchange currently requires the articles of each quoted company to comply with the provisions set out in The Yellow Book (1994). Those provisions concern amendments to Table A. They relate specifically to the separation of the ownership-control elements of the company.

> though they may not be law, a body of law has grown up around them as a result of their interpretation in the many jurisdictions possessing the British company law heritage (1986: p.62).

Flynn (1991: pp.101-102) while exploring the apparent divergence between the wording of article 80 and its interpretation in the case law, notes the traditional assumptions regarding ownership and control. He states:-

> [a]ny consideration of the power relationships within the corporation should initially focus on the way in which the directors and other members of the managerial group actually interact with the general shareholding body. The importance of this relationship is rooted in our corporate law system's standard reaction to these groups, treating them as the sole constituent elements of the corporate entity, simultaneously denying other corporate constituencies any relevance, let alone power.

The "corporate law system's standard reaction" as Flynn identified above has evolved from the model legal structure set out in the Table A articles contained in the Companies Act 1963.[15]

Thus Gower (1979: p.10) refers to a model company where ownership is separated from control, when he makes the following general comment:-

> [t]oday the great bulk of industrial enterprise is in the hands not of individual entrepreneurs but of large public companies in which many individuals have property rights as shareholders and to the wealth of which they have directly or indirectly contributed. Investments in companies probably constitute

[15] Companies Act 1963, First Schedule.

> the most important single item of property, but whether this property brings profit to its owners no longer depends on their energy and initiative but on that of the management from which they are divorced. The modern shareholder has ceased to be a quasi-partner and has become instead simply a supplier of capital.

The vesting of the control power upwards to the directors occurs in Table A article 80. It states:-

> [t]he business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and registering the company and may exercise all such powers of the company as are not, by the Companies Act 1963 to 1983 or by these regulations, required to be exercised by the company in general meeting, subject, nevertheless, to any of these regulations, to the provisions of the Act and to such directions, being not inconsistent with the aforesaid regulations or provisions, as may be given by the company in general meeting; but no direction given by the company in general meeting shall invalidate any prior act of the directors which would have been valid if that direction had not been given.

It should be noted that the powers of management are vested in the directors as a board, not in the directors as individuals.

In SALMON V QUIN & AXTENS LTD. [1909] 1 Ch. 311. (C.A.); [1909] A.C. 442, (H.L.) it was accepted that the general meeting cannot interfere with the powers of the board unless they act in conflict with the Companies Acts or the articles.[16] The general meeting can of course amend the powers of the directors through a special resolution or remove the directors through an ordinary

[16] The directors cannot do anything illegal or ultra vires.

resolution.[17]

Regulation of the Interaction Between the Board of Directors and the General Meeting.

Table A articles 92-100 provide for the retirement of directors by rotation and their re-election by the general meeting. Any casual vacancies may be filled until the next general meeting, and both the board and the general meeting may appoint additional directors. Power to remove a director lies with the general meeting, who may do so by ordinary resolution. A member or members holding 51 per cent of the voting shares in the company can be sure of electing the whole of the board or at least having a veto over the membership of that board.

The ownership organ of the company is created by Table A regulations 47-50. The company is required to "each year hold a general meeting as its annual general meeting in addition to any other meeting in that year."[18] Thus the members of the company must meet at least once a year to exercise their control function. Regulation 49 states that "all general meetings other than annual general meetings shall be called extraordinary general meetings" and regulation 50 places the power to call a general meeting in the hands of the directors who "may, whenever they think fit, convene an extraordinary general

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[17] Even a director for life can be removed if the articles are amended by special resolution.

[18] Regulation 48.

meeting".[19]

Regulation 50 also provides for the members to requisition an extraordinary general meeting in accordance with the Companies Act 1963, section 132, which provides that:-

> [t]he directors of a company, not withstanding anything in its articles, shall, on the requisition of members of the company holding at the date of the deposit of the requisition not less than one-tenth of such of the paid up capital of the company as at the date of the deposit carries the right of voting at general meetings of the company..., forthwith proceed to convene an extraordinary general meeting.

Thus the intention is that the shareholder, through his participation in the general meeting, may exercise control or have an input into the exercise of control. The exercise of this control is limited by the fact that there is only one compulsory general meeting each year, and the right to call a general meeting is limited to the directors and those members who fulfil the share qualification in section 132 of the Companies Act 1963.

The articles define the general meeting as the unit of ownership. They go on to regulate its conduct and interaction with the board of directors. The following paragraphs detail the procedural aspects of the general meeting's powers.

Table A regulation 51 provides minimum notice

[19] Failure by the directors to call a meeting may lead to shareholder action, see Milman (1988: pp.186-187), and Fox (1988: pp.1261-1262).

provisions for the annual general meeting of 21 days and 14 days for all other general meetings. These notice provisions are clearly intended to curb abuses of the directors' power to call general meetings and to give the members adequate time to arrange to attend a meeting.

The proceedings at general meetings are governed by regulations 53 to 62. These regulations provide that no business shall be transacted at the general meeting unless the quorum is present, and unless otherwise provided the quorum shall be three. The chairman of the board of directors shall be the chairman of the general meeting and where there is an equality of votes the chairman shall have a casting vote. Voting at the general meeting shall be by a show of hands, unless a poll is demanded by the chairman, or at least three members present in person or by proxy, or by any member or members present in person having shares which are equal to one tenth of the total sum paid up on all the shares conferring the right to vote.

Regulations 63 to 73 deal in detail with the exercise of the members' vote. The regulations provide for voting on a show of hands, and on a poll where each share carries one vote. They deal specifically with the qualifications of the member; for example, if a member is insane, his vote may only be exercised through his committee, receiver, guardian or other person appointed by the court. In order to exercise the membership rights attached to the ownership of the company's shares, all sums due to the company in respect of shares held must be paid before a member is entitled to vote at any general meeting. The members' votes can also be exercised by proxy, and any instrument appointing a proxy shall be in writing under the hand of the appointer or his attorney. A valid instrument confers the right to demand a poll. Regulation 74 allows any body corporate which is a member of the company to appoint any person to represent it at any meetings of the company. That person shall have all the powers the body corporate could exercise as a member of the company.

The Residual Function of the General Meeting.

The general meeting after the upward delegation of the management powers to the board retains a number of powers.[20] The powers that remain to the general meeting come from a number of sources. The Companies Acts 1963-1990 give control over various important management decisions to the general meeting, by requiring special resolutions to be passed before the board can proceed. Thus the Companies Act 1963 requires a special resolution to change the company name, to alter the objects or articles of association, to authorise an application to Court seeking a reduction of capital, for the company to purchase its own shares, to wind up the company voluntarily (except on the grounds of insolvency or under

[20] Companies Act 1963, Table A, article 80. For a discussion of the effect of this article see the judgment of O'Connor M.R. in RE GALWAY AND SALT HILL TRAMWAYS CO. [1918] 1 I.R. 62.

the provisions of the articles), or to present a petition for an order for a compulsory winding up.[21] The articles also reserve specific functions to the general meeting such as the power contained in article 76 of Table A to fix the remuneration of the directors.

As well as specific reserved functions the general meeting retains power through its general role as a legislator. This function allows it to amend the company's constitutional documents through special resolutions and also to exercise its ordinary resolution power.[22]

The general meeting has a truly residual power in a number of situations, such as when there is no board of directors. Then the general meeting may exercise all the functions of the company.[23] The general meeting may also ratify acts which were ultra vires the directors but intra vires the company.[24]

One of the most controversial residual powers of the company is the power of the general meeting to ratify wrongs done by the directors to the company. The leading English authority on this issue, BAMFORD V BAMFORD [1968]

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[21] Companies Act 1963, sections 23, 10, 15, 72, 60, 251, 213, respectively.

[22] The Companies Act 1963, section 182 states that removal of a director is by ordinary resolution. Appointment is as per the articles of association, usually by ordinary resolution.

[23] FIRTH V STAINES [1897] 2 Q.B. 70 and MAHONY V EAST HOLYFORD MINING CO. (1875) L.R. 7 (H.L.).

[24] RE BURKE CLANCY & CO. LTD. H.C., UNREPORTED, 23 MAY 1974, IRVINE V UNION BANK OF AUSTRALIA (1877) 2 App. Cas. 366.

3 W.L.R. 317 concerned directors who in order to ward off a take-over bid from another company, allotted 500,000 shares in their company to a third company. The company's articles of association placed the disposal of all unissued shares in the hands of the directors. Two shareholders challenged the allotment of the shares by the directors, on the grounds that they had not acted "bona fide in the interests of the company."

The directors then convened an extraordinary general meeting and a resolution approving the allotment to the third company was passed. The question arose whether, assuming that the directors had not acted bona fide for the benefit of the company, the action of the general meeting cured the irregularity. Harman L.J. stated:-

> [t]he only question is whether the allotment, having been made, as one must assume, in bad faith, is voidable and can be avoided at the instance of the company .... at their instance only and of no one else, because the wrong, if wrong it be, is a wrong done to the company. If that be right, the company, which had the right to recall the allotment, has also the right to approve of it and forgive it; and I see no difficulty at all in supposing that the ratification by the decision of December 15 in the general meeting of the company was a perfectly good "whitewash" of that which up to that time was a voidable transaction. And that is the end of the matter.

It must be noted that the position in Ireland is somewhat different. Budd J.[25] sets out clearly in NASH V LANCEGAYE SAFETY GLASS (IRELAND) LTD. (1958) 92 I.L.T.R.

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[25] The judge in the case was Budd J. but the report refers to Dixon J.

11 that elements of bad faith in the exercise of directors' powers will render the act or acts involved, unratifiable by the general meeting.

Not all wrongs can be easily ratified by the general meeting. The general meeting cannot by a simple majority ratify a breach of an individual membership right.[26] The general meeting could, though, alter the constitutional document conferring the membership right by passing a special resolution.[27]

Certain wrongs remain un-ratifiable, and the company can always maintain a right of action against the wrongdoer. Examples of un-ratifiable wrongs are transactions which are ultra vires the company,[28] a criminal act of any sort,[29] or a fraud on the minority.[30]

The final residual power of the general meeting is the ability of the members to pass a resolution releasing the directors from the duties owed by them to the company in advance of any breach.[31] This can be done only if the

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[26] The section 25 contract gives the shareholder a right of action to rectify the wrong.

[27] This itself would be subject to the provisions of the articles of association regarding alteration of class rights and the provisions of the Companies Acts 1963-1990.

[28] See HENNESSY V NATIONAL AGRICULTURAL AND INDUSTRIAL DEVELOPMENT ASSOCIATION [1947] I.R. 159.

[29] See COCKBURN V NEWBRIDGE SANITARY STEAM LAUNDRY CO. LTD. [1915] 1 I.R. 237 at 255 where O'Brien L.C. considered that a company cannot ratify its own criminality.

[30] See MENIER V HOOPER'S TELEGRAPH WORKS (1874) L.R. 9 Ch. App. 350.

[31] SHERRARD V BARRON [1923] 1 I.R. 21.

anticipated breach is one which is ratifiable. This problematical element of the model company will be dealt with later in chapter two.[32]

<u>The Rights and Obligations of the Members and the Company Defined in the Articles of Association.</u>

The final part of the second element in the model company concerns the relationship between the members and the constitutional documents. Central to this relationship is the Companies Act 1963, section 25 (1).

Section 25 (1) states:-

> [s]ubject to the provisions of this Act, the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, to observe all the provisions of the memorandum and of the articles.

This section has a long history in both the statute and case law dealing with the articles of association. The origin of the wording may be traced to the U.K. Joint Stock Companies Act 1844. The 1844 Act took the existing method of forming an unincorporated joint stock company[33] and added the benefits of incorporation once the company followed the proper registration procedure. The deed of settlement was the constitutional document and formed a

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[32] See Chapter two, pp.120-121.

[33] By deed of settlement.

contract between the members who sealed it.

The Joint Stock Companies Act 1856 removed the deed of settlement as the constitutional document of a joint stock company, and introduced instead the memorandum and articles of association. Along with this new format, the 1856 Act introduced a provision similar to section 25 (1) above in order to maintain the contractual relationship between the members.

Ross J. in CLARK V WORKMAN [1920] 1 I.R. 107 stated:-

> [w]e must first consider what is the position of a shareholder in this and similar companies. He does not hold his property simply at the mercy of the majority. His rights are carefully guarded, and his chief protection consists in the articles of association. Now, what do the articles of association amount to in point of law? They constitute a contract between every shareholder and all the others and between the company itself and all the shareholders. It is a contract of the most sacred character and it is on the faith of it that each shareholder advances his money.[34]

Thus the articles of association constitute a statement of the rights and obligations of the members and the company towards each other, which are enforceable contractually.

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[34] Ross J. is here referring to the Companies Act 1908, section 14. See also the judgment of Farwell L.J. in SALMON V QUINN & AXTENS LTD. [1909] 1 Ch. 311. (C.A.); [1909] A.C. 442, (H.L.).

1.3 FOSS V HARBOTTLE: Majority Control.

From the above it can be seen that the general meeting makes decisions on a majority basis. Resolutions can be by simple majority or in the case of an amendment to the articles, by special resolution requiring a 75% majority. The democratic principles applied here come from ATT. GEN. V DAVEY (1741) 2 Atk. 212 where at common law it was recognised that corporations vote by majority.[35]

In FOSS V HARBOTTLE (1843) 2 Hare 461 the company in general meeting refused to take an action against the directors who were alleged by the minority shareholders to have wronged the company. The court dismissed an action by the minority shareholders who sought to force the directors to put right the wrong to the company. It held that only the company had a right to bring such an action. Thus it lies with the organs of the company to instigate an action. Such an action should be brought by the board of directors as the control organ,[36] if the directors can not, or will not, bring an action, the power reverts to the general meeting.[37]

The principles in FOSS V HARBOTTLE (1843) 2 Hare 461

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[35] There Hardwicke L.C. stated "[i]t cannot be disputed that wherever a certain number are incorporated a major part of them may do any corporate act.."

[36] SHAW & SONS (SALFORD) LTD. V SHAW [1935] 2 K.B. 113, (C.A.).

[37] PENDER V LUSHINGTON (1877) 6 Ch. D. 70.

have been reiterated in cases since 1843. In MAC DOUGALL V GARDINER (1875) 1 Ch. D. 13 an individual shareholder suing on behalf of himself and the other shareholders complained of a breach of the articles by the chairman of the general meeting. The suit was rejected as the litigation should have been in the companies name.

In O'NEILL V RYAN AND OTHERS [1990] I.L.R.M 140 the plaintiff here alleged that the principle shareholder in Ryanair Ltd. had entered into a price fixing arrangement with Aer Lingus. He claimed that Ryanair's interests had been damaged and that the value of his minority shareholding had been reduced. Lynch J. described it as "a classic case to which the rule in FOSS V HARBOTTLE applies." Only the company could bring such an action.

Thus the legal entity of the company which arises due to the mechanism of the Companies Acts and SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) is controlled by the organs created in the articles of association and enforced through the rule in FOSS V HARBOTTLE (1843) 2 Hare 461.

Part 2.

1.4 The Erosion of SALOMON V SALOMON.

The starting point in examining the erosion of the principle expounded in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) begins not with the judgment of the House of Lords but with the judgment in the Court of Appeal. The views of the judges in the Court of Appeal[38] differ so widely from the opinion of the House of Lords that the gulf warrants examination. Taking the statute as the sole guide Lord Halsbury L.C. found that, since the company was incorporated in accordance with the Act, it was ex hypothesi a valid entity. The motives of the six nominal shareholders were unimportant as long as there was no fraud.

On the issue of fraud Lord Halsbury L.C. decided that when all the shareholders are aware of the conditions under which the company was formed and the conditions of purchase it was impossible to maintain that the company was defrauded. This was entirely consistent with ERLANGER V NEW SOMBRERO PHOSPHATE CO. (1878) 3 App. Cas. 1218. The rest of the judges followed a similar line. The important difference between the higher court and the Court of Appeal is that the House of Lords firmly restricted the interpretation of the statutory intention to the words contained in the Act.[39]

In his judgment Lord Halsbury states clearly that he is using only the words of the statute in his attempt to determine the main question. He states "I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself." He continues to criticise the

[38] SALOMON V SALOMON & CO. [1895] 2 Ch. 337 (C.A.).

[39] Joint Stock Companies Act 1844.

decisions of the judges in the Court of Appeal for "inserting into the Act of Parliament limitations which are not to be found there".

The judges in the Court of Appeal were, in their consideration of elements outside the Act, attempting to get to the intention of the legislators. Lord Halsbury took a narrower view of the considerations which could be brought to bear on the Salomon case. He considered only the wording of the Act.

The judgment of Kay L.J. in the Court of Appeal would appear to merit more discussion than the dismissal of Lord Halsbury would suggest. There Kay L.J states:-

> [t]he statutes were intended to allow seven or more persons, bona fide associated for the purpose of trade, to limit their liability under certain conditions and to become a corporation. But they were not intended to legalise a pretended association for the purpose of enabling an individual to carry on his own business with limited liability in the name of a joint stock company.

Kay L.J. is there attempting to ascertain the true meaning of the Act. In doing so he considered elements outside the wording of the Act, the motives of the promoters and members. The subsequent development of the law, which has provided wide exceptions to the judgment of Lord Halsbury, also considered elements outside the wording of the Act.

It is clear that the company as a separate legal entity is not a sacred doctrine. Ussher (1986: pp.24-25) considers the Salomon judgment a statement of normality from which the courts may depart.[40] He further catalogues those departures into five categories.[41] The judiciary may thus depart from the rule in these circumstances. When the company is being used to circumvent an existing legal duty.[42] When the court has a discretion to grant a remedy it is likely that it will investigate elements behind the corporate "veil."[43] Where the law requires that the courts determine the corporation's status as a person.[44] Where the corporation is being used as an artificial scheme for the avoidance of tax.[45] Where the

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[40] For a consideration of the situations where the rule in SALOMON V SALOMON & Co. [1897] A.C. 22 (H.L.) is reversed pursuant to various statutory provisions, and personal liability is imposed on the shareholders or the directors or both, for all or part of the debts and liabilities of the company, see Mac Cann (1991d: pp.206-210) and Mac Cann (1991e: pp.232-236). There he concludes:-

> it can be seen that although the Rule in SALOMON V SALOMON has not been abolished the principle of limited liability has been gradually eroded by the Companies Acts...

[41] See also Keane (1991: p. 123), Wardman (1994: pp.179-181) and Pennington (1985: pp.53-63) where they all provide that there are five exceptions to the Salomon rule.

[42] See the judgment of Meredith M.R. in CUMMINGS V STEWART [1911] 1 I.R. 236 at 240 for a statement of when this exception applies. See further GILFORD MOTOR CO. LTD. V HORNE [1933] Ch. 935 and JONES V LIPMAN [1962] 1 ALL. E.R. 442.

[43] See the judgment of Devlin L.J. in MERCHANDISE TRANSPORT LTD. V BRITISH TRANSPORT COMMISSION [1962] 2 Q.B. 173 at 202 and also RE BUGLE PRESS LTD. [1961] Ch. 270.

[44] Lord Parker in DAIMLER COMPANY LTD. V CONTINENTAL TYRE (GREAT BRITAIN) COMPANY LTD. [1916] 2 A.C. 307 looked at the individual members of the company to determine its character. See also UNIT CONSTRUCTION LTD. V BULLOCK [1960] A.C. 351 (H.L.).

[45] FIRESTONE TYRE & PUBLIC COMPANY V LLEWELLIN [1957] 1 ALL E.R. 561.

interests of justice require it.[46]

The judgment of Lord Halsbury L.C. has effectively been set aside.[47] Lord Denning in LITTLEWOODS STORES V I.R.C. [1969] 1 W.L.R. 1241 was vocal on the point where he stated:-

> [t]he doctrine laid down in Salomon's case has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit.

Gower (1979: p.131) felt:-

> there is evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group.[48]

The judiciary now seem to be doing that which Lindley,

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[46] See the judgment of Costello J. in POWER SUPERMARKETS LTD. V CRUMLIN INVESTMENTS LTD. H.C., UNREPORTED, JUNE 22 1981 where he stated "a Court may, if the justice of the case so requires treat two or more related companies as a single entity..." See also the judgment of Lord Morris of Borth-y-Gest in LEE V LEE'S AIR FARMING [1961] A.C. 12 where he suggested that the existence of "a sham or a simulacrum" might lead to a finding that the company and the controller were not separated.

[47] Lowry (1993b: pp.41-42) examines the judicial practice of "lifting the corporate veil". He concludes:-

> [t]he problem that can naturally arise from this approach is the uncertainty which it casts over the safety of incorporation. The use of the policy to erode established legal principle is not necessarily to be welcomed.

[48] Lord Denning repeated this statement from Gower in D.H.N. LTD. V TOWER HAMLETS [1976] 1 W.L.R. 852.

Lopes and Kay L.JJ. did in SALOMON V SALOMON & CO. [1895] 2 Ch. 337 where they looked at the membership of the company to determine whether it was a sham.[49] [50] [51]

1.5 Restricting the Scope of the Memorandum and section 25.

The Memorandum.

If a company trades outside the ambit of its objects clause that transaction will be ultra vires and void at common law. The rule led to a number of hardships[52] In order to redress the balance, the legislature enacted section 8 of the Companies Act 1963. Section 8 modified the ultra vires rule where the third party is not actually aware that the transaction was ultra vires.

The legislature were obliged by a European Community Directive[53] to enact Statutory Instrument 163/1973.

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[49] For an in-depth examination of when the veil of incorporation will be "lifted", "peeped behind", "penetrated", "extended" or "ignored", see Ottolenghi (1990: pp.338-396).

[50] Further erosion occurs in a winding up of a company on the "just and equitable" grounds in the Companies Act 1963, section 213. There the company has been treated as analogous to a partnership.

[51] See Gallagher and Ziegler (1990: pp.292-313) for an examination of when the courts will at common law lift the veil of incorporation. They conclude that the lifting of the veil impacts on other aspects of the law such as the directors' duty to the company as a whole, individual taxation principles, and the rule in FOSS V HARBOTTLE (1843) 2 HARE 461.

[52] See RE JON BEAUFORTE (LONDON) LTD. [1953] Ch. 131 above.

[53] The First Council Directive on Companies No. 68/151/E.E.C.

Section 6 essentially modifies the ultra vires rule in the same way section 8 does. If the person dealing with the company deals in good faith and the directors decide on the transaction then section 6 provides that the transaction is valid.[54]

The statutory erosion of the ultra vires rule has meant that the objects clause is to all intents and purposes obsolete. The company as a legal entity has no longer any direction provided by the objects clause.

The Erosion of the Statutory Contract.

The section 25 contract set out above in Part 1 is, at face value, a statement of the rights and obligations of the members and the company. It is here argued that the contract itself has inherent difficulties and that the judiciary, while recognising these difficulties, have been over-restrictive in defining its nature as a contract. The result of this over restrictive approach has been a degradation of the contractual nature of the articles, to the extent that the rights and obligations of the parties are no longer certain.

The problems created by a statutory contract for the judiciary arose in defining the boundaries of such an unusual contract.

Some of the problems were obvious, a contractual relationship is certain, whereas the relationship arising

[54] For a consideration of the English position, see Ferran (1992: pp.124-128).

from the articles is alterable.[55] In a contractual relationship, generally only the contracting parties can be bound but the articles of association bind even third parties[56] who are not parties to the initial document.

Keane, discussing the nature of the relationship created by section 25, states:-

> [i]t should also be remembered that any contract which can be spelled out from the articles between the company and its members differs significantly from other contracts, since it is always open to the company unilaterally to alter the terms of the contract by amending the articles in the manner permitted by law. (1991: p.63)

One thing appears certain from the case law: it is not a contract like other contracts. Steyn L.J. stated in BRATTON SEYMOUR SERVICES CO. LTD. V OXBOROUGH [1992] B.C.L.C. 693:-

> [i]t derives its binding force not from a bargain struck between parties but from the terms of the statute. It is binding only insofar as it affects the rights and obligations between the company and the members acting in their capacity as members. If it contains provisions conferring rights and obligations on outsiders, then those provisions do not bite as part of the contract between the company and the members, even if the outsider is coincidentally a member. Similarly, if the provisions are not truly referable to the rights and obligations of members as such it does not operate as a contract. Moreover, the contract can be altered by a special resolution

[55] Within statutory confines.

[56] Future shareholders in the company.

> without the consent of all the contracting parties. It is also, unlike an ordinary contract, not defeasible on the grounds of misrepresentation, common law mistake, mistake in equity, undue influence or duress. Moreover, as Dillon L.J. has pointed out, it cannot be rectified on the grounds of mistake.

The company in this case argued that in order to give business efficacy to the articles a term should be implied into the articles. Dillon L.J. referred to this concept and dismissed it. Thus normal rules regarding contracts do not apply.[57]

Section 25 (1) creates a contract where in fact there is none.[58] The reason such an unusual contract was created was as an attempt to bridge the changeover between the deed of settlement company and the new company formed under The Joint Stock Companies Act 1856.

The practical problem for the legislature was that while the old deed of settlement created a contractual relationship between the members who sealed it, the new constitutional documents[59] would not. The answer was to create an artificial contract.[60]

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[57] See SCOTT V FRANK F SCOTT (LONDON) LTD. [1940] 3 ALL E.R. 508 where it was held that the court had no jurisdiction to rectify the articles of association of a company. Sir Christopher Slade referred to the judgment of Jenkins L.J. in HOLMES V LORD KEYES [1958] 2 ALL E.R. 129 in dismissing the business efficacy argument.

[58] At least not one fulfilling the normal conditions for the creation of a contract.

[59] Memorandum and articles of association.

[60] The original wording in the Act of 1844 evolved almost unchanged through the 1856 Act, the Companies Act 1862 section 16, the Companies Act 1948 section 20 (1), into the Irish Companies Act 1963 section 25 (1) and finally to reside unchanged

Capacity.

The judicial restriction of the section 25 contract began when the contract was interpreted in terms of the capacity of the person who wishes to rely upon the rights contained in the articles, as in ELEY V POSITIVE GOVERNMENT SECURITY LIFE ASSURANCE CO. (1876) 1 EX. D. 88 (C.A.). In that case the plaintiff argued that the articles formed a contract under which he could sue the company.[61] It was held that the articles of association were a matter between the shareholders inter se, or the shareholders and the directors, and did not create any contract between the plaintiff and the company.

In IN RE TAVERONE MINING CO.:PRITCHARD'S CASE (1873) L.R. 8 Ch. 956 at 960, Mellish L.J. stated:-

> I am of the opinion that the articles of association cannot be considered as a contract in writing between De Thierry and the company for the sale of the mine to them. It may no doubt, be the case, if no other contract was entered into, and if De Thierry signed these articles and they were acted upon, that a Court of Equity would hold that as between him and the company--from their acting upon it--there was a binding contract; but in themselves the articles of association are simply a contract as between the shareholders inter se in respect of their rights as shareholders. They are the deed of partnership by which the shareholders agree inter se.

In MELHADO V PORTO ALEGRE RY. CO. (1874) LAW REP. 9 C.P. 503 Lord Coleridge stated:-

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in the U.K. Companies Act 1985 section 14 (1).

[61] He relied on ORTON V CLEVELAND FIRE BRICK CO. 3 H.& C. 868, MAIR V HIMALAYA TEA CO. LAW REP. 1 Eq. 411 and MELHADO V PORTO ALEGRE RY. CO. (1874) LAW REP. 9 C.P. 503.

> [t]he action is brought on a clause in the articles of association, by which the directors are authorised to pay certain expenses if they should consider them to be properly deemed preliminary expenses. The declaration avers that all conditions were performed necessary to entitle the plaintiffs to be paid their expenses; and therefore I think we must take it that they were expenses which, if the directors had thought proper to pay them, the articles would have justified them in paying. The question, therefore, is whether an action will lie for the payment of these expenses, in pursuance of the articles of association, to which the plaintiffs were not parties.[62] I have come to the conclusion that no such action will lie.[63]

In BROWNE V LA TRINIDAD (1887) 37 Ch. D. 1, (C.A.) at 13,

Cotton L.J. stated:-

> [t]he memorandum of agreement of the 24th of November, 1844, is in no way a contract between the plaintiff and the company. It is said that it was adopted and incorporated into the articles, but I cannot accede to that. The company by its directors acted upon the agreement, but that does not make it binding upon the company. Then it is incorporated into the articles in such a way as to entitle the plaintiff to say I have such a contract between me and the company as can be enforced by a Court of law, and as I might enforce in equity by way of specific performance? That point is settled I think, by Eley v Positive Government Security Life Assurance Co. (1876) 1 EX. D. 88 (C.A.).

Lindley L.J. continued:-

> [h]aving regard to the terms of s.16, there would be some force, or in all events some

[62] Mellor J. said "[t]he plaintiffs were not in any way parties to the articles of association, and there was not, therefore, any express contract to pay them."

[63] Brett J. referred to KELNER V BAXTER (1866) L.R. 2 C.P. 174 in dismissing the argument for ratification of a contract made before the existence of the company.

> plausibility, in the argument that, being a member, the contract which is referred to in the articles has become binding between the company and him. Of course the argument is open to the difficulty that there could be no contract between him and the company until the shares were allotted to him, and it would be remarkable that, upon the shares being allotted to him, a contract between him and the company, as to a matter not connected with the holding of shares, should arise.

It should be emphasised once again that section 25 (1) only creates a contract with regard to the rights and duties of members in their capacity as members. Astbury J. stated in HICKMAN V KENT OR ROMNEY MARSH SHEEP-BREEDERS' ASSOCIATION [1915] 1 Ch. D. 881 Ch.:-

> I think this much is clear, first, that no article can constitute a contract between the company and a third person; secondly, that no right merely purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as for instance, as solicitor, promoter, director, can be enforced against the company; and, thirdly, that articles regulating the rights and obligations of the members generally as such do create rights and obligations between them and the company respectively.[64]

Thus if the articles confer rights on a member other than in his capacity as a member there is no contractual relationship established unless it is contained in a collateral contract established separately from the articles.

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[64] He referred to BISGOOD V HENDERSON'S TRANSVAAL ESTATES [1908] 1 Ch. 759 where Buckley J. stated "[t]he purpose of the memorandum and articles is to define the position of the shareholder as a shareholder, not to bind him in his capacity as an individual."

The cases above indicate that the judiciary had reached a consensus on this particular restriction on the contractual aspect of the articles of association.[65] The capacity of those seeking to rely upon the statutory contract is of great importance. Those outside the judicial interpretation of the statutory contract and those suing in a capacity other than members are excluded from enforcing the contract.[66] The certainty of the contract is now no longer clear.

Who May Rely on the Contract?

The judiciary also considered the extent to which the parties to the contract could enforce it against each other. The authorities clearly show that the company was entitled as against its members to enforce and restrain

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[65] Another problem was that the wording of the 1856 Act was such that it failed to take account of the separate legal identity of the company. As Gower states:-

> [u]nhappily, full account was not taken of the vital new factor, namely, the fact that the incorporated company was a separate legal entity, and the words "as if ...signed and sealed by each member" did not have added to them "and by the company." (1979: p.315).

The present wording of the Companies act 1963, section 25 (1) has evolved almost unchanged from the 1856 Act and so retains this anachronistic omission. The reason that the section was adopted straight from the U.K. Companies Act 1948 is perhaps because the case law had already dealt with the problems arising from the omission, and so there was no need to add extra wording to include the company.

[66] See RAM KISSENDAS DHANUKA V SATYA CHARAN LAW (1949) L.R. 77 I.A. 128 where the enforcement of a right contained in the articles by a shareholder had the indirect effect of protecting an outsider's position under those articles. For a consideration of this case and the position of outsider rights generally see Smart (1989: pp.143-147).

breaches of the articles of association.[67] The degree to which the articles could be enforced against the company by the shareholders was also clarified.[68]

In IMPERIAL HYDROPATHIC HOTELS CO. BLACKPOOL V HAMPSON (1882) 23 Ch. D. 1, 13 it was held that the members, in turn, have a corresponding right to take legal proceedings against the company to enforce the articles.[69] Thus as in JOHNSON V LYTTLE'S IRON AGENCY (1877) 5 Ch. D. 687[70] a member may sue the company in order to restrain it from excluding him from membership,[71] or a member may as in GRIFFITH V PAGET (1877) 5 Ch. D. 894 sue the company for a return of his capital on winding up.

The question as to the enforceability of the contract between members is one which has caused some

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[67] See MAC DOUGALL V GARDINER (1875) 1 Ch. D. 13, PENDER V LUSHINGTON (1877) 6 Ch. D. 70 and IMPERIAL HYDROPATHIC HOTEL CO. BLACKPOOL V HAMPSON (1882) 23 Ch. D. 1, 13.

[68] In BRADFORD BANKING CO. V BRIGGS (1886) 12 App. CAS. 29, 33. Lord Blackburn stated "[t]his property in the shares was, by virtue of the 16th section of the Act already quoted, I think, bound to the company as much as if he had (at the time he became the holder of these shares) executed a covenant to the company in the same terms as article 103, but I do not think it was bound any further."

[69] Cotton L.J. states: "we have really to consider whether in the present case the contract between these shareholders has been followed."

[70] In JOHNSON V LYTTLE'S IRON AGENCY (1877) 5 Ch. D. 687 James L.J. stated "[t]he notice.... did not comply strictly with the provisions of the contract between the company and the shareholders which is contained in the regulations of [T]able A."

[71] See also GREAT NORTH OF ENGLAND RAILWAY COMPANY V BIDDULPH 7 M. & W. 243 and NEWRY AND ENNISKILLEN RAILWAY COMPANY V EDMUNDS 2 Ex. 122.

difficulty.[72] It is clear that the articles constitute a contract between the members themselves but there has been much judicial debate as to whether a member can enforce a right contained in the articles directly against another member or whether the company is the proper plaintiff in such an action.

In WOOD V ODESSA WATERWORKS CO. (1889) 42 Ch. D. 636 Stirling J. stated that "[t]he articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholders and every other."

In SALMON V QUIN & AXTENS LTD. [1909] 1 Ch. 311. (C.A.); [1909] A.C. 442, (H.L.) Farwell L.J. considered Stirling J.'s words and stated "I think that is accurate subject to this observation, that it may well be that the Court would not enforce this covenant as between the individual shareholders in most cases."

Lord Herschell, dissenting in WELTON V SAFFERY [1897] A.C. 299, stated:-

> [t]he articles thus become in effect a contract under seal by each member of the company, and regulate his rights. They cannot, of course, diminish or affect any liability created by the express terms of the statute; but, as I have said, the statute does not purport to settle the rights of the members inter se, it leaves these to be determined by the articles (or the articles and the memorandum together), which are the social contract regulating these rights. I think it was intended to permit

[72] See the comments of Stirling J. and Farwell L.J. below and the confusion which the statement of Lord Hershell also below, has caused.

perfect freedom in this respect.

He continued:-

> [i]t is quite true that the articles constitute a contract between each member and the company, and that there is no contract between the individual members of the company, but the articles do not any less, in my opinion, regulate their rights inter se. Such rights can only be enforced by or against a member through the company, or through the liquidators representing the company, but I think that no member has, as between himself and another member, any rights beyond that which the contract with the company gives.

Following this accepted authority, the articles do not constitute a contract between the members themselves and the only proper plaintiff in an action to enforce rights contained in the articles between members is the company itself.[73]

On the other hand, there is much authority for the opposite view that the articles are enforceable by one member directly against another. Vaisey J. in RAYFIELD V HANDS [1960] Ch. 1 considered all the conflicting authorities[74] on the issue and stated:-

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[73] This would be entirely consistent with the company as a separate legal entity as in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) and with the company as proper plaintiff as in PRUDENTIAL ASSURANCE COMPANY LTD. V NEWMAN INDUSTRIES LTD. AND OTHERS [1982] Ch. 209.

[74] In particular he focuses on Lord Herschell's judgment in WELTON V SAFFERY [1897] A.C. 299 where he states "[i]t is quite true that the articles constitute a contract between each member and the company, and that there is no contract in terms between the individual members of the company; but the articles do not any the less, in my opinion, regulate their rights inter se."

> [n]ow the question arises at the outset whether the terms of article 11 relate to the rights of members inter se (that being the expression found in so many of the cases), or whether the relationship is between a member as such and directors as such. I may dispose of this point very briefly by saying that, in my judgment, the relationship here is between the plaintiff as a member and the defendants not as directors but as members....[75]

While Vaisey J. advocated the above approach, he was aware that it may be limited to specific circumstances. Vaisy J. discussed the judgment of Wynn-Parry J. in RE HARTLEY BAIRD LTD. [1954] 3 ALL E.R. 695 where he stated:- "[i]n my view, interpreting such a commercial document as the articles of association, the maxim ut res magis valeat quam pereat should certainly be applied, and I intend to interpret these articles in the light of that maxim." He referred also to HOLMES V LORD KEYES [1958] 2 ALL E.R. 129 where Jenkins L.J. stated "articles of association of the company should be regarded as a business document so as to give them reasonable business efficacy.."[76]

In his conclusion he stated:-

> [t]he conclusion to which I have come may not be of so general an application as to extend to the

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Vaisey J. regarding the above, comments that Lord Herschell's statement is somewhat cryptic.

[75] See also RE LEICESTER CLUB & COUNTY RACECOURSE CO. EX P. CANNON (1885) 30 Ch. D. 629. In particular Pearson J. at p.633 on the directors character as members.

[76] Both of these cases diminish further the contractual certainty of the articles of association.

> articles of association of every company, for it is, I think material to remember that this private company is one of a class of companies which bears a close analogy to a partnership.

This thesis would suggest that Vaisey J. was perhaps swayed too much by the statements of Wynn-Parry J. and Jenkins L.J.. He himself may have realised this as in the final line of his conclusion he states somewhat cryptically:-

> I do not intend to decide more in the present case than is necessary to support my conclusion, though it may be that the principles on which my conclusion is founded are of more general application than might be supposed from some of the authorities on the point.

There is still confusion with regard to which is the correct position. Barc and Bowen (1988a: p.126) agree that Lord Herschell's dicta, with the quasi-partnership exception provided by Vaisey J., represents the true position. Thus a member therefore cannot enforce the articles of association of a company directly against another member. The proper plaintiff in such a situation is the company itself.

Pennington does not agree and holds the opposite opinion. He states:-

> [h]owever it has now been settled that the members are contractually bound to one another to obey the provisions of the memorandum and articles so far as they relate to their rights and duties as members (Rayfield v Hands [1960] Ch. 1). In the case which so decided it was held that a member could enforce an obligation imposed by the articles on his fellow members who were directors to purchase his shares from him when he wished to dispose of them.
> (1985: p.67)

As can be seen from the above, the same authority, RAYFIELD V HANDS [1960] Ch. 1 is used to support differing views.

Gower states:-

> [t]he principal occasions on which this question is likely to be important arise when articles confer on members a right of pre-emption or first refusal when another member wishes to sell his shares (Borland's Trustees v Steel [1901] 1 Ch. 279), or, more rarely, a duty on remaining members to buy the shares of a retiring member (Rayfield v Hands [1960] Ch. 1). A direct action between the shareholders concerned is here possible; and for the law to insist on action through the company would merely be to promote multiplicity of actions and involve the company in unnecessary litigation (1979: pp.316-317).

Again RAYFIELD V HANDS [1960] Ch. 1 is used as authority for Gower's statement. It must be noted that Vaisey J. in RAYFIELD V HANDS [1960] Ch. 1 stated that his opinion was that his decision was one not one of general principle[77] and that it was particular to a quasi-partnership situation. The position in the U.K. is unclear; it seems illogical to place great emphasis on one part of Vaisey

[77] Although his final statement suggests otherwise.

J.'s judgment and to ignore another significant part.

The situation in Ireland appears much simpler as the case law follows only one strand of thinking on the subject of direct enforceability of the articles between the members. Ross J. in CLARK V WORKMAN [1920] 1 I.R. 107 laid down the rule which has been followed since.[78] Thus a right contained in the articles can be enforced directly member to member. Indeed this principle was not a new one to Irish law, it had it origins in ATT. GEN. FOR IRELAND V JAMESON [1904] 2 I.R. 644 (K.B. DIVISION); [1905] 2 I.R. 218 (C.A.) a case dealing with pre-emption rights where the majority judgments accepted direct enforcement of the articles between members.

The Proper Plaintiff.

The deficiencies in the contractual nature of the articles of association are widespread. They stem not only from the unusual contractual nature of the articles but from a confused judicial interpretation.

The uncertainty of the articles is compounded finally and terminally, when many of the duties imposed by the articles of association are construed as being owed not to the members but to the company as an entity.

Thus following the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 the company is the proper plaintiff. Even though the members fulfil the capacity criteria they may not be able to sue as the cause of action belongs to the

[78] See above statement of Ross J.

company or will have to undergo the mechanism of the derivative action.

In MOZLEY V ALSTON (1847) 1 Ph. 790 the directors failed to retire by rotation as provided by the articles. They were treated as having committed a wrong to the company rather than breaching individual members rights regarding re-election. In MAC DOUGALL V GARDINER (1875) 1 Ch. D. 13 the court refused to recognise an individual shareholder's right to a poll.

These cases are clearly confused. To an extent the judiciary have categorised certain rights within the articles as personal thus not requiring the application of FOSS V HARBOTTLE (1843) 2 Hare 461. In PENDER V LUSHINGTON (1877) 6 Ch. D. 70 a nominee's votes were refused at a general meeting. The member obtained an injunction against the directors acting on the resolution passed at the meeting. Jessel M.R. stated:-

> he is entitled to have his vote recorded---an individual right in respect of which he has the right to sue. That has nothing to do with the question raised in Foss v Harbottle and that line of cases.

Similarly in CLARK V WORKMAN [1920] 1 I.R. 107 shareholders obtained an injunction against the board of directors stopping them acting on a board resolution. The basis of their action was that the chairman had not been appointed in accordance with the articles of association. Ross J. stated "it is essential that the chairman should be elected by the machinery provided by that contract, and in no other way."[79]

In EDWARDS V HALLIWELL [1950] 2 ALL E.R. 1064 the rules concerning voting at a union meeting were broken. Two individual members obtained a declaration invalidating a resolution. Jenkins L.J. stated:-

> the personal and individual rights of the membership of each of them have been invaded by a purported, but invalid, alteration.... In those circumstances, it seems to me that the rule in Foss v Harbottle has not application at all, for the individual members who are suing sue, not in the right of the union, but in their own right to protect from invasion their own individual rights as members.

Within the Irish jurisdiction the right of action which arises from the infringement of a personal right contained in the articles is reinforced by the protection of private property contained in Article 43.1 of the Constitution.[80]

The articles of association purport to contain the rights and obligations of the members and the company towards each other. The Companies Act 1963, section 25 makes that relationship contractual. The nature of that contract is uncertain. A shareholder seeking to rely on a term in that contract must first look to see does the

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[79] See also HENNESSY V NATIONAL AGRICULTURAL AND INDUSTRIAL DEVELOPMENT AUTHORITY [1947] I.R. 159 where a quorum requirement was treated as an individual membership right.

[80] See section below, Equitable Considerations Concerning Members Voting Rights.

term give him a right in his capacity as a shareholder. Then he must see if this term confers a right which is a personal one rather one owed to the company. If he can fulfil these conditions then he can sue under the section 25 contract.

The restriction of the articles to rights impacting on a membership is illogical and unsustainable.

Ussher (1986: pp.165-166) finds that:-

> [t]he doctrine is easy enough to state, but difficult to apply. The difficulty lies in the fact that the rights of members within a company are not uniform. We have seen affirmed in Bushell v Faith the liberty which a company has to create shares with widely differing rights. Therefore the possibility of making the only firm and logically sustainable distinction, namely that between rights possessed by all members of a company and those purported to be granted to only some, disappears.

Thus ELEY V POSITIVE GOVERNMENT SECURITY LIFE ASSURANCE CO. (1876) 1 EX. D. 88 (C.A.) and BUSHELL V FAITH [1970] A.C. 1099 contradict each other.

The position has reached the point that the member has no general right to rely on Ross J.'s "sacred" contract.[81]

This thesis maintains that the problem lies not with the Companies Act 1963. The Companies Act 1963, section 25 (1) is quite clear in creating a contractual

[81] CLARK V WORKMAN [1920] 1 I.R. 107.

relationship between the members and the company. It is the judicial restrictions which have clouded the issue.

ELEY V POSITIVE GOVERNMENT SECURITY LIFE ASSURANCE CO. (1876) 1 EX. D. 88 (C.A.) illustrates this point. If section 25 (1) is applied on its literal construction, "signed and sealed by each member, to observe all the provisions of the memorandum and the articles," the member who tried to enforce a right contained in the articles to be employed for life as the company solicitor should at least have been able to establish a contractual relationship. The use of the word "all" in section 25 implies no restriction. Astbury J.s' statement in HICKMAN V KENT OR ROMNEY MARSH SHEEP-BREEDERS' ASSOCIATION [1915] 1 Ch. D. 881 Ch.[82] distorts the literal construction of the section by restricting the contractual relationship to the aspects of the articles relating to rights regarding capacity as a member.

The question arises as to what the basis of this judicial interpretation is? Logically, section 25 (1) creates a contractual relationship between the members and the company.[83]

There is in fact no legal basis to that restriction save policy considerations. As an answer to the problem of the change from the contractual deed of settlement company to the articles of association modern company a

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[82] See above p.36.

[83] As indicated above the case law would support this.

statutory contract was a clumsy, though pragmatic choice.[84] The implications of a contract that could constantly change and bind third parties, yet still retain contractual status were clearly not realised by the legislators. The judiciary, who were left to deal with the practical implications of the statutory contract immediately restricted its impact, by restricting its scope.

The problem of defining the nature of the section 25 contract lies at the heart of the judicially evolved restrictions.[85] There need not necessarily be a problem about defining the nature of the section 25 contract. There is clearly a contractual relationship present although it may be an unusual one.[86] While the origin of the contract may be unusual, it need not necessarily cloud the nature of the function of the contract.[87]

A contract has a clear function; it defines the rights and obligations of the parties to it. Statute

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[84] It avoided the complications which would have arisen if a new member had to sign the deed of settlement upon joining.

[85] Lindley M.R. addresses this point in ALLEN V GOLD REEFS CO. OF WEST AFRICA [1900] 1 Ch. 656 where he states "[t]hey have the effect of a contract (see s.16); but the exact nature of this contract is even now very difficult to define".

[86] All the judges in BRATTON SEYMOUR SERVICE CO. LTD. V OXBOROUGH [1992] B.C.L.C. 693 refer to the novelty of the contract.

[87] Which would be to create legal relations. In the words of Lord Stowell in DALRYMPLE V DALRYMPLE (1811) 2 Hag. Con. 54 contracts "must not be the sport of an idle hour, mere matters of pleasantry and badinage, never intended by the parties to have any serious effect whatever."

purports to do this too. The statutory contract created by section 25 seeks to define the rights and obligations of the members and the company towards each other. As such its function is clear. The flaw in the statutory contract was the ease with which the rights and obligations could be varied,[88] by passing a special resolution.

This seems to have been the difficulty which led the judiciary to attempt a re-definition of the contract. The literal interpretation of the wording of section 25, creates a contract between the members and the company which can be constantly varied[89] and which is not restricted to the members' rights as members.[90] The courts have re-defined the section 25 contract to restrict the rights under the contract to those rights inherent in membership. While the intention of the judiciary was clearly to provide certainty as to the extent of the contract, the re-definition has moved too far from the wording of the Act to have any validity or

[88] See the judgment of Lindley M.R. in ANDREWS V GAS METER CO. [1897] 1 Ch. 361 on alteration of the constitution.

[89] A potential solution was ruled out in WALKER V LONDON TRAMWAYS CO. (1879) 12 Ch. D. 705 where it was held that any regulation or article purporting to deprive the company of this power is invalid on the grounds that it is contrary to the statute.

[90] Thus the solicitor in ELEY V POSITIVE GOVERNMENT SECURITY LIFE ASSURANCE CO. (1876) 1 EX. D. 88 (C.A.) would have been able to enforce the article appointing him solicitor.

certainty.[91]

Equitable Considerations Concerning Members' Voting Rights.

The thesis now turns to examine a specific point regarding alteration of the section 25 contract. Ross J.[92] makes the point that although the power to alter the "contract" exists:-

> the statutory powers of altering articles of association by special resolution must be exercised subject to the general principles of law and equity which are applicable to all powers enabling majorities to bind minorities.[93]

The point being made by both Ross J. and Lord Lindley is that while the contract is an unusual one it does contain a safeguard against abuse.

One of the most common phrases associated with the exercise of members' votes is the statement of Lindley M.R. in ALLEN V GOLD REEFS CO. OF WEST AFRICA [1900] 1 Ch. 656 at 671. There he states:-

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[91] This thesis does take note though of the point made by Ross J. in CLARK V WORKMAN [1920] 1 I.R. 107 and Lord Lindley in ALLEN V GOLD REEFS CO. OF WEST AFRICA [1900] 1 Ch. 656 that there are safeguards. But see the section below on equitable considerations, where this point is dealt with in detail.

[92] See CLARK V WORKMAN [1920] 1 I.R. 107 above in section 1.2. The Memorandum, Articles of Association and Section 25.

[93] Ross J. relies here on the words of Lord Lindley in ALLEN V GOLD REEFS CO. OF WEST AFRICA [1900] 1 Ch. 656. Where he refers to the alteration of articles of association having implied conditions. It is important to note his usage of contractual terms when referring to the articles.

> [w]ide however as the language of s.50 is, the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.[94]

In CLEMENTS V CLEMENTS BROS. LTD [1976] 2 ALL E.R. 268 Foster J. in the court of first instance declined to recognise the ability of a majority shareholder to authorise an allotment of shares, the motive behind the share allotment being to dilute the voting power of the minority shareholder plaintiff.[95] Foster J. based his decision on what he termed "equitable considerations." Thus the mala fides element of the allotment precluded it from ratification.

Evershed M.R. considered the bona fide issue in GREENHALGH V ARDERNE CINEMAS LTD. [1951] Ch. 286 (C.A.) where he stated:-

> it is now plain that "bona fide" for the benefit of the company as a whole" means not two things but one thing. It means that the

[94] This statement of principle follows on from Romer L.J. in MENIER V HOOPER'S TELEGRAPH WORKS (1874) L.R. 9 Ch. App. 350 holding that, where the majority of a company propose to benefit themselves at the expense of the minority, the court may interfere to protect the minority.

[95] He considered MENIER V HOOPER'S TELEGRAPH WORKS (1874) L.R. 9 Ch. App. 350 as a clear case where there was a restraint on the shareholders exercise of powers at the general meeting. There the majority purported to expropriate the property of the company to the exclusion of the minority.

> shareholder must proceed on what, in his honest opinion, is for the benefit of the company as a whole. Secondly, the phrase, "the company as a whole", does not (at any rate in such a case as the present) mean the company as a commercial entity as distinct from the corporators. It means the corporators as a general body. That is to say, you may take the case of an individual hypothetical member and ask whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit.

Foster J. in CLEMENTS V CLEMENTS BROS. LTD. [1976] 2 ALL E.R. 268 agreed with Evershed M.R., and was of the opinion that "Miss Clements is not entitled to exercise her vote in any way she pleases".[96]

It is difficult to see how the judgment of Evershed M.R. can be reconciled with the concept of the corporation as a separate entity and with the members rights of property inherent in his shareholding.[97] [98]

The law here is confused as the votes of members are rights of property. The case law makes this clear.[99]

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[96] See also Lord Wilberforce's judgment in EBRAHIMI V WESTBOURNE GALLERIES LTD. [1972] 2 ALL E.R. 492.

[97] More particularly in the Irish jurisdiction where Article 43.1 of the Constitution protects their right of private property.

[98] For a definition of a "share" see Pennington (1989: pp.140-144). There he concludes:-

> the most that may be said of shares in a registered company by way of definition is that they are a species of intangible movable property which comprise a collection of rights and obligations relating to an interest in the company of an economic and proprietary character, but not constituting a debt.

[99] They may even enter into agreements as to the exercise of that vote in future. Regarding shareholders' agreements generally, see Lower (1994b: pp.241-243).

In NORTH-WEST TRANSPORTATION V BEATTY (1887) 12 APP. CAS. 589, P.C. it was held that members are free to vote in their own self interest even if it is contrary to the interest of the company.[100] There Sir Richard Baggallay stated:-

> [i]t would be very undesirable even to appear to relax the rules relating to dealings between trustees and their beneficiaries; on the other hand, great confusion would be introduced into the affairs of joint stock companies if the circumstances of shareholders, voting in that character at general meetings, were to be examined, and their votes practically nullified, if they also stood in some fiduciary relation to the company.

The freedom that the members have when exercising their votes could not be a more striking contrast to the restrictions on the directors' freedom to vote in the management organ.[101] Shareholders are essentially free from the duties of good faith to which the directors are subject.[102]

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[100] See also GOODFELLOW V NELSON LINE [1912] 2 Ch. 324. More recently RUSSELL V NORTHERN BANK DEVELOPMENT CORPORATION [1992] 3 All E.R. 161 regarded the shareholders' right to deal with their own interests by contract and confirmed their freedom to do so. There that freedom almost had the effect of circumscribing the exercise of statutory powers by the company. For a consideration of the above case and the shareholders' rights of property generally see, Ferran (1994: pp.343-366), Savirimuthu (1993: pp.137-140), Shapira (1993: pp.210-215) and Sealy (1992a: pp.437-439).

[101] See Gower (1979: pp.571-613).

[102] Gower (1979: p.615) states "it has been repeatedly laid down that votes are proprietary rights......which the holder may exercise in his own selfish interests even if these are opposed to those of then company."

The right of property inherent in share ownership is a very significant one.[103] Even directors who are also members can exercise their votes as members in disregard of their fiduciary duties. In NORTHERN COUNTIES SECURITIES LTD. V JACKSON & STEEPLE LTD. [1974] 1 W.L.R. 1133 the directors were bound to recommend the shareholders vote for a resolution. They, themselves as shareholders, could vote against it if so minded. Directors with de facto control of the company can disregard their fiduciary duties and force through a confirming resolution by the exercise of their own votes.

Walton J. in that case stated:-

> I think in a nutshell the distinction is this. When a director votes as a director for or against any particular resolution in a directors' meeting he is voting as a person under a fiduciary duty to the company for the proposition that the company should take a certain course of action. When a shareholder is voting for or against a particular resolution he is voting as a person owing no fiduciary duty to the company who is exercising his own right of property to vote as he thinks fit. The fact that the result of the voting at the meeting (or a subsequent poll) will bind the company cannot affect the position that in voting he is voting simply as an exercise of his own property rights.

He continues in the judgment to discuss the restrictions on a director exercising his votes in his capacity as a member:-

[103] See also STANDARD CHARTERED BANK V WALKER [1992] 1 W.L.R. 561 for a consideration of the shareholder's right to do as he pleases with his property.

I think that a director who has fulfilled his duty as a director of a company by causing it to comply with an undertaking binding on it is nevertheless free, as an individual shareholder, to enjoy the same unfettered and unrestricted right of voting at general meetings of the members of the company as he would have if he were not also a director.

Clearly it can be seen that there is potential for abuse of the majority power position.[104] Simple majority power confers control[105] and that majority can easily be guilty of behaviour which is damaging to the company and the minority, but yet the majority would still be within its legal powers. The law has tried to remedy this behaviour but, in trying to balance the principle of majority control with an equitable solution, the law on this area is somewhat labyrinthine and most certainly unclear.[106] [107]

The balance between the members' property right and any equitable considerations would seem unclear in the English jurisdiction. The right of property contained in Article 43.1 of the Irish Constitution would be likely to override any equitable considerations. Thus any balance created by any equitable controls of the articles of

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104 See COOK V DEEKS [1916] 1 A.C. 554 and also CANADA SAFEWAY LTD. V THOMPSON [1951] 3 D.L.R. 295.

105 See Companies Act 1963, Table A.

106 In particular the exceptions which flow from the admission by Wigram V.-C. in FOSS V HARBOTTLE (1843) 2 Hare 461 that "claims of justice" might apply.

107 See Tuffnell (1993: pp.90-93) for an examination of the law regarding restrictions on the rights of shareholders to vote in the English jurisdiction.

association, as per Ross J. and Lord Lindley above, has been removed.

1.6 The Erosion of the Rule in FOSS V HARBOTTLE.

A problem arises when as a result of the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 majority shareholders are conferred with untrammelled rights. The majority could easily abuse their voting powers either controlling directors or voting in general meeting.

The rule protects the company from frivolous behaviour by unhappy shareholders who are in the minority. Also any action by such a shareholder would be futile where the majority control the general meeting. The potential harshness of the rule was recognised in the case law and a number of exceptions evolved.

The exceptions arose out of the judgment of Wigram J. in FOSS V HARBOTTLE (1843) 2 Hare 461 where he stated:-

> [i]f a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a 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 in Wallworth v Holt 48 R.R. 187 (4 My. & Cr. 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.

Thus, no majority vote can be effective to sanction an act of the company which is ultra vires or illegal.[108] If procedures either required by law or by the company's articles are not observed, then the majority must follow that procedure or else the decision is invalid.[109] If a member is deprived of his individual membership rights then he may sue to enforce that right.[110] [111] If those who control the company act oppressively or defraud the company the minority may bring an action against the majority.[112] If this were not allowed then the wrong would go unchecked as the majority would be unlikely to authorise action against themselves.

In particular the exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 prove much more elusive in practice.[113] This is especially so when a shareholder

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[108] ASHBURY RAILWAY CARRIAGE AND IRON CO. V RICHE (1875) L.R. 7 H.L.C. 653.

[109] JACKSON V MUNSTER BANK 13 L.R. (Ir.) 118.

[110] PENDER V LUSHINGTON (1877) 6 Ch. D. 70 there Jessel M.R. stated "[t]his is an action by Mr. Pender for himself. 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 the right to sue."

[111] See also CLARK V WORKMAN [1920] 1 I.R. 107 and HENNESSY V NATIONAL AGRICULTURAL & INDUSTRIAL DEVELOPMENT ASSOCIATION [1947] I.R. 159.

[112] Under the Companies Act 1963, section 205 a member can petition for an order ending the oppressive conduct or under section 215 petition to wind up the company on the grounds that it is "just and equitable" to do so or that there has been oppressive conduct. An action may also lie in an exception to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461.

[113] See Keane (1991: pp.280-283) for a discussion of the procedural problems.

wishes to bring an action relying on the exception to the rule which permits an action to be brought where a majority in control of the company are committing a fraud on the minority.[114] The basis of the exception is that a wrong is being done to the company itself and so the company is the proper plaintiff.[115] The majority are unlikely to agree to this and so the law allows an exception to the rule that proceedings can not be brought on the basis of a wrong done to someone else.

The minority shareholders are permitted to bring a derivative action in the name of the company.[116] The action derives from the wrong done to the company, rather than a wrong to the individual shareholders. Difficulties have arisen with the procedural aspects of this area.[117] Firstly, it can occur that there is not actually a majority in favour of the fraudulent conduct. Thus, although there has been an act which may amount to fraudulent conduct, the majority can still decline to ratify the action, and take steps to remedy it. Thus, any derivative action would be premature where the wrongdoers

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[114] COOK V DEEKS [1916] 1 A.C. 554.

[115] See the judgment of Jenkins L.J. in EDWARDS V HALLIWELL [1950] 2 ALL E.R. 1064 at 1066.

[116] WALLERSTEINER V MOIR (NO.2) [1975] Q.B. 373 per Lord Denning at 390-391.

[117] For a further examination of the problems surrounding derivative actions and the likely future development of the law in this area, see Boyle (1990: pp.3-5) and Doyle (1992: pp.1172-1173).

are not actually in control.[118] Any shareholder contemplating a derivative action must first take all steps necessary to establish that the wrongdoers are in control, that is to say convene an extraordinary general meeting or if the shareholder has not enough votes, petition the court to convene one.[119]

Another difficulty for a shareholder is the fact that it may not be possible until a full hearing has been held to determine whether fraud has occurred or not. If the court decides that there has been no fraud then there was never an exception to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 and so the action should not have been allowed in the first place.

This issue was discussed in PRUDENTIAL INSURANCE CO. LTD. V NEWMAN INDUSTRIES LTD. AND OTHERS [1982] Ch. 209. The Court of Appeal said that the way to deal with this

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[118] The court must be satisfied that the wrongdoers are in control: ATWOOL V MERRYWEATHER (1867) L.R. 5 Eq. 464n.

[119] There would appear to be a difference in approach to establishing control between the Irish and English courts. Keane (1991: p.281) provides the not altogether convincing opinion that "the court may, as we have seen convene a meeting itself and would probably do so before embarking on a lengthy trial." In this Keane is presumably referring to the suggestion of Wigram V.-C. in FOSS V HARBOTTLE (1843) 2 Hare 461, at 494 that a shareholder could institute proceedings only if all means had been used to put the general meeting in motion and had failed.
The English courts have adopted a pragmatic approach to establishing control. The court must be satisfied that the wrongdoers are in effective control. In particular see PAVLIDES V JENSEN [1956] Ch. 565 where it was held that it was not necessary to prove control but merely to allege facts which, if proved, would establish control; if the plaintiffs can not establish the allegations at trial then they will lose. Further to this in MASON V HARRIS (1879) 11 Ch. D. 97, (C.A.) control could be established if the defendants were in a majority on the board and the register of members indicated that the directors hold a clear majority of the shares.

problem was to determine it as a preliminary issue and require the plaintiff to make out a prima facie case as to the fraud.[120]

This approach is unlikely to be adopted in Ireland as the Supreme Court in CAMPUS OIL LTD. AND OTHERS. V MINISTER FOR INDUSTRY AND ENERGY AND OTHERS. (No.2) [1983] I.R. 88 expressed their disapproval of such issues being decided at an interlocutory stage.[121] Keane (1991: p.282) comments on this as follows:-

> [t]he plaintiff, after all, is the person who is likely to suffer in costs if the plea is unsustainable. The impracticability of adopting any other course was graphically demonstrated in SMITH V CROFT (No.2) [1988] Ch. 144, where the court of first instance in endeavouring loyally to apply the Prudential Insurance Co. Ltd. technique found itself in the midst of what counsel for the plaintiff described as a 'procedural shambles'. In the event, the 'preliminary' issue took 17 days to resolve.

In SMITH V CROFT (NO.2) [1988] Ch. 144 Knox J. in his conclusion made the following recommendations for change:-

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[120] The Court of Appeal stated "[i]n our view, whatever may be the properly defined boundaries of the exception to the rule, the plaintiff ought to at least be required before proceeding with his action to establish a prima facie case (i) that the company is entitled to the relief claimed and (ii) that the action falls within the proper boundaries of the exception to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461".

[121] There Keane J. stated "on an application for an interlocutory injunction the Court should not normally express any concluded opinion upon the issues raised between the parties. In this case, as in all others of a similar nature, a final determination of the issues between the parties must await the full hearing of the action".

> [f]irst I consider that there may well be a much stronger case for requiring a prospective plaintiff to have the onus of establishing that this case falls within the exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461, 67 E.R. 189, or outside it altogether than there is for putting the same onus on him to show that the company would be likely to succeed if it brought the action. On the latter it might well be appropriate to apply the usual test under RSC Ord 18, r19 and the inherent jurisdiction which puts the onus on the defendants to show the case is effectively unarguable.

He continues:-

> [t]hird I believe that it would be helpful for there to be specific procedure laid down, whether by way of rules of court or practice direction I do not know, for the initiation and prosecution of actions by minority shareholders to recover on behalf of a company.[122]

As well as an action taken to remedy a wrong to the company, a shareholder can take a representative action. Lord Denning in WALLERSTEINER V MOIR (NO.2) [1975] Q.B. 373 describes it as where:-

> [s]tripped of mere procedure, the principle is that, where the wrongdoers themselves control the company, an action can be brought on behalf of the company of the minority shareholders, on the footing that they are its representatives to obtain redress on its behalf.[123]

When taking such an action it has often been accompanied in England by a preliminary issue regarding

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[122] See further, Prentice (1988: pp.341-346) and Stallworthy (1988: pp.217-222).

[123] See also Gower (1979: p.647).

costs. The court may order the company to indemnify the plaintiff against the costs of the action.[124] In WALLERSTEINER V MOIR (NO.2) [1975] Q.B. 373 the court held that an order for costs should be made, where it was reasonable and prudent in the company's interest for the plaintiff to bring the action, and he does so in good faith.[125] [126] The order should also be made irrespective of the outcome of the case.

The rule in FOSS V HARBOTTLE (1843) 2 Hare 461 enshrines the principle of majority rule. The minority in a limited number of circumstance may challenge the decisions of the majority.[127]

The convoluted mechanisms necessary to bring an action alleging an exception to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 are really an attempt to maintain some structure to the model company.[128] The action is in fact being brought by the individual shareholder. It is not instigated by the organs of the

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[124] Similar to the way a trustee is entitled to indemnity from his cestui que trust who is sui juris: see HARDON V BELILIOS [1901] A.C. 118 and RE RICHARDSON [1911] 2 K.B. 705.

[125] There Lord Denning stated "[a]ssuming that the shareholder had reasonable grounds for bringing the action -- that it was reasonable and prudent course to take in the interests of the company -- he should not himself be liable to pay the costs..."

[126] See Graham (1986: pp.153-155) regarding the determination of the best commercial interests of the company.

[127] Only those exceptions which impinge on the company as a separate legal entity appear here.

[128] Reform of this area in Australia and New Zealand has led to the proposal that the rule in FOSS V HARBOTTLE (1843) 2 HARE 461 be abolished; Sealy (1991: pp.175-179).

company. Thus it is truly an exception to the rule that only the company can maintain an action for a wrong against itself. The mechanism of the action maintains the pretence that the action is being instigated by the company and that this in some way maintains the integrity of the rule.

As well as the above established exceptions there may be potential to create others. The minority may be entitled to added protection, notwithstanding the rule in FOSS V HARBOTTLE (1843) 2 Hare 461. Hamilton J. in MOYLAN V IRISH WHITING MANUFACTURERS LTD. H.C. UNREPORTED, 14 APRIL 1980 suggested that the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 must be applied in the light of the Constitution. In doing so he examined many authorities which suggested that there may be further exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 46, arising in the interests of justice.

In that judgment Hamilton J. did not explain the constitutional basis for his decision. Instead he set out the rule in BURLAND V EARLE [1902] A.C. 83 where Lord Davey held that:-

> [t]he cases in which the minority can maintain such an action are therefore, confined to those in which the actions complained of are of a fraudulent character or beyond the powers of the company.

Then Hamilton J. turned to consider RUSSELL V WAKEFIELD WATERWORKS CO. (1875) L.R. 20 Eq. 474 where Sir George

Jessel held:-

> [b]ut this is not a universal rule, that is a rule subject to exceptions and the exceptions depend very much on the necessity of the case, that is the necessity for the court doing justice....

He turned finally to HEYTING V DUPONT [1964] 1 W.L.R. 854 (C.A.) where Lord Justice Harmond stated:-

> [t]here are cases which suggest that the rule is not a right one and that an exception will be made where the justice of the case demands it.

Hamilton J. then considered that there is an exception to the rule where the justice of the case demands it. It is not clear however how the constitution impacts on the justice of the case.[129]

The idea that there could be further exceptions was dealt with in PRUDENTIAL ASSURANCE COMPANY LTD. V NEWMAN INDUSTRIES LTD. AND OTHERS [1982] Ch. 209. There the Court of Appeal stated that in their view "the interests

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[129] In GAIMAN V NATIONAL ASSOCIATION FOR MENTAL HEALTH [1971] Ch. 317 at 335 the argument was raised that the directors of a company must exercise their powers in accordance with the principles of natural justice. That argument was dismissed by Megarry J.

Hamilton J. may be suggesting that the presence of a written constitution in the Irish jurisdiction raises a presumption of natural justice in the way directors exercise their powers. The constitutional right to protection of private property contained in article 43.1 strengthens such a suggestion.

of justice" as an exception would not be applied.[130]

This thesis believes that it is not possible for the judiciary to close off the exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461. They flow from the words of Wigram J. where he states "the claims of justice would be found superior to any difficulties arising out of technical rules." As such if the "claims of justice" require a fifth exception to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 it must be allowed.[131]

Hamilton J.'s constitutional reference is equally hard to understand in the light of the company's status in the constitution. The judgment failed to deal with one important element of the argument: the issue of corporate personality.[132] [133]

The matter of the effect of the Constitution on corporate personality has proved to be a difficult one. The corporation has been disqualified from holding rights that are classified as personal. For example, the

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130 Keane (1991: p.279) agrees; he states "[i]t is thought that the exceptions to the rule are so clearly defined that in practice the Irish courts would be reluctant to extend them."

131 See Keane (1991: p.278) for a survey of the case law on the fifth exception. See also Barnes (1987: pp.92-95) and Oserheimen (1987: pp.1-13).

132 See QUINN'S SUPERMARKETS LTD V ATTORNEY GENERAL [1972] I.R. 1 and PRIVATE MOTORISTS' PROVIDENT SOCIETY V ATTORNEY GENERAL [1984] I.L.R.M. 88 for an analysis of the corporations position.

133 For a consideration of the nature of the separate legal entity of the corporation see, Smart (1990: pp.126-136) where he argues that the legal personality of the corporation differs from that of the individual. Rules of law which were developed for the individual need substantial modification for application to the corporation. See further, Tapper (1994: pp.350-353).

corporation has no right of private property[134] or freedom of worship.[135] The Constitution in Ireland has meant that the corporation has been degraded to a second class constitution existence through fixed wording which uses human characteristics to convey rights.[136] For example, the preclusion of the corporation from holding private property in Ireland on the grounds that the words "man, in virtue of his rational being..." can not apply to a corporate being.[137]

Taking the ambiguous nature of the corporation under the constitution into consideration it is not easy to see how exactly Hamilton J. is seeking to apply the Constitution.

Statutory Exceptions.

The thesis now turns to consider other exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461 in both Ireland and the U.K. The statutory exceptions provide shareholders with a cause of action which does not require the organs of the company as instigators.

Section 210 of the U.K Companies Act 1948 was designed to remedy situations where a winding up of the

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[134] Article 43.1.

[135] Article 44.2.1 states; freedom of conscience and the free profession and practice of religion are, subject to public order and morality, guaranteed to every citizen. See further MC GEE V ATTORNEY GENERAL [1974] I.R. 284.

[136] See for example Article 40.1 where it refers to "human persons".

[137] Article 43.1.

company was not applicable, and there was no fraud on the minority.[138] It proved cumbersome, as it contained the proviso that the same grounds for a just and equitable winding up must be established before any relief could be granted. The section proved difficult to minorities in private companies but the presence of the "just and equitable" grounds precluded its use by minorities in public companies. Instone (1981: pp.1316-1318) states, the committee:-

> [u]nfortunately, in summarising this recommendation in para. 153 of the report, used language which evidently misled the Department of Trade into supposing that the Committee intended the new jurisdiction of the Court to be coextensive with its power to make a winding up order. It is this limitation (embodied in section 210 (2) (b) of the 1948 Act) which long ago gave rise to a general recognition that the section was inadequate.

It was almost impossible for a minority within a public company to establish any of the grounds needed for a "just and equitable" winding up, such as the substratum of the company has gone, or that the basis of association between the members and the directors has broken down.[139]

In 1962 the Jenkins Committee recommended that the just and equitable grounds be removed from section

[138] This was the intention of the Cohen Committee (1945) upon which the U.K Companies Act 1948 is based.

[139] See the U.K. Companies Act 1948, section 210 (2) (b).

210.[140] This recommendation was not implemented until 1980, when section 210 was replaced and re-enacted by section 75 of the Companies Act 1980.[141] The same provisions are now contained in section 459 of the Companies Act 1985, as amended by the Companies Act, 1989.[142] [143] The amendment in 1989 added the words "of members generally". This widened the scope of the section which had been criticised as still too restrictive.[144] [145]

In Ireland the 1963 Companies Act implemented many of the recommendations of the Jenkins Committee (1962).[146] The 1963 Act contained section 205 which is substantially based on section 210 of the U.K. 1948 Companies Act. Section 205 does not contain the

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[140] The Committee also recommended the introduction of the term "unfairly prejudicial".

[141] The recommendation of the Jenkins Committee that the available remedies should be amended to allow a court order requiring that the company to institute legal proceedings was never implemented. This is despite judicial dissatisfaction with the present system; see the comments of Knox J. in SMITH V CROFT (NO.2) [1988] Ch. 144 above.

[142] Schedule 19, para. 11.

[143] For a comparison of section 459 and the exceptions to the rule in FOSS V HARBOTTLE (1843) 2 HARE 461, see Griffin (1992a: pp.389-393).

[144] See Bouchier (1991: pp.132-143) for a consideration of the effect of the 1989 amendment. See also Griffin (1992b: pp.83-88) and Stapledon (1993: pp.94-97) for an examination of the problems which have arisen since 1989.

[145] For an examination of the most recent cases, see Mercer and Shilling (1994: pp.2-3) and Mays (1994: pp.3-4).

[146] The timing of the Irish Act is not unrelated to the Report of the Jenkins Committee (1962) the year before.

restrictive just and equitable grounds.[147]

The Irish legislation is thus less obviously restrictive. Section 205 of the 1963 Act provides:-

> [a]ny member of a company who complains that the affairs of the company are being conducted or that the powers of the directors of the company are being exercised in a manner oppressive to him or any of the members (including himself), or in disregard of his or their interests as members, may apply to the court for an order under this section.

Section 205 has been successfully used by minorities in private companies, but is difficult for minorities in public companies to use.[148] Even the remedies provided by the courts for those actions of private company members points to a specific problem with judicial thinking in minority v majority actions. The most frequent remedy granted under section 205 is an order for the majority to purchase the shares of the minority.[149] This remedy is an unusual choice when the court has a discretion to remedy unscrupulous conduct even where no legal rights have been

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[147] The recommendations of the Jenkins Committee (1962) with regard to the minority protection section were applied as well as the recommendations of the Cox Committee (1959). The further recommendations of the Jenkins Committee with regard to the court order requiring companies to institute legal proceedings were not.

[148] The first recorded judgment given on the section was not until 1974 in RE WESTWINDS HOLDINGS LTD., H.C., UNREPORTED, 21 MAY 1974.

[149] This was the remedy applied by Keane J. in RE GREENORE TRADING COMPANY LIMITED. [1980] I.L.R.M. 94.

infringed and power to make such order as it sees fit.

Logically, if the majority have by their behaviour caused the minority to seek a remedy and the minority have fulfilled the criteria of section 205, the majority should be the ones who have their shares bought out. For the court to use its powers to exclude the minority from the running of the business makes commercial sense but does not, it is submitted, result in an equitable or fair solution.

The lack of any substantial case law on section 205 suggests that something is wrong either with the application of the section or with the section itself. Keane (1991: pp.284-285) is of the opinion that the section is very successful; in fact the lack of case law is attributable to its success. He states:-

> [t]he volatile and quarrelsome Irish temperament makes the possibility of internecine warfare between shareholders in such companies more likely than in the neighbouring jurisdiction. It is all the more surprising, therefore, to find that so few decisions have been given by the Irish courts on the section since its enactment. Experience suggests, however, that while recourse to the section is more frequent than the number of decisions would indicate, a great many applications are settled without the court being called upon to adjudicate.

While Keane's observations may in some way explain the lack of case law, it is not entirely satisfactory when minorities within public limited companies are considered.[150]

As well as using the procedure under section 205 of the Companies Act 1963, a member of the company may petition to have the company wound up. If the court is satisfied that the company's affairs are being conducted or that the powers of the directors of the company are being exercised in a manner oppressive to any member or in disregard of his interest as a member, it will wind up the company. The court must also consider that the winding up is justified in the general circumstance. The court may also dismiss the petition and instigate an action under section 205. The individual member has thus twin statutory exceptions to the rule in FOSS V HARBOTTLE (1843) 2 Hare 461.

Minorities in Public Limited Companies.

The minority protection legislation is more applicable to the private limited company, than the public limited company. The area of minority protection in both the U.K. and the Irish jurisdiction failed to come to terms with the increasing use of the Stock Exchange as a source of finance. The lack of use of minority legislation against publicly quoted companies certainly suggests that there is some problem with its applicability to the problems of the minority shareholder

[150] Keane (1991: p.284) does admit that the legislation is more likely to be used by minorities in private limited companies.

within the public limited company.[151]

In attempting to frame minority legislation that is equally applicable to both public and private companies, the legislature has failed to recognise that the nature of minorities in public and private companies are fundamentally different. In the U.K. the legislation effectively ignores the needs of minority shareholders within public companies.[152] In Ireland the legislation is more applicable to both minorities but has been no more effective than its U.K. counterpart.

The relationships between shareholders and directors within private companies are essentially closer and more personal than those in public companies.[153] This makes it easier to legislate for any problems that might arise. The ratio of private companies to public companies in Ireland would also suggest that the legislation be primarily aimed at the problems of minorities in private companies.

In 1925, the number of private companies in the Irish state was 1,088; the number of public companies was

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[151] The Jenkins Committee (1962) referring to all types of companies, considered the minority legislation under-utilised. Only two applications for relief were brought under s.210 since its introduction in 1948. They were SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER [1959] A.C. 324 (H.L.) and RE H.R. HARMER LTD. [1958] 3 ALL E.R. 689, C.A.

[152] By maintaining legislation which is difficult to use: see above comments on the Companies Act 1985, section 459.

[153] While the two forms of business may share similar articles of association, the nature of their shareholdings are entirely different. On this particular point see Chapter five.

368.[154] [155] In 1956, the number of private companies in Ireland was 7,385; and public companies had remained virtually static at 372[156]. In 1982, the number of private companies was 69,432; and the public companies numbered 337.[157] By 1987, private companies numbered 92,811; and public companies 349.[158]

The above figures are of importance as they indicate the dominance of the private company as the premier form of incorporated business in Ireland. As such the Companies legislation is aimed at that form. The public company is an essentially different creature than its private counterpart. It is nonetheless a significant, "high profile" form of business.

The legislation as framed and used to date can only discourage the minority within public companies.[159] A minority shareholder in a public company is unlikely to

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[154] Report of the Cox Committee (1958).

[155] In 1933 only 24 of those public companies were listed on the Dublin Stock Exchange; Meenan (1970: pp.146-7).

[156] By 1957 the number of quoted companies had risen to 80; Meenan (1970: pp.146-7).

[157] Department of Industry and Commerce (1987).

[158] In 1995 the number of quoted companies was 90; Irish Independent (1995).

[159] Further there is no finance available from the company. Griffin (1992c: pp.137-139) examines the law regarding the funding of shareholder actions. He concludes:-

> [i]t has been clearly established and confirmed by recent case law that it is a fundamental principle of company law that a company should not be involved in providing money for the defence of a minority petition, in which the dispute in question is in reality one as between the shareholders.

pursue a costly legal action, which will only result in his shares being bought by the company. He could have sold his shares on the Stock Exchange in the first place.[160] Another reason why the legislation is little used by minority shareholders is that they look to the institutional investors to protect their interests.[161]

Conclusion.

The rule in FOSS V HARBOTTLE (1843) 2 Hare 461 is no longer a rule which has general application.[162] There are four well established exceptions to the rule at common law and the open-ended potential for others under the heading "interests of justice." The two statutory exceptions are wide, and provide the member with a course of action procedurally less cumbersome than the exceptions at common law.[163] It can no longer be said that it lies with the organs of the company to instigate an action for a wrong to the company.

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[160] While this point is valid for the U.K. exchange it must be tempered by the size of the Irish Stock Exchange where liquidity is sometimes difficult. See Nuki (1994: p.3). Also only a small number of public companies are listed on the Irish Stock Exchange.

[161] See chapter three, 3.3 The Effect of the Institutional Investor.

[162] For an examination of the Australian experience with the rule in FOSS V HARBOTTLE (1843) 2 Hare 461, see Sealy (1989a: pp.52-57). There he concludes that the Australian judiciary are willing to minimise the common law procedural obstacles that assemble under the rule.

[163] For a consideration of the combination of the rule in FOSS V HARBOTTLE (1843) 2 HARE 461 and the English statutory exception, see Graham (1989: pp.66-67).

1.7 The Unworkable Model.

This chapter set out to describe a model company. Three aspects of the model were regarded as of particular importance, SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) the memorandum and articles of association, and the rule in FOSS V HARBOTTLE (1843) 2 Hare 461. SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) established the company as a legal entity separate and distinct from its members and promoters. The legal entity was governed by the memorandum and the articles of association which provided its direction, structure and regulation. The rule in FOSS V HARBOTTLE (1843) 2 Hare 461 interacts with both the decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) and the ownership and control mechanisms in the articles of association, by placing any cause of action for a wrong to the company in the hands of the organs of the company and maintaining the company as the proper plaintiff.

It has been shown that the decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) has been seriously eroded. The motives of the members and promoters are no longer separate and distinct from that of the company. The company is no longer ubiquitously considered to be a separate legal entity. The memorandum which purports to provide the company with its direction through the objects clause is no longer of importance due to the statutory remedies for ultra vires transactions. The contractual import of the articles of association have no longer any certainty and the member has no longer a general right to rely on the provisions thereof. The rule in FOSS V HARBOTTLE (1843) 2 Hare 461 has many exceptions, to the extent that it can no longer be said that the organs of the company instigate an action for a wrong done to the company or that the company is the proper plaintiff. The model is no longer workable.

CHAPTER TWO: THE BOARD OF DIRECTORS.

Part 1.

2.0 The Board of Directors as the Management Organ.

This chapter continues the hypothesis outlined in the previous chapter, that the model company has been eroded. This chapter describes a model board of directors, then examines how it has been degraded to a secondary organ. As in chapter one the description is in two parts. In Part 1 the thesis examines the model role of the board as the management organ of the company. In Part 2 the chapter turns to examine the way in which the board of directors has been degraded as the management organ of the company.

The model board of directors is created through the registration procedure in the Companies Acts 1963-1990. That registration procedure involves the provision of a memorandum and optional articles of association. The articles of association provide the management structure of the company and the Companies Acts provide for the appointment of the first directors. Thus the directors are appointed and vested with power in the same procedure as gives rise to the separate entity of the company.[1] The directors then exercise that power in pursuit of the objects of the company, all the while being regulated by the procedures in the articles of association, the

[1] SALOMON V SALOMON & CO. [1897] A.C. 22, (H.L.)

Companies Acts and the fiduciary duties which arise in the appointment to the board and which are owed to the company as an entity.[2]

The Vesting of Power.

The registration procedure for the incorporation of a company has been dealt with in detail in chapter one.[3] This section of the thesis touches on the impact of the registration procedure on the board of directors.

As has been discussed in the first chapter, one of the most significant consequences of incorporation is that the company is itself a legal person.[4] This is in essence an artificial device as the "person" of the company can in no way act for itself. Cairns L.J. discussed this in FERGUSON V WILSON (1866) L.R. 2 Ch. 77 at 89 where he stated:-

> [t]he company itself cannot act as its own person; it can only act through directors and the case is, as regards those directors, merely the ordinary case of principal and agent.

The company acts through the board of directors as an

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[2] "The articles constitute the contract between the company and the member in respect of his rights and liabilities as a shareholder. Furthermore, it is to be remembered that the management of the company is entrusted to the directors, who have to exercise their powers in the interests of the company as a whole" per Neill L.J. in BURR V HARRISON AND OTHERS, (C.A.) CIVIL DIVISION, UNREPORTED, 25 MARCH 1994.

[3] See chapter one, 1.2 The Memorandum, Articles of Association and Section 25.

[4] SALOMON V SALOMON & CO. [1897] A.C 22, (H.L.).

organ of the company. That organ is created by the registration of articles of association.[5]

The registration procedure required by the Companies Acts provides for the appointment of the first directors and secretary,[6] and thereafter for the appointment of directors to be placed in the hands of the general meeting.[7] As Gower (1979: p.140) states:-

> the theory seems to be that the company, as such, has, in its constitution, appointed its agents and clothed them with authority; the act which gives birth to the company operates as an appointment and delegation by the company.

It is the company which delegates powers to the directors. The extent of that power depends on the article which delegates it. The usual case is that the directors may exercise all the powers of the company which are not by the Acts or the articles required to be exercised by the company in general meeting.[8] Essentially the board of directors can do whatever the company may

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[5] Companies Act 1963, sections 11-15.

[6] The first directors of a company must be named in the particulars delivered with the memorandum to the Registrar of Companies in order to fulfil the requirements of the Companies (Amendment) Act 1982, section 3. Those named in the particulars become the directors of the company upon the issuing of the certificate of incorporation by the registrar.

[7] See Companies Act 1963, Table A.

[8] As per Companies Act 1963, Table A, article 80.

do. Thus the board may not act illegally or ultra vires.[9] The powers of the board are vested collectively and thus must be exercised collectively.

As can be seen from chapter one, the articles of association contain an article which delegates the management function upwards from the general meeting to the board of directors.

Ussher states:-

> the article most commonly used in these islands for over a century to delegate powers of management to the board of directors has been consistently interpreted by the courts as vesting exclusive management powers in the board. (1986: p.85)

The company once the incorporation procedure is complied with is "born" with its management structure, fully vested with power, in place.

Regulation by the Articles of Association and the Companies Acts.

Table A, articles 92-100, provide for the retirement of directors by rotation and their re-election by the general meeting.[10] Any casual vacancies may be filled until the next general meeting, and both the board and the general meeting may appoint additional directors.

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[9] Note here that the directors are pursuing the objects of the company. They can only use their powers in pursuit of those objects. If they operate outside the objects that transaction will be ultra vires and invalid. See chapter one 1.2 The Memorandum, Articles of Association and Section 25.

[10] Usually by ordinary resolution.

Power to remove a director lies with the general meeting, who may do so by ordinary resolution.[11]

The Companies Act 1963, section 174 provides that all companies must have at least two directors. The adoption of the "two directors" rule is another feature selected from the recommendations of The Jenkins Committee (1962). The requirement was designed as a protective measure for shareholders, and to avoid difficulties arising from the death of a sole director. The intention of the Jenkins Committee (1962) was to "check the present spate of irresponsible incorporations."[12] The measure is strictly enforced. Carroll J. in RE HUNTING LODGES LTD. [1985] I.L.R.M. 75 dealt with a wife who was a nominal second director. She stated that the wife:-

> cannot evade liability by claiming that she was only concerned with minding the house and looking after the children. If that was the limit of her responsibilities she wanted, she should not have become a director of the company, or having become one she should have resigned. Any person who becomes a director takes on responsibilities and duties, particularly where there are only two. The balance sheet and profit an loss account and directors' report should have been signed by her. A director who continues as a director but abdicates all responsibility is not lightly to be excused.[13]

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[11] Companies Act 1963, section 182.

[12] Cmnd. 1749, paras. 20, 25.

[13] Carroll J. found that Mrs. Porrit had in fact participated in the business of the company and that applying the definition of Pennycuick V.-C. in IN RE MAIDSTONE BUILDING PROVISIONS LTD. [1971] 1 W.L.R. 1085 she came within the ambit of the Companies Act 1963 section 297 (1) (fraudulent trading).

Apart from the requirement that there must be two directors, the Companies Acts do not contain any further qualifications for a director to fulfil. There is no objective requirement that they have any knowledge of the fiduciary character of their function, or of the procedural restrictions on their powers. There are though persons the Companies Acts specifically exclude from holding office as directors.

The Companies Act 1990, Part VII provides for the disqualification and restriction of directors and other officers on conviction on indictment of any indictable offence in relation to a company, or involving fraud or dishonesty. Such persons are disqualified from holding office as an auditor, director, or other officer, receiver, liquidator or examiner or be in any way, whether directly or indirectly, concerned or take part in the promotion, formation or management of any company.

The Companies Act 1963, section 176 prohibits a body corporate from holding office as a company. This is a further adoption of the recommendations of the Jenkins Committee (1962)[14] which was designed to prevent the use of a multiplicity of corporate personalities to shield directors from their responsibilities.

Some companies do require directors to fulfil a share qualification before they can be appointed. This is a matter for the general meeting to decide upon and the standard form articles of Table A do not contain such a

[14] Cmnd. 1749, para. 84.

provision.

As mentioned above, directors' powers are conferred collectively on the board as a whole. Thus that power can, prima facie, only be validly exercised at a board meeting which complies with the notice and quorum requirements. It was decided in BROWN V LA TRINIDAD (1887) 37 Ch. D. 1 (C.A.) that notice in the context of board meetings means reasonable notice with regard to the practice of the company.

Voting is by way of a majority decision but if the minority are not notified of a board meeting then such votes at the meeting are ineffective. The logic behind this was set out by Jessel M.R. in BARBER'S CASE (1877) 5 Ch. D. 963 (C.A.) at 968. In that case it was held that the meeting was invalid and ineffective; and non constat that the persuasive oratory of the minority would not have induced the majority to change their minds. Table A provides that a resolution in writing signed by all the directors entitled to receive notice of meetings shall be valid as if a meeting had been held and a resolution voted on.

From this it can be gathered that neither an individual director or any group of directors has powers to delegate vested in him or it. The board will only have power to delegate their authority if the articles or memorandum expressly authorise them to do so. Table A does provide power to so through article 112 which states:-

> [t]he directors may entrust to and confer upon a managing director any of the powers exercisable by them upon such terms and conditions and with such restrictions as they may think fit, and either collaterally with or to the exclusion of their own powers, and may from time to time revoke, withdraw, alter or vary all or any of such powers.

This article provides a means by which wide powers can be conferred upon a managing director and yet may be withdrawn if necessary. Essentially the terms of the managing director's appointment will define the scope of his powers.

In HOLDSWORTH & CO. V CADDIES [1955] 1 W.L.R. 352 the appointment of a managing director to a holding company provided that he should perform the duties and exercise the powers in relation to the businesses of the holding company and its subsidiaries, as would be assigned to him by the board of the holding company. Problems arose, and the board directed him to confine his attentions to the business of one of the subsidiaries. It was held that this did not amount to a breach of the service contract, even though he was no longer fulfilling managerial functions in relation to the company which employed him.[15] The Court further held that the post of managing director does not carry, by virtue of its nature, certain specific functions. It is up to the

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[15] A board resolution was passed which read "[t]he board decided that the managing director confine his attentions to British Textile Manufacturing Co., Ltd. only. Permanent arrangements for management at Balne Mills will be made later." It was held that this did not breach the contract of service and that even if it did such breach did not go to the root of the contract.

parties to define the scope of the appointment.

The wording of article 112 is important. The words "to the exclusion of their own power" are an implicit acknowledgement of the ability of the board to divest themselves of their own powers in favour of a managing director. It is therefore possible that, if the board did not reserve to themselves a power of supervision in any appointment of a managing director, the board could not exercise the powers conferred during the period of the appointment. Therefore it is possible for the board to substitute the managing director for the board's function as a primary organ, the managing director exercising such powers as agreed, the board exercising such powers as retained and the general meeting exercising residual powers. The general meeting retains the ultimate veto of removing the board and managing director, thus retaining theoretical control. Any breach of a managing director's contract by the board or the general meeting would give rise to damages as provided by the Companies Act 1963, section 182 (7) thus providing one disincentive for removal.

2.1 The Model Fiduciary.

> An individual director stands in a fiduciary relationship to his company. A fiduciary has power to deal with the property of another, and it is assumed therefore to occupy a position of trust and confidence in relation to that other, whom we might loosely call the beneficiary. Ussher (1986: p.200)

The law with regard to the fiduciary relationship of the director with the company has evolved in piecemeal. The fiduciary duties by no means form a coherent code, and are in general drawn from particular decisions of the courts. Many duties overlap and so an act by a director may breach many duties at once.[16]

It was noted above that the general meeting is but one of the two primary organs present in the company. In practice the powers of the company are mostly vested in the board of directors not the general meeting. The board either exercises that managerial power itself or delegates it to professional managers. It is of great importance to see what duties are owed by directors, particularly as the power to manage moves further away from the originating source of the general meeting.

The fiduciary duties owed by directors have been generally described in terms of trustee status.[17] This relates specifically to the origins of Companies themselves. Companies, prior to the Joint Stock Companies Act 1844 were unincorporated and the constitutional document was a deed of settlement vesting the assets of the company in trustees. The early case law tended to use the words "fiduciary" and "trustee" interchangeably.[18]

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[16] See Flannigan (1989: pp.285-322) and Bayne (1986) for a consideration of the law regarding directors as fiduciaries.

[17] For a consideration of the use of the trustee analogy see Mac Cann (1991c: pp.56-61).

[18] Sealy (1962: p.69) discusses the use of the term "fiduciary" and traces its judicial usage to the 1840's. For a consideration of the use of the terms "fiduciary" and "trustee",

In ATT. GEN. V BELFAST CORPORATION (1855) 4 Ir. Ch. Rep. 119 at 160 Maziere Brady L.C. attributed the word "trustee" to the relationship between the office holder and the corporation in which he holds office. In GRIMES V HARRISON (1859) 26 Beav. 435 the directors of a building society were held liable for breach of trust while the actual trustees escaped liability. The court was of the opinion that the trustees had only a supervisory role, acting on the instructions of the directors. It was common at that time for the trustees and directors to be different persons and the court of equity treated the directors as trustees in so far as they dealt with the company's property.[19]

With the advent of incorporated companies, the analogy with trustees became less appropriate. The courts, though, continued to apply the law to directors as if they were trustees. In RE GERMAN MINING CO. EX P. CHIPPENDALE (1853) 4 DE G.M. & G. 19 the courts carried this concept to extremes by granting directors a trustee's right to be indemnified as the beneficiaries of the members.

There are some similarities between the duties of directors and trustees, in that, while the board exercises its power collectively, the fiduciary duties are owed by the individual. This compares exactly with the trustee who acts jointly but owes duties of good

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see Lowry (1994a: pp.1-12).

[19] See further Gower (1979: pp.571-572).

faith severally to the beneficiaries. It must be noted though that this alone is not sufficient to confer trustee status on the director.

Romer J. in RE CITY EQUITABLE FIRE INSURANCE CO. [1925] Ch. 407 sought to clarify the issue. He stated at p.426:-

> [i]t is sometimes said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship with 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 appears to me to be wholly misleading. I can see but little resemblance between the duties of a director and the duties of a trustee of a will or of a marriage settlement. It is indeed impossible to describe the duty of a director in general terms, whether by way of analogy or otherwise. The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of another. In one company for instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous and the more important the matters that must of necessity be left to the managers, the accountants and the rest of the staff. The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines...

It has thus been the case that directors are not per se in a position analogous to a trustee.

The fiduciary relationship between a director and a company imposes a set of duties of good faith which are virtually identical to the duties imposed on a trustee. It is when dealing with these duties, that the analogy with a trustee seems to be applied. The analogy can not be extended further as the duties of skill and care owed by a director to the company are completely different to those of a trustee to the beneficiary.[20]

Another reason why the word "trustee" has been used is because of the judicial use of the constructive trust to remedy situations where a fraud has been committed by a director. Directors are only trustees in exceptional circumstances, such as when they have committed a fraud.[21] The directors who have become constructive trustees have become so, essentially through the fraud they have committed. A comparison between the duties of such a constructive trustee and the fiduciary duties of a director who is running a company in the normal course of business is not at all appropriate. The nature of the constructive trustee's duties arises from his fraud, whereas the fiduciary nature of the duties owed by the director, acting in the normal course of business, arises upon accepting his position as a director. In LINDGREN V L. & P. ESTATES LTD. [1968] Ch. 572, (C.A.) an argument that "directors-elect" are in a

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[20] See Gower (1979: pp.602-603).

[21] For a consideration of the applicable principles regarding constructive trustee status, see RUSSELL V WAKEFIELD WATERWORKS CO. (1875) L.R. 20 Eq. 474, BELMONT FINANCE CORPORATION V WILLIAMS FURNITURE LTD. (NO.2) [1980] 1 ALL E.R. 393 and ROLLED STEEL PRODUCTS (HOLDINGS) LTD. V BRITISH STEEL CORPORATION [1986] Ch. 246.

fiduciary relationship with the company was rejected.[22] The duties begin once the appointment takes place.

If the director is not a trustee but is in a fiduciary relationship with the company, from where does this fiduciary relationship arise? The weight of case law would suggest a connection between agency and the fiduciary relationship.[23]

The company, through its adoption of articles of association, has in the same instance appointed the directors as agents. This agency is created by article 80. Ussher (1986: p.201) states:-

> [t]he term "fiduciary" is of comparatively recent coinage; it is a generic term covering a variety of relationships, most of which are a species of agency, and of which that between a director and his company is only one.

Gower (1979: p.571) states:-

> [n]evertheless, to describe directors as trustees seems today to be neither strictly correct nor invariably helpful. In truth, directors are agents of the company rather than trustees of its property. But as agents they stand in a fiduciary relationship to their principal, the company.

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[22] REGAL (HASTINGS) LTD. V GULLIVER [1942] 1 ALL E.R. 378 was distinguished by Danckwerts L.J. as the directors in that case had made a profit from their position and the action had been brought against them when they were no longer directors, on behalf of the company, by a new board.

[23] See Cairns L.J in FERGUSON V WILSON (1866) L.R. 2 Ch. 77 above.

The connection between agent and fiduciary is further substantiated by the case law dealing with directors who have become agents for the shareholders with which we now deal.

As a general rule the fiduciary duties of directors are owed to the company alone, not the individual members or even potential members.

This was established in PERCIVAL V WRIGHT [1902] 2 Ch. 421 by the judgment of Swinfen Eady J. An earlier Irish authority proposition for this can be found in SMITH V CORK & BANDON RAILWAY CO. (1870) 5 I.R. Eq. 65 where Christian L.J. stated:-

> I am aware that there have been cases in which, for some purposes, directors of joint stock companies have been assimilated to trustees as for example, in the not permitting them to make their office a source of private profit - but that they are actual trustees for each individual shareholder is a proposition which presents itself to my mind with all the effect of novelty...

It can occur, though, that the directors stand in a direct fiduciary relationship with the shareholders when the directors assume some form of agency position for the members.[24] When this has occurred the case law has drawn a clear connection between the agency and fiduciary status of the directors. In BRIESS V WOOLLEY [1954] A.C. 333. (H.L.) the directors were authorised by the members to negotiate on their behalf with a potential takeover

[24] For an examination of this concept, see Collins (1992: pp.556-562).

bidder. The directors in that case had assumed the status of agents for the members, and so also had a fiduciary relationship with them.[25]

The law has evolved since then to a position where a relationship which falls short of agency may give rise to a fiduciary relationship.[26] In COLEMAN V MEYERS [1977] 2 N.Z.L.R. 225 (N.Z.C.A.) Woodhouse J. held that a full agency relationship may not be a necessity in order to give rise to a fiduciary relationship between the directors and shareholders in a small private company. He stated at p.324 that a fiduciary relationship could arise:-

> depending upon all the surrounding circumstances and the nature of the responsibility which in a real and practical sense the director has assumed towards the shareholder...

The implications of the case are important. It is clear from the case that Woodhouse J. was certain that an agency relationship will also give rise to a fiduciary one.[27] The creation of a category of responsibility which

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[25] See also WEIR V BELL (1878) 3 EX.D. 238 where Bramwell L.J. stated "every person who authorises another to act for him in the making of any contract, undertakes for the absence of fraud in that person in the execution of the authority given, as much as he undertakes for its absence in himself when he makes the contract." See also MAIR V RIO GRANDE RUBBER ESTATES LTD. [1913] A.C. 853.

[26] For an examination of the evolving concept of the "fiduciary", see Mason (1994: pp.238-259).

[27] For an examination of this case and a consideration of the position generally in Australia, see Ashe (1994: pp.24-26).

falls short of agency but which still gives rise to a fiduciary duty, creates an area of responsibility which hitherto had not existed for directors.

Further weight has been given to the proposition that directors may in certain circumstance depending on the nature of their responsibility become fiduciaries for the members. In SECURITIES TRUST LTD. V ASSOCIATED PROPERTIES LTD. H.C., UNREPORTED, NOVEMBER 19 1980 the directors of a company suppressed important information in the offer documents of a potential take-over bid. McWilliam J. discussed the directors' fiduciary responsibility:-

> I have not been addressed on the duty of directors towards their own members or their position as agents or otherwise vis a vis the shareholders on such a transaction but, although a director is not a trustee for the shareholders, directors are to some extent in a fiduciary position...

While fiduciary duties to the members can potentially arise in agency or quasi-agency situations, the position has remained ambiguous as to when exactly this relationship can be established. Ussher (1986: p.206) comments on this by stating that there may be:-

> an emergent fiduciary duty owed by directors to members to disclose material facts when the members' rights are to be directly affected by proposals to which the directors are party or privy, provided that the directors are trusted and relied upon to do so by the members, which will not of course, always be the case.

The agency which arises from article 80 also gives rise to the fiduciary duties owed to the company by the directors.[28] The company as an entity is formed complete with a separation of ownership and control. The articles and the Companies Acts regulate the interaction of the board and the general meeting. The separation of ownership and control gives rise to a fiduciary relationship which has evolved a number of specific duties, owed individually by the directors.

In this context, the question may arise as to when the directors are appointed agents of the company. The answer is that if Table A or its equivalent is adopted, the directors are appointed as agents as and from incorporation of the company.

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[28] Hunter Q.C. in GILMORE V DENNYS Q.B., UNREPORTED, 17 DECEMBER 1993 stated:-

> [t]he potential for conflict within a joint stock company is obvious. Whether the shareholders number in their thousands or whether there is just a handful of shareholders, who in economic terms at least can be regarded as in substance a partnership, there are in the nature of business life likely to be differing alliances of interest which will form and disband and differences of opinion which will arise and then disappear in an ever-changing kaleidoscope depending on the particular issue. The structure and constitution of the modern registered company is designed to provide a mechanism for the efficient resolution of such disputes while giving proper recognition to the legitimate rights and interests of all concerned.

Part 2.

2.2 The Degraded Board of Directors.

In this second section of the chapter, the thesis argues that the model board of directors is no longer the primary organ of the Table A company. The delegation of the control power vested in the board by the general meeting through article 80 is unclear and open to interference from the general meeting. The acceptance of the judiciary of the appointment of directors to serve another interest has eroded the board as the primary management organ and lessened the fiduciary duties owed to the company.

The fiduciary duties owed to the company have been successively defined in terms of the major component element of the company; the shareholders rather than the company. Thus the duty is no longer owed to the company but to the shareholders. Consequentially the existence of a large block of shareholders with interests other than the company's can distort the intention of the fiduciary duties.[29]

The fiduciary duties of directors to avoid conflict of interest and fettered discretion have been eroded by the recognition of nominee directors and the ability of shareholders to waive the duties owed in the articles of association. The statutory duty contained in section 53

[29] See chapter four.

of the Companies Act 1990 further erodes the management's ability to make decisions in the interest of the company as it introduces a duty to the employees. The directors must also comply with a quasi-duty to the shareholders arising from the Companies Act 1963, section 205, not to act oppressively or in disregard of their interests. This duty is complex as decisions of the board may be judged oppressive or in disregard of the interests of the members even though the directors were acting in good faith and within their legitimate powers.[30]

The final and perhaps the most complete erosion of the board's power to manage is the existence of a large group of shareholders within the company who have interests other than the company's to pursue. This is especially prevalent in public limited companies listed on the Stock Exchange, where institutional shareholders predominate.

2.3 Members' Power to Interfere in Management Decisions.

While it is clear that the company has two organs, the general meeting and the board of directors, their exact relationship to each other is ambiguous. While article 80 delegates the management power of the general meeting upward to the board, the extent of that

[30] RE IRISH VISITING MOTORISTS BUREAU LTD. H.C., UNREPORTED, 27 JANUARY 1972. See also the English decision RE A COMPANY, EX.P. SCHWARCZ (NO.2) [1989] B.C.L.C. 427 and Lowry (1994c: pp.606-609).

delegation needs to be explored.

The original concept of the relationship was that the general meeting was the company proper, and that the board of directors were purely acting as the agents of the company. The board had no separate autonomy and was subject to the total control of the general meeting.

An example of this concept can be found in ISLE OF WIGHT RAILWAY V TAHOURDIN (1883) 25 Ch. D. 320, (C.A.) where the directors of a company sought to prevent the holding of a general meeting, one purpose of which was to appoint a reorganisation committee to review the management of the company. Cotton L.J. at p.329 stated:-

> [i]t is a very strong thing indeed to prevent shareholders from holding a meeting of the company, when such a meeting is the only way in which they can interfere, if the majority of them think that the course taken by the directors, in a matter intra vires of the directors, is not for the benefit of the company.

By the turn of the century the practical implications of shareholder interference in management had forced a rethink in the defining factors of the relationship as we shall demonstrate from the case law below. The articles of association became the focus of such judicial attention.

The first expression of this rethinking came in AUTOMATIC SELF-CLEANSING FILTER SYNDICATE CO. V CUNINGHAME, [1906] 2 Ch. 34, (C.A.) where the court decided that the division of power between the board and the general meeting was entirely dependent on the terms of the articles of association. Once powers were conferred on the board, the general meeting could not fetter their exercise. The case is important in that it involved a discussion of the nature of an article which was a predecessor to article 80 of the present Table A. The article which delegated the management power of that company was held to constitute a contract whereby the members agreed that the directors alone shall manage the company.

This expression did not receive universal approval as there were differences in the articles of ISLE OF WIGHT RAILWAY V TAHOURDIN (1883) 25 Ch. D. 320, (C.A.) and AUTOMATIC SELF-CLEANSING FILTER SYNDICATE CO V CUNINGHAME, [1906] 2 Ch. 34, (C.A.) which could differentiate the two decisions. It was not until SALMON V QUIN & AXTENS LTD. [1909] 1 Ch. 311. (C.A.); [1909] A.C. 442, (H.L.)[31] that it was universally accepted that the general meeting cannot interfere with the powers of

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[31] See also the judgment of Buckley L.J. in GRAMOPHONE AND TYPEWRITER LTD. V STANLEY [1908] 2 K.B. 89. There he stated:-

> even a resolution of a numerical majority at a general meeting of the company cannot impose its will upon the directors when the articles have confided to them the control over the company's affairs. The directors are not servants to obey directions given by the shareholders as individuals; they are not agents appointed by and bound to serve the shareholders as their principals. They are persons who may by the regulations be entrusted with the control of the business, and if so entrusted they can be dispossessed from that control only by the statutory majority which can alter the articles.

the board[32] unless they act in conflict with the Companies Acts or the articles.[33] [34]

The Companies Act 1963 complicated matters by redrafting the previous delegation article.[35]

Article 80 now reads as follows:-

> [t]he business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and registering the company and may exercise all such powers of the company as are not, by the Companies Act 1963 to 1983 or by these regulations, required to be exercised by the company in general meeting, subject, nevertheless, to any of these regulations, to the provisions of the Act and to such directions, being not inconsistent with the aforesaid regulations or provisions, as may be given by the company in general meeting; but

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[32] There Farwell L.J. stated "[a]ny other construction might, I think be disastrous, because it might lead to an interference by a bare majority very inimical to the interests of the minority who had come into the company on the footing that the business should be managed by the board of directors."

[33] See further JOHN SHAW & SONS (SALFORD) V SHAW [1935] 2 K.B. 113 where Greer L.J. stated:-

> [a] company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles...

and also the approval of this principle by Budd J. in NASH V LANCEGAYE SAFETY GLASS (IRELAND) LTD. (1958) I.L.T.R. 11.

[34] Another example of this is found in SCOTT V SCOTT [1943] 1 ALL E.R. 582 where it was held that the general meeting could not by ordinary resolution require the directors to declare an interim dividend. See also BRECKLAND GROUP HOLDINGS LTD. V LONDON & SUFFOLK PROPERTY LTD. [1989] B.C.L.C. 100.

[35] Companies Act 1908, Table A, article 71.

> no direction given by the company in general meeting shall invalidate any prior act of the directors which would have been valid if that direction had not been given.

The Companies Act 1963 had substituted the word directions above, for the word regulations, which had been present in the old form Table A. This substitution gave rise to speculation that the change of wording had somehow changed the balance of power between the general meeting and the board.

Lang (1973: p.241) was of the opinion that this balance of power had shifted completely to the shareholders, who could now issue commands to the board on the management of the company.[36] Sullivan (1977: p.569) discussing the U.K. article 80, opines that the general meeting can by an ordinary resolution overrule the board.[37] The basis of his argument is that article 80 only places the management function generally in the board. Thus the general meeting can interfere with the management function on specific issues.[38]

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[36] By ordinary resolution as opposed to special resolution.

[37] For an opposing view of the U.K. position prior to 1985, see MacKenzie (1983: pp.99-102) and Sealy (1989b: pp.26-28).

[38] In the U.K. the position that the general meeting cannot interfere with the management function by way of ordinary resolution is now expressly provided in an updated version of article 80; Companies (Tables A-F) Regulations 1985 (S.I. 1985 No. 805) article 70. But see Lord Wedderburn of Charlton (1989: pp.401-408) where he states:-

> [o]ne finds indications that a different rule may apply where what is in issue is control of company litigation--the initiation, defence or compromise of actions--and that this function may not be regarded as

Ussher (1975: pp.303-304) on the other hand dismisses these arguments. He maintains that while the Courts will be bound to interpret "directions" as being ordinary resolutions, those resolutions are subject to the proviso that they are "not inconsistent with the aforesaid regulations." The word "regulations" refers to the other articles of Table A. Thus the logic follows that the members in general meeting may not by ordinary resolution interfere with powers conferred on the board by the articles.

While Ussher disagrees with the wide interpretation accorded to the articles by Lang, he does conclude that there is some uncertainty about the scope of the general meeting's power to issue directions. Ussher (1986: p.88) states:-

> [t]he new form of article 80 is best avoided by company draughtsmen, not only to avoid the uncertainties of it, but also to fulfil the expectations of most company promoters who would like to see matters of management exclusively the province of the board. The older form of article or a new form which deletes all mention of directions from the general meeting, should therefore be adopted.

Mac Cann (1991: p.421) considers both the arguments of Ussher, Lang and the case law on article 80. He concludes:-

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merely part of the management of the company's business. Indeed, so uncertain are the decisions that writers have left open the possibility that the board and the general meeting may here enjoy parallel powers in some manner over actions in the company name.

> the wording of article 71 was different in certain respect from article 80 of Table A of the Principal Act and accordingly these cases would no longer seem to represent good law in Ireland. Article 80 is understood to mean that the members may by ordinary resolution validly interfere with the directors' general powers of management. In the case of other powers which have been expressly reserved to the directors by statute or by the articles themselves, the members can only interfere by special resolution.

Thus the adoption of Table A article 80 will not delegate the power of management upwards to the directors.[39] In most facets of the management of the company the general meeting may interfere by ordinary resolution.[40] In the case of a specific power delegated to the board[41] the members may not interfere save through a special resolution.[42] If a power is conferred by statute to the board then the members may not interfere at all, even through a special resolution.[43]

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[39] See Flynn (1991: pp.101-117) for a consideration of the interpretation of the wording of article 80. He concludes that on the wording of the article the managerial power is subject to interference through an ordinary resolution.

[40] See RE EMMADART LTD. [1979] Q.B. 540 where Brightman J. stated:-

> [t]he board can also properly act on an ordinary resolution of the shareholders conferring the requisite authority on the board provided that this does not contravene any provision in the articles.

[41] Such as the power to elect a chairman under article 104.

[42] See CLARK V WORKMAN [1920] 1 I.R. 107 where Ross J. stated "the company cannot interfere in the subject-matter of the delegation unless by special resolution"; and KEHOE V WATERFORD AND LIMERICK RAILWAYS (1888-89) 21 L.R. Ir. 221.

[43] The general meeting can remove the directors of the company by special resolution and substitute a more compliant board. It should be noted that while it is unclear to what extent

The general meeting is thus maintained as the primary managerial organ as its decisions will bind the board of directors.[44]

2.4 Directors Appointed to Serve Another Interest.

The second area where the managerial discretion of the board has been interfered with, is through the custom or practice of the appointment of directors whose function is to represent a particular interest. The fiduciary duties of a director can become somewhat complex when a director is appointed by a particular group of shareholders or debenture holders. The intention is clearly that the director act primarily in what he perceives the interest of his appointor to be. If he fails to do this, he will lose his place on the board.[45]

The Accepted Position.

> [T]ake a nominee director, that is, a director of a company who is nominated by a large shareholder to represent his interests. There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves.

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an ordinary resolution may interfere with the management of the company, it is clear that the same votes may achieve the more draconian measure of replacing the board.

[44] Save for the above exceptions.

[45] As he can be removed by ordinary resolution, pursuant to the Companies Act 1963, section 182.

This dissenting judgment of Lord Denning in BOULTING V A.C.T.A.T [1963] 2 Q.B. 606 at 626 referred specifically to the issue of the director appointed to serve another interest. Lord Denning's opinion is clear. The director must be left free to exercise his judgment bona fide in the interests of the company.[46] A representative director is not prima facie in conflict with his fiduciary obligations.[47]

A director once appointed, while representing a particular interest, has to have regard to the duties he owes to the company.[48] This position in equity and the extent to which directors owe these duties was considered in SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER [1959] A.C. 324 (H.L.). In this case Scottish Co-operative Wholesale Society (S.C.W.S.) formed a subsidiary company to manufacture rayon. The society appointed three representative directors to the board of its subsidiary. The manufacture of rayon was strictly controlled until 1952. When the controls were removed, S.C.W.S.

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[46] PERCIVAL V WRIGHT [1902] 2 Ch. 421.

[47] Lord Denning continues:- "but if he is put on terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful..."

[48] In JOHN CROWTHER GROUP PLC. V CARPETS INTERNATIONAL PLC. [1990] B.C.L.C. 460 Vinelott J. held that where directors undertake to exercise their powers in relation to the management of the affairs of a company in a manner which would fetter their ability to act in the future in what may then appear to them to be the best interests of the company, a term ought to be implied to the effect that such undertaking is subject to the limitation that the directors will not thereby be required to do anything that would be inconsistent with the fiduciary duties they owe to the company.

transferred the rayon business from the subsidiary to itself. The subsidiary consequently had no function.

An application was brought by one of the minority shareholders against S.C.W.S. under the Companies Act 1948, section 210[49] on the ground of oppression. One of the arguments put forward concerned the duties of the representative directors. Lord Denning considered these:-

> [w]hat, then, is the position of the nominee directors here? Under the articles of association of the company, the society was entitled to nominate three out of the five directors, and it did so. It nominated three of its own directors and they held office, as the articles said, "as nominees" of the society. These three were, therefore, at one and the same time directors of the society--being three out of twelve of that company--and also directors of the company--three out of five there. So long as the interests of all concerned were in harmony, there was no difficulty. The nominee directors could do their duty by both companies without embarrassment. But, so soon as the interests of the two companies were in conflict, the nominee directors were placed in an impossible position.[50]

The presumption raised in SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER, [1959] A.C. 324 (H.L.) and BOULTING V A.C.T.A.T [1963] 2 Q.B. 606 is that the position of such a director is an accepted one, unless

[49] Now the U.K. Companies Act 1985, section 459, (as amended by the Companies Act 1989, Sched. 19, para 11).

[50] Inactivity in a conflict situation will also constitute a breach of duty; COLDMAN V HILL [1919] 1 K.B. 443.

that director is in conflict.[51] [52] Then his position is untenable, and he must presumably resign.[53]

Of interest in this area is the way the legislators of Ghana sought to deal with this problem. The Ghana Companies Code 1963 (Act 179) at section 203 (3) states:-

> [i]n considering whether a particular transaction or course of action is in the best interests of the company as a whole, a director, when appointed by, or as a representative of, a special class of members, employees or creditors may give special, but not exclusive, consideration to the interests of that class.

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[51] The same difficulties arise when directors of a company are also directors of a rival competing company. Chatterton V.-C. in MOORE V M'GLYNN [1894] 1 I.R. 74 considered this situation. There a trustee had been left the testator's business to run for the beneficiaries. He subsequently set up his own business in competition with the testator's. Chatterton V.-C. stated:-

> I am not prepared to hold that a trustee is guilty of a breach of trust in setting himself up in a similar line of business in the neighbourhood, provided that he does not resort to deception, or solicitation of custom from persons dealing at the old shop.

The same conclusion was reached by the House of Lords in BELL V LEVER BROS LTD. [1932] A.C. 161. For a contrary view, see HIVAC LTD. V PARK ROYAL SCIENTIFIC INSTRUMENTS LTD. [1946] 1 ALL E.R. 350 where it was held that working for a competitor in any situation where a disadvantage might accrue to the company, was not allowable.

[52] Further, see THOMAS MARSHALL (EXPORTERS) LTD. V GUINLE [1978] 2 W.L.R. 116 where it is suggested that competing is per se a breach of duty and that it would inevitably lead to other fiduciary breaches. Although it was an employees duty of good faith that was at issue in that instance, Megarry V.-C. accepted an analogy with the duties of a director. The same argument would apply to representative directors. See also Christie (1992: pp.506-520) where he concludes that the "[c]ourts should unhesitatingly acknowledge that these judgments are inconsistent with long established principles of Equity regulating directors."

[53] Or abstain from voting.

Thus the code accepts that the representative director will consider interests other than the company's.[54] [55]

The position in Ghana received implicit approval in KUWAIT ASIA BANK E.C. V NATIONAL MUTUAL LIFE NOMINEES LTD. [1990] B.C.L.C. 868 where it was held that a nominee director may owe a duty to the person who appointed him, that duty is secondary and subject to the director's overriding duty to the company itself.

The position of representative director is an accepted one. The representative director is not prima facie in conflict with his fiduciary duties by virtue of his appointment.[56] When the interests of his appointor and the company do conflict, the director is allowed

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[54] The position of nominee directors was accepted by The Bullock Committee (1977: Cmnd. 6706, Chapter 8, para. 40) its only comment was to recommend that no representative director should be appointed to act in a particular way.

[55] This approach is mirrored by the judicial approach to liquidators who may have potential conflicts of interests. Dillon L.J. in RE ESAL (COMMODITIES) LTD. [1989] B.C.L.C. 59 stated:- "these sort of potential conflicts do not in practice give rise to any serious difficulty because they are well known to the experienced insolvency practitioner." Hoffmann J. in RE ARROWS LTD. [1992] B.C.C. 121 stated:-

> [i]t is by no means uncommon in the case of an insolvency of a substantial group of companies for cross-claims and conflicts of interest to arise between companies in the group. That does not usually deflect the court from appointing a single firm of insolvency practioners in the first instance to deal with the whole insolvency of the group, leaving the question of potential conflict of interests to be dealt with if and when it arises."

For a consideration of when the liquidators conflict may be too acute see; RE WALLACE SMITH & CO. LTD. [1992] B.C.L.C. 970.

[56] See Lord Denning above in SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER [1959] A.C. 324 (H.L.).

consider interests other than the company's.[57]

The thesis now turns to consider how the acceptance of the representative director by the judiciary impacts on the fiduciary duties.[58] [59]

Fiduciary Duties Considered.

> Nominee and multiple directors are widely used, yet there are few cases dealing with the question of the applicability of the fiduciary duties generally owed by directors to these categories of director. Nor are there any statutory provisions in England, Australia and New Zealand to be discussed which regulate nominee or multiple directors or attempt to clarify this issue. Boros (1989: p.211)[60]

It is the contention of this thesis that the acceptance of the representative director by the judiciary has eroded the fiduciary safeguards contained in the model company. Further the acceptance of a secondary fiduciary

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[57] KUWAIT ASIA BANK E.C. V NATIONAL MUTUAL LIFE NOMINEES LTD. [1990] B.C.L.C. 868.

[58] Rohatyn (1993: p.64) considers that major institutional shareholders need to be actively involved in the performance oversight functions of boards of directors. This could be done by creating a cadre of professional directors, chosen from the ranks of men and women with extensive business and management experience. These directors would not be the representatives of the institutions, but would report to them as their conduit and as their eyes and ears.

[59] See Avory J. in KREGOR V HOLLINS (1913) 109 L.T. 225 where he discusses the position of conflict of duties.

[60] See further Boros (1989: pp.211-219) for an examination of the position of representative directors in the commonwealth jurisdictions.

duty owed to the representative director's appointor degrades the board of directors' managerial discretion.

It is difficult to see how the duty of the director to act bona fide in the interests of the company can be reconciled with the position of a representative director.[61] [62] The duty is to act in the interests of the company as a separate entity,[63] [64] not the members, employees,[65] creditors[66] or a group of the members.

The representative director is appointed to serve a particular interest; that of his appointor. This is in conflict with the duty to act in the interest's of the company as an entity. The courts have allowed the

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[61] Lord Greene M.R. in RE SMITH & FAWCETT LTD. [1942] Ch. 304 at 306, C.A. on the subject of the directors duty of good faith stated "[t]hey 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."

[62] Gibson L.J. in NICHOLAS V SOUNDCRAFT ELECTRONICS LTD. [1993] B.C.L.C. 360, considering the interests of the company, was of the opinion that it may be necessary for directors to take steps which are prejudicial to some of the members in order to secure the future prosperity of the company or even its survival.

[63] As per SALOMON V SALOMON & CO. [1897] A.C. 22, (H.L.)

[64] Regarding the duty to act in the interests of the company see RE W. & M. ROITH LTD. [1967] 1 W.L.R. 432 and also RE LEE BEHRENS AND CO. LTD. [1932] ALL E.R. 889.

[65] This remains the position in equity but note the position under the Companies Act 1990, section 52 creates a duty to the employees which is considered infra at page 122.

[66] Creditors interests may warrant consideration where the company is insolvent; WALKER V WIMBORNE (1976) 137 C.L.R. 1. Further in that case directors who pursued a general policy in disregard of the individual companies within a group and in favour of the larger group were held to breach the duty to act in the interests of the company.

position of representative director to stand.[67]

There were originally some restrictions on a representative director. At first the line was drawn where the interests of the director's appointor and the company's were in conflict. The director's position was then "impossible".[68]

This has since been modified to allow the director to legitimately consider interests other than the company's.[69] Thus the position of representative director is accepted even where the interest's of the company and the interests of the representative director's appointor are in conflict.

This is not a correct statement of the law.[70] The position of representative director is in conflict with the fiduciary duty to act bona fide in the interests of the company. Thus his very appointment to serve another interest breaches the duty to the company.

As well as conflicting with the duty to act "bona

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[67] Boros (1990: pp.6-10) concludes:-

> [n]ominee directors and multiple directorships in competing companies both give rise to a real possibility of conflict between the duty owed by the director to a principal or other company and that owed to the company.

[68] As per Lord Denning above in SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER [1959] A.C. 324 (H.L.).

[69] KUWAIT ASIA BANK E.C. V NATIONAL MUTUAL LIFE NOMINEES LTD. [1990] B.C.L.C. 868.

[70] It at least lacks consistency. In BRENTS BREWERY CO. LTD. V HOGAN [1945] 2 ALL E.R. 66 and in D.C. THOMSON & CO. LTD. V DEAKIN [1952] 2 ALL E.R. 361 it was held that it is wrong to induce another to act inconsistently with the duty of fidelity which he has undertaken by contract or trust to perform.

fide in the interests of the company", the representative director may not place himself in a position where his personal interests and his duty to his principal conflict.[71] The rule does not rely on fraud or absence of bona fides.[72] The representative director may have difficulty complying with this duty.[73]

Yeo (1990: pp.149-150) considers the position of representative and interlocking directors. He states:-

> [t]he duty of undivided loyalty is a frail doctrine that poses difficulties and is unworkable in practice. It is submitted that the doctrine should be reconsidered especially where there are so many nominee and interlocking directors.... their dual or multiple fiduciary responsibilities to their other companies may inevitably lead to conflicts of interests.....These problems are likely to increase as businesses become bigger and more international...
>
> The courts are still not responding to these changes. The resolution of the courts to the dilemma faced by these directors is that a director has a duty of loyalty to both companies and he serves both to their best interests. This is, however, not a readily workable option for directors in the face of commercial reality.[74]

The managerial discretion of the board of directors

[71] PATTEN V HAMILTON [1911] 1 I.R. 47 see also above Part 1, 2.1 The Model Fiduciary.

[72] Per Lord Russell in REGAL (HASTINGS) LTD. V GULLIVER [1942] 1 ALL E.R. 378 at 386.

[73] In particular if the words of Lord Cranworth L.C. in BROUGHTON V BROUGHTON (1855) 5 De G.M. & G. 164 are applied. There he stated "the rule really is that no one who has a duty to perform shall place himself in a situation to have his interest conflicting with his duty."

[74] See also Crutchfield (1991: pp.136-142).

can be further restricted by the shareholders within the company.[75] Additional pressures can be brought to bear on the directors' managerial discretion by introducing a remuneration system which ties the directors' interests to that of the shareholders. This is done through giving the directors share options which are large enough to create such a coincidence of interests.[76] The interests of the principal[77] are no longer the primary concern. The directors and the shareholders are acting in tandem and the concept of the company as a separate entity is further eroded. The duty to the company no longer impacts.

In particular representative directors in public limited companies listed on the Stock Exchange have complex problems.[78]

The nature of their appointment is to represent the interests of the institutional fund at board level.[79] The

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[75] And indeed by the workings of the marketplace, See Riley (1992: pp.782-802) where he states;-

> [t]he discipline on management to pursue shareholders' interests is compounded, it is claimed, by an efficient market in corporate control: the tendency of management to shirk or to pursue its own interests at the expense of the shareholders will be regulated by their fear of takeovers and the consequential loss of managerial power.

[76] See Meredith (1993: pp.48-49) for a consideration of this issue.

[77] The company.

[78] There institutional investors appoint directors to represent their interests.

[79] See chapter three.

representative director receives his remuneration from the institutional fund. He has a personal interest in its performance,[80] also, he may receive share options from the company. Thus the representative director can potentially be in conflict with both the company[81] and the institutional fund.[82]

McGough (1994: R8) comments on the growing phenomenon in the U.S. where mutual-fund managers sit on the board of companies in which their fund holds shares.[83] He points out that the practice is laden with potential conflicts of interest.[84]

These conflicts can arise in a number of ways. The position of director also attracts lucrative personal

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[80] Through that remuneration and his career with his primary employer.

[81] Through his remuneration from the institutional fund.

[82] Through his personal interest in the share options.

[83] McGough (1994: R8) also found that some fund managers had acquired personal shareholdings in companies at a lower per-share price than their funds had. This in itself seems to be a conflict of interest. Further, some fund managers had acquired seats on boards when working for previous employers and retained them when they moved employers. Their present employers refrained from investing in those companies because of the personal involvement of those fund managers. This raises the point that the personal involvement of these fund managers in a successful company has affected the funds performance as it could not invest in that company.

[84] McGough (1994: R8) points also to difficulties which arise due to insider trading laws. Fund managers who are also directors on the boards of companies their funds invest in have to thread a very fine line to comply with insider trading provisions. The position of insider can sometimes be a positive detriment to the fund managed by the director. McGough provides an example of one such fund manager. His fund had to suffer through the price dive as any sale prior to a public announcement would have been a violation of the insider-trading laws.

stock options which could lead to a fund manager hesitating to dump a company's stock from a fund while sitting on that company's board, waiting for personal options to rise. McGough (1994: R8) provides an example of one such fund manager where he states:-

> [t]hat's the situation facing Martin Whitman of Third Avenue Value Fund, with assets of $114 million. He serves not only on the board but as chairman of a financial company that has given him stock options. And he personally owns a chunk of stock. As a director of Danielson Holding Corp., New York, he earns only "$75,000" according to last spring's proxy material. But stock options promise to give him much more. He received options to purchase 210,000 shares at $3 apiece, the 1993 proxy material shows. With the stock at $7.50 on the American Stock Exchange, Mr. Whitman has a paper profit of $945,000 ---- and a big incentive to avoid having his fund dump the stock.

At present regulation of representative directors in the United States is inadequate.[85] [86]

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[85] See Grundfest (1994: pp.963-1024) for an examination of the role of the Commission.

[86] The U.S. Securities and Exchange Commission's purpose is to administer federal securities laws that seek to provide protection for investors. The purpose of these laws is to ensure that the securities markets are fair and honest and to provide the means to enforce the securities laws through sanctions where necessary. The United states Congress created the Securities and Exchange Commission (S.E.C.) under the Securities Exchange Act of 1934. The S.E.C. is an independent, nonpartisan, quasi-judicial regulatory agency.

The Commission is made up of five members: a Chairman and four Commissioners. Commission members are appointed by the U.S. President, with the advice and consent of the Senate, for five year terms. The Chairman is designated by the President. Terms are staggered; one expires on June 5th of every year and not more than three members may belong to the same political party.

The final fiduciary duty which impacts on the representative director is the duty of a director not to fetter his discretion. Gower states the position as follows:-

> [t]hus it seems clear as a general principle, despite the paucity of reported cases on the point, that directors cannot validly contract (either with one another or with third parties) as to how they shall vote at future board meetings.[87]

Is it not the case that a representative director is agreeing to vote, if not in a particular way, then at least in a particular interest. Does this not in itself conflict with the duty to not to fetter his discretion?[88]

The position of the representative director is one which presents unique difficulties. The case law on the specific issue of representative directors, while sparse, indicates an acceptance of the position of representative director as legitimate. The fiduciary duties owed by

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Under the direction of the Chairman and the Commissioners, the staff ensures that publicly held entities, broker-dealers in securities, investment companies and advisers, and other participants in the securities markets comply with federal securities laws. These laws were designed to facilitate informed investment analyses and decisions by the investing public, primarily by ensuring adequate disclosure of material information. As such, at present they do not cover the behaviour of representative directors (Office of Public Affairs 1992).

[87] For a further consideration as to whether directors can in fact agree to vote a particular way in the future, see Kenyon-Slade (1993: pp.218-220).

[88] See CLARK V WORKMAN [1920] I.R. 107 where Ross J. considers directors decisions must be taken "unfettered by any undertaking or promise".

directors seem to be in conflict with that accepted position of representative director.

This thesis maintains that at very worst the position of representative director is in conflict with the concept of a fiduciary. At best the director is surrounded by a mire of duties which if complied with make his position untenable.

The above case law on the representative director accepts this position. The fiduciary safeguards owed to the company are thus eroded and the judiciary allow the general meeting to further influence the managerial discretion of the board of directors.

2.5 The Erosion of the Fiduciary Safeguards.

As can be seen above in Part 1 the act of formation creates the agency which gives rise to the fiduciary duties owed individually by the directors.[89]

Thus the director owes a duty to act in good faith in the interests of the company as a whole. The test for that duty is subjective. If that individual director believes that what he is doing is in the interests of the company then the court will not interfere.[90]

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[89] Above Part 1, 2.1 The Model Fiduciary, p.86. See also Barc and Bowen (1988a: pp.317-348).

[90] Even if that decision might appear to be to the detriment of the company; RE GRESHAM LIFE ASSURANCE SOC. [1872] L.R. 8 Ch. 446. Although this is now in doubt as the court applies an objective test to determine the directors belief. See chapter four for a full consideration of this objective test.

In PERCIVAL V WRIGHT [1902] 2 Ch. 421 a director bought shares from a member without disclosing that the board were at the time negotiating for the purchase of all the shares of the company at a much higher price. The shareholder subsequently found out and sought to bring the director to account. Swinfen Eady J. held that the director owed a duty to the company as a whole and not to the individual shareholders. The shareholder could not succeed.[91]

A director may not place himself in a position where his personal interests and his duty to his principal conflict.[92] Lord Cranworth L.C. in ABERDEEN RAIL CO. V BLAIKIE BROS (1854) 1 Macq. (H.L.) 461 stated:-

> 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 may possibly conflict with the interests of those whom he is bound to protect.[93]

A director must exercise his power for the purpose which it was conferred. If the directors exercise their power for an improper purpose they are liable accordingly.[94]

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[91] Note the insider trading provisions in the Companies Act 1990 would now cover this type of behaviour.

[92] GABBETT V LAWDER (1883) 11 L.R. Ir. 295. For an examination of this doctrine at work, see Hopkins (1990: pp.220-223) and Stallworthy (1993: pp.C80-81).

[93] For an examination of this duty, see Bean (1994: pp.266-272).

[94] HOWARD SMITH LTD. V AMPOL LTD. [1974] A.C. 821.

Directors may not enter into agreements as to how they should vote at future board meetings.[95] Their discretion to make decisions must remain unfettered.[96]

The difficulty for the judiciary in interpreting a phrase like "bona fide in the interests of the company as a whole" is that the company is an artificial entity. How are the interests of such an artificial entity to be determined? The judicial answer has been to look at the component parts of the entity. If that criteria is applied then the general meeting is the significant element.[97] Cases such as PARKE V DAILY NEWS LTD. [1962] Ch. 927 and HUTTON V WEST CORK RAILWAY CO. (1883) 23 Ch. D. 654 bear this out. Ussher (1986: pp.220-221) states:-

> "[n]o one else, no other interest group, comes within the definition of the company as a whole...

Thus the fiduciary duty to act "bona fide in the interests of the company as a whole" does not mean to act objectively in the interest of the company as an entity.[98] It means generally to act in the interests of

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[95] Contrast this with the freedom shareholders have to enter into voting agreements.

[96] CLARK V WORKMAN [1920] 1 I.R. 107.

[97] See the Report of the Second Savoy Hotel Investigation (1954).

[98] Indeed in NICHOLAS V SOUNDCRAFT ELECTRONICS LTD. AND ANOTHER [1993] B.C.L.C. 360 the court held that the welfare of a parent company was in the interests of the company. Note also the implications of this judgment for SALOMON V SALOMON [1897] A.C. 22, (H.L.).

the members.[99] Thus the directors' managerial discretion is further eroded due to the judicial definition of their fiduciary duty. They now must act "bona fide in the interests of the members."[100] Taking this judicial definition one step further, the existence of a large group of shareholders with interests other than the company's can abuse the intention of the fiduciary duty.[101]

Another problem regarding the fiduciary duties is that they can be waived by the general meeting.[102] Table A articles 84-87 expressly provide for such waiver.[103] [104] Thus Gower (1979: p.601) comments:-

> waiver clauses have, as we have seen in

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[99] See chapter five for a complete analysis of the duty to act "bona fide in the interests of the company."

[100] In IN RE WINCHAM SHIPBUILDING BOILER AND SALT CO. (1878) 9 Ch. D. 322 Jessel M.R. stated "[i]t has always been held that the directors are trustees for the shareholders, that is, for the company."

[101] See chapter three, 3.1 The Interests of the Institution.

[102] In BRAY V FORD [1896] A.C. 51 Lord Herschell stated:-

> [i]t has therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it can be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrongdoing. Indeed, it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustee should act for them professionally rather than a stranger, even though the trustee were paid for his services.

[103] That is as long as the disclosure requirements in the Companies Act 1963, section 194 regarding directors' interests in contracts are complied with.

[104] See also, Grantham (1993: pp.245-271).

> relation to directors' contracts continued to be inserted in articles and since they appear in Table A, they must be regarded as permissible and, at any rate to some extent, as effective... If, however, blanket waiver clauses of this sort are effective it enables a considerable hole to be driven in the equitable principle..[105] [106] [107]

From the above, and from the examination of the fiduciary duties regarding representative directors, it can be seen that the fiduciary obligations have been degraded. The board itself no longer owes effective fiduciary obligations to the company as an entity.

Complicating the issue for the board of directors are the statutory duties owed. The Companies Act 1990, section 52 provides:-

> [t]he matters to which the directors of a company shall 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 the members.

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[105] An even more alarming development has been the apparent ability of directors to contract to act in a particular way at future board meetings. This would appear to be allowable as long as some benefit accrues to the company thus the duty to act bona fides in the interests of the company is complied with. Where exactly this leave the duty of a director not to fetter his discretion is unknown. For a full discussion on this point see FULHAM FOOTBALL CLUB LTD. AND OTHERS V CABRA ESTATES PLC. [1994] 1 B.C.L.C. 363.

[106] See also Cranston (1992: pp.197-211) for an examination of the shareholders ability to release the director from his fiduciary obligations.

[107] Consideration of this area has occurred in Australia and New Zealand. There it is proposed that the shareholders' power to validate or ratify an act of the board or individual director which is in breach of duty, be removed. See Sealy (1991: pp.175-179).

It should be emphasized that the duty is owed to the employees in general. This makes it difficult to determine who may enforce the duty in the first place. Section 52 (2) continues:-

> [a]ccordingly, the duty imposed by this section on the directors shall be owed by them to the company (and to the company alone) and shall be enforceable in the same way as any other fiduciary duty owed to the company by its directors.

Thus the duty is grafted onto the existing fiduciary duty. The best "interests of the company" include the interests of the employees.

What is the position if "the financial interests of the members" is not the same as "the best interests of the company"? Such a situation could arise in a takeover bid where the financial interests of the members and the employees could be at odds with each other. At present the answer is that the shareholders' interest is paramount. The directors are required to <u>have regard</u> to the interests of the employees but must <u>act</u> in the "interests of the company", which equates to the shareholders' interest.[108] Thus the statutory addition has added nothing to the fiduciary duty except perhaps a slight confusion. The duty to act in the interests of the company as an entity is thus further eroded as the directors must consider the quasi-duty to the

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[108] See chapter four for an analysis of the judicial definition of the "interests of the company."

shareholders created by the Companies Act 1963, section 205.

The Companies Act 1963, section 205 concerns the right of a shareholder to take an action alleging oppression or disregard of their interests by the directors or members. The director has thus some sort of quasi-duty[109] not to act oppressively or in disregard of the members' interests. This poses complex responsibilities as directors may be perfectly within their legitimate powers in taking a particular course of action, but yet their actions could still constitute oppression[110] and give rise to a remedy under section 205.

One example of this was RE CLUBMAN SHIRTS LTD. [1983] I.L.R.M. 323 H.C.[111] where a minority shareholder alleged that the sale of the business without consulting him was an exercise of the board's powers oppressive to him. This lack of consultation prevented him[112] from being informed of the financial affairs of the company. O'Hanlon J. dealt firstly with the directors' contention

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[109] It is not in fact a duty at all but gives rise to an awareness on the board of directors part that their actions may lead to an application under section 205.

[110] In RE GREENORE TRADING CO. LTD. [1980] I.L.R.M. 94 oppression was defined as conduct which is "burdensome, harsh and wrongful." See also RE JERMYN STREET TURKISH BATHS LTD. [1971] 1 W.L.R. 1042.

[111] See also RE IRISH VISITING MOTORISTS BUREAU LTD. H.C., UNREPORTED, 27 JANUARY 1972 where it was held that acts may be oppressive even where the directors act honestly and in good faith.

[112] As he claimed he was so entitled.

that the directors were acting within the powers conferred on them by the articles of association, where he stated:-

> [t]his proposition may be correct in strict law, but it would be a highly unusual course for any board of directors to adopt when they propose to dispose of the whole business undertaking of the company for a consideration which will yield not a penny to the shareholders, as happened in the present case. A minority shareholder is entitled to have such a transaction, completed without his knowledge or consent, subjected to the closest scrutiny to ensure that he has been dealt with fairly by those who controlled the destinies of the company.

While O'Hanlon J. was unsure as to whether the conduct complained of constituted "oppression" within the meaning of the section, he was of the opinion that the petitioner had made a case for limited relief.[113] That relief entailed the purchase by the majority shareholders of the petitioner's shares, based on the value at the date he should have been consulted.

Thus the duties owed to the company have been circumvented in many ways. The idea that the duties are owed to the company is certainly not the case. The directors' discretion to act objectively in the interests of the company as an entity has been eroded. The final erosion of the directors' discretion to act is the quasi-duty arising above. It restricts even the directors'

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[113] In considering whether a case for relief has been made the court should have regard to the facts of each case and not exclusively to narrow legal definitions; SCOTTISH WHOLESALE CO-OPERATIVE SOCIETY LTD. V MEYER [1959] A.C. 324 (H.L.).

legitimate power to act.

2.6 The Board of Directors as a Secondary Organ.

> Every company has two primary organs, the board of directors and the company in general meeting. When a person subscribes for shares in a company, he recognises that the enterprise which the company has been formed to pursue will need direction and management and that directors will in due course be appointed to discharge that responsibility.

The words of Hunter Q.C. above in GILMORE V DENNYS Q.B., UNREPORTED, 17 DECEMBER 1993 refer to the model company where the board is a primary organ. The above chapter has shown that the model board of directors has been degraded to a secondary organ.

Thus actions of the board are open to the influence of the members through the confusion regarding the delegation of the managerial control in article 80, the acceptance of representative directors, the interpretation of fiduciary duties in terms of members' interests, the ability of the members to waive fiduciary duties and the coercive influence of section 205 which have all resulted in the inability of the board to act objectively in the interests of the company.

Outside Influences.

The thesis now turns in the next chapter to examine the external extra-constitutional influences on an already degraded board of directors.

The board of directors does not operate in a vacuum. It is open to influences other than those within the corporate structure. The presence of a large block of institutional investors in public limited companies creates a very strong lobby.[114]

The institutions significant voting rights allow them access to the board.[115] Other organisations such as the Stock Exchange, the City Panel on take-overs and mergers, and the institutional associations all support the institutional view point. This thesis now considers their influence on the model corporate structure.

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[114] With interests which may differ from the company's.

[115] Through representative directors and extra-constitutional meetings, termed institutional briefings.

CHAPTER THREE: THE INSTITUTIONAL INVESTOR.

3.0 Introduction.

This chapter examines the significance of "institutional shareholder dominance" within the shareholding population of public limited companies. It establishes that such a dominance does exist, then continues to examine the impact of the institutional presence on the degraded model legal company structure.

The presence of the institutional investor (a term described below) impacts on the degraded model in two ways. First, the interests of the institutions can be materially different to those of the legal entity. Second, the size of the institutional shareholding within companies enables the institutions to gain an input into the managerial discretion of the board of directors, through representative directors and informal extra-constitutional meetings with the management.

The thesis then combines the hypothesis of the degraded model with an account of the influence of the institutions in a take-over situation. It can then be shown that the model legal structure is not just degraded but destroyed altogether.

3.1 The Interests of the Institution.

The use of the phrase "institutional investor" denotes shares held by institutions such as pension funds, insurance companies, and other private investment funds in companies listed on The Stock Exchange.[1] Those shares are purchased by the institutions, and are managed on behalf of their clients. Managers are appointed by the institutions. Each fund manager is given a block of funds. A particular strategy is assigned. It may be either to generate income, maximise capital gains, or some combination of the two, from the fund. The investment manager then structures his investment, and turn-over of shares to that particular goal.

The investment manager has a number of tools to use in obtaining the goal of his fund. Firstly, he can structure his investment in companies on the basis of their past performance in generating either income or capital gains. Second, he can turn-over the shares in his fund in order to maximise the gain to his fund of short term market fluctuations.[2] Third, and less formally

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[1] Blank et al (1979: p.16) define the "institutional investor" as insurance companies, pension funds, investment trusts and unit trusts.

[2] The first two tools above have been the subject of academic research since the early 1960's. The focus of this research centres on the relationship between turnover activity within a given fund and the performance of that fund.

Put simply, is there any benefit to the fund if the manager is aggressive rather than passive? Ippolite (1989: pp.1-23) studied this phenomena over the period 1965-84. He concluded that while there did seem to be a gain to the funds where turnover was high, the cost of the transactions meant that the net gain was small. That raises an important point about the investment manager as an employee of the institution. The manager's function is not just to manage the fund allotted to him, he must be aggressive in his management as it attracts attention. The passive manager is unlikely to be regarded as a good manager even though his fund is performing adequately or well.

acknowledged, is the institutional manager's power to utilise the voting capacity of the shares the fund has purchased.[3] [4]

The fund manager is also under pressure to perform better than his competitors whether they be from other funds outside his institution or internal funds of the same nature. This competition between the funds managed by the various institutions is a short term one.[5] The performance of the various funds are compared both quarterly and annually and so the investment manager must achieve the funds goal over a twelve month period.[6] Thus a fund manager has a in built bias towards the short

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[3] Thus fund managers who have common interests and large shareholdings can appoint directors or remove them to secure that combined interest, they may also have an input into the management organ through informal briefings.

[4] Stewart (1993: pp.34-41) found that as institutional shareholders assert their prerogatives of ownership, they necessarily clip the power of corporate management.

[5] For a consideration of the short-term pressures fund managers are subjected to, when their performance is evaluated on a quarterly basis, see Innovation Advisory Board (1990).

[6] The British Labour Party (1987) stated:-

> [m]any industrial companies find it [the City] values their shares by present profits rather than future prospects, and that those who fail the test are vulnerable to takeover. The perverse result is to inhibit management from investment in research and development which will only show a return in the long term, for fear that the necessary reduction in distributed profit will reduce share prices in the short-term. Thus the short-term perspective which the City adopts in share dealing obliges industry to manage on the same short-term horizon.

term.[7] [8]

Russell and Montague-Jones (1990) comment on this. They state:-

> [i]t is estimated that 65% of U.K. listed companies are owned by institutional investors, such as insurance companies and pension funds. Institutional investors are generally under a duty to maximise investment returns and such returns are publicly compared with those of their competitors on a quarterly basis. This leads to accusations that their approach is orientated towards short term profits, and that this in turn encourages companies to maximise short term earnings per share.(1990: p.5)[9]

It clearly creates pressures on the fund manager to utilise the third tool above to ensure the company behaves according to his investment strategy.[10]

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[7] Nicholas Brady then U.S. Treasury Secretary in February 1990, quoted in Marsh (1990: p.6) regarding short-termism stated, they:-

> [c]an't possibly contribute in an important way to performance, much less to national goals...we need to create a climate where business leaders can concentrate on the long-term objectives rather than worrying about the next quarter's earnings...the Treasury is examining aspects of the corporate governance process which will encourage both the executives and institutional investors to think long term.

[8] When the Stock Exchange assumed its modern form, the process of division between finance and industrial capital had a habit of shorter term investment; For a consideration of this historical development see, Cottrell (1975) and Ingham (1984).

[9] This is clearly at odds with the interests of the clients of a pension fund as it is long term performance which really matters.

[10] For a full consideration of the short-term orientation see; Law (1986: pp.80-83) and Cosh et al (1990).

Sheridan and Kendall describe the communal interests as follows:-

> [t]he starting point is, as we have already indicated, to understand that the institutions are investors, and see themselves as such, not as owners. Their interest is in their funds and the performance of the funds, rather than the companies they have invested in, and they are judged, publicly, on their funds' performance. (1992: p.96)[11]

This communal emphasis on the fund's performance does damage a company's ability to perform.[12] The Innovation Advisory Board (1990) stated:-

> [t]he damage to companies may typically occur as follows:- the shorter the performance period the more a fund manager will opt for shares likely to deliver the short-term profits esteemed by market makers; moreover, if his portfolio starts to under-perform the fund manager may go even more short-term; in response, the companies give priority to the sought-after short-term profits in preference to R&D and other innovative investments.

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[11] They have another interest to serve in that they are also in a fiduciary relationship with their clients, see Moffat (1993: pp.471-496) and Nolan (1994a: pp.58-60).

That fiduciary relationship requires them to get the best performance from the fund, see Peters (1989: pp.871-872,876), Quick (1990: p.76) and Irish et al (1994: pp.10-23).

[12] Clarkham (1990) discusses the lack of proprietorial behaviour by fund managers who:-

> [f]or all practical purposes regards shares as if they were commodities, objects of value like gold or cocoa or porkbellies to be traded, but without any intrinsic qualities or value other than that of being readily tradeable in an active market... What the company does itself is largely irrelevant... Nothing matters about it except what may affect the immediate movement of its share price... It is a buy at 180 and a sell at 230.

Sheridan and Kendall are clear that:-

> [i]n general, however, the institutions still appear to be not so much concerned with corporate planning, marketing strategies, organisational developments, succession planning, R & D, technological developments and strategic alliances, which is the essence of what companies are really about. (1992: p.97)[13] [14]

Miles (1993: pp.1379-1396) considers all the arguments regarding short-termism and concludes:-

> [w]hat our results show is not that short-termism certainly exists, but that those who believe it does not exist do need to explain something about the operation of the security market which makes longer-term cash flows appear to be discounted at much higher rates than shorter-term flows.[15]

To conclude, the institutional investor has a distinct interest which may be at odds with the interests of the

[13] In Canada the short term approach of the institutions has led some companies to pursue individual private investors who will give the company's management greater freedom to pursue strategies that are better for the company in the long term; Bart (1994: pp.10-13).

[14] For an economic perspective on the impact of the institutional shareholder on corporate strategy, see Lowe et al (1994: pp.245-257).

[15] In the U.S. corporate managers have difficulties reconciling the demands of the market place with the long term goals of their companies. As institutional investors have become more sophisticated they have also become more demanding and more likely to exercise voting power and influence; McConville (1993: pp.29-32).

company invested in.[16]

Russell and Montague-Jones (1990: p.5) maintain that institutions hold 65% of the shares publicly quoted on the stock exchange.[17] Phillips and Drew (1990) maintain that institutions hold 70% of U.K. equities. Sheridan and Kendall (1992: p.92) using a survey completed by The Independent in November 1991, maintain that the institutional holdings are larger than either Phillips and Drew or Russell and Montague-Jones allow. In 1991 The Independent survey reported that institutions held 83.9% of the equities on the London Stock Exchange. That figure represented an increase from 1990 of 1.9% and an increase of 11.9% from the start of the decade.[18] Anonymous (1994b: p.4) places institutional ownership at about 80%.

Whatever the true figure, the sources quoted in the previous paragraph indicate the influence that institutional shareholders have over quoted companies.[19]

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[16] Nigel Lawson then Chancellor of the Exchequer on the 9 June 1986, quoted in Nickel and Wadhwani (1987) stated:-

> [t]he big institutional investors nowadays increasingly react to short term pressure on investment performance. As a consequence many British industrial managers complain that their institutional shareholders are unwilling to countenance long-term investment or a sufficient expenditure on research and development.

[17] The Wilson Committee (1977) found that institutional holdings in equities had increased from 26.6% in 1966 to 42.5% in 1975. It also forecast that percentage would rise by 50% by 1980 and that by the year 2000 it would be between 69% and 84%.

[18] 1980.

[19] For a consideration of the size and increasing influence of the institutional shareholder in corporate governance in Canada, see Montgomery and Leighton (1993: pp.38-46).

The figures translated across to voting power are extremely significant. The combined voting powers of institutions within companies normally confers ordinary resolution powers, and indeed within some companies the combined institutional votes carry special resolution powers. Examples of this can be seen from the 1990 annual reports of U.K. companies. 117 shareholder accounts control 55% of B.T.R.'s share capital; 500 control 77% of B.P. (thus conferring special resolution powers), 353 control 63% of Shell; 100 control almost half of I.C.I. and 450 control 70% of Hanson.

The figures for the Irish stock exchange are even more startling. According to the Irish Stock Exchange figures for 1989,[20] 13 shareholder accounts control 78% of A.I.B. Further, Three shareholders, Irish Life, I.B.I. Nominees, and Ulster bank control 40% of A.I.B.'s share capital. Four shareholders, Irish Life, Standard Life, Prudential Assurance Co., and I.B.I. Nominees control 60% of James Crean Plc. Five shareholders, A.I.I.B., I.B.I., Irish life, Standard Life and Bank of Ireland Nominees hold 54% of the share capital of C.R.H. Plc.

The size of the institutional investment in the overall equities market is enormous.[21] The small size of the Irish market and the dominance of a core group of institutions makes the Irish market particularly

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[20] O'Neill (1989: pp.104-111).

[21] It is also likely to increase over the next decade as individuals build investible assets in retirement and saving plans, see Clowes (1993: p.1).

susceptible to institutional pressures due to the likelihood of a coincidence of interests between the major institutions.[22]

From the above we have established that the institutions have an interest other than the company's to pursue. They also own a significant majority of the shares in the marketplace.

3.2 Institutional Input into Managerial Discretion.

The thesis now turns to survey the institutional input into managerial power. In order to do this the thesis divides the section in two. The first section regards the normal life of the company where the institutional investor can impact on the managerial discretion of the board through representative directors and through informal contacts. The second section regards the company in a take-over situation. There the interests of the company and the institutional shareholder are opposed. The degraded model is thus exposed and the dominance of the shareholders' interests prevails to the detriment of the company's interest.

Normal Life of the Company.

The position of the representative director was

[22] One of the disadvantages of going public is the need to conform to the investment strategy of the institutional investor, see Fletcher (1994: pp.20-24).

explored in detail in the last chapter. This chapter does not intend to comment any further on the representative director save to bring its relevance to bear on the present argument. The position of representative director is an accepted one.[23] The position of dominance within listed companies of the institutions confers significant voting rights on them. The institutions can thus appoint directors to represent their views.[24]

The Cadbury Report (1992) contained some recommendations regarding the involvement of institutional shareholders in companies.[25] [26] Sir Adrian Cadbury stated:-

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[23] See chapter two 2.4 Directors Appointed to Serve Another Interest.

[24] Institutional shareholders are encouraged to take an active role in regulating companies. This can be seen clearly in the report of the Cadbury Committee (1992) which was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy bodies. The impetus for the setting up of such a committee was the concern of the sponsoring bodies at the lack of confidence in British financial reporting and in the value of audits.

[25] Sir Adrian Cadbury, regarding the impetus for the Cadbury Report, stated :-

> [t]he underlying factors were seen as the looseness of accounting standards, the lack of a clear framework for ensuring that directors kept under review the controls in their businesses and the competitive pressures on companies and on auditors made it difficult for auditors to stand up to demanding boards. (1993: p.1)

While financial reporting was the concern of the Cadbury Committee it did touch on institutional involvement.

[26] For a consideration of the main recommendations of the Cadbury Committee, see Osman (1992: pp.24-25).

> [t]he last section of the Report is addressed to the shareholders. We welcomed the Institutional Shareholders Committee's (I.S.C.) call for regular and systematic contact between institutional investors and companies. They urged their members to take a positive interest in such matters as the composition of the board and the appointment of a core of ned's (non-executive directors) of the necessary calibre, experience and independence. The I.S.C. also advised their members to use their voting rights; we supported that and recommended that institutional investors should disclose their policy on voting. (1993: p.9)[27]

The London Stock Exchange (L.S.E.) has made it a condition of listing that the directors state in the Annual Report whether they have complied with The Cadbury Report (1992) and give reasons for non-compliance.[28] The whole emphasis of The Cadbury Report (1992) is on placing more control in the hands of the shareholders.[29]

Both The Ryan Report (1992) and The Cadbury Report (1992) emphasised the need for institutional involvement in corporate governance. This is a recognition of not just a feature of corporate governance but a fundamental shift in the way the market place is working.

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[27] See Finch (1992a: pp.581-595) for a critical analysis of the Cadbury Committee's approach to institutional shareholders.

[28] Regarding the Cadbury Committee (1992), Davis (1993: pp.58-59) suggests that a committee of supervision should be set up representing the City institutions. Its role would be to supervise and develop corporate governance from the starting point of the Cadbury code of conduct. For a more critical analysis of the Cadbury report, see Finch (1994b: pp.51-62) and Dine (1994: pp.73-79).

[29] See Star (1994: p.17) where she considers that institutional shareholders are increasingly taking on the role of powerful lobbyists. She concludes that the institutions see the board of directors as a vital link in expressing their concerns.

Dissatisfaction at a company's performance leads the institutional investor to two distinct choices, get involved in the company or sell the shares. Some institutions choose to use their voting rights, others sell the shares.

The present market environment is dominated by institutional investors, thus the majority of buyers in the market place are institutions. An institution unhappy with a company's performance will have to sell its shares to another institution. This will become more and more difficult and the more attractive option will be to get involved in the company.[30] Ryan commented as follows:-

> [t]he present tenuous relationships between directors and shareholders are ultimately unsustainable. A majority of the shares in almost all large PLCs is held by institutions. The sheer size of some of these institutions (and especially the pension funds) will compel them to behave more like proprietors and less like punters. Trading shares among themselves will offer smaller and smaller rewards. More and more, the performance of the funds depends on the performance of the large companies, whose shares they must hold more or less permanently in their portfolios. Fund managers will therefore be forced to take a direct interest in underperforming firms. This means being active in the choice and appointment of directors. Indeed, there could be advantages in Non-Executive directors having close links with institutional shareholders who are long term shareholders. It would give the Non-Executive directors a constituency to back them up, and any loss of independence they might suffer would be more than counterbalanced by their increased weight when dealing with management.

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[30] See Marckus (1994: p.21) regarding the removal of Maurice Saatchi as Chairman of Saatchi & Saatchi Plc. Mr Saatchi alleged that his removal was instigated by a fund manager at Harris Associates of Chicago who threatened the board of directors with removal.

(1993: p.6)

As well as encouragement from the above Commissions and the Stock Exchange, the Institutional Shareholders Committee[31] (I.S.C.) encourages its members to take an active role in the companies in which they invest.[32] Thus the institutions are being encouraged from all sides to use their voting power to elect directors.

Those representative directors are representing an interest which is clearly not the company's, yet the law holds that no conflict arises between the nature of their appointment and their fiduciary duties.[33]

The institutions also influence managerial discretion through extra-constitutional informal briefings.[34] [35] Sheridan and Kendall (1992: p.83) comment

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[31] An organisation set up to represent the views of the institutional shareholders. For a consideration of how this organisation impacts on directors, see Evans (1991: pp.183-184).

[32] Institutional Shareholders' Committee (1992: pp.7-8).

[33] Again see chapter two, 2.4 Directors Appointed to Serve Another Interest.

[34] Marsh (1990: pp.108-109) states:-

> there has been a move away from using stockbrokers and their analysts as the principal intermediaries between companies and their institutional investors, in favour of more direct dialogue. The use of this additional, direct channel may well be helping to improve communications.

[35] Stahl (1994: pp.34-40) considers that the practice of investor relations can mean the difference between a strong company and a lackluster one. Investor relations represents the main contact between public companies and shareholders and analysts, and it is the basis by which brokerage firms and their sales department make a market in an institution's stock.

on this:-

> [t]he connection between annual general meetings and policy-making is remote. Commenting on A.G.M.'s, it has been remarked that never have so many given so little information to so few. The shareholders simply do not attend what is, in theory, a key company meeting. As an effective policy-making arena, the A.G.M. is a joke. The real owners of the company - the institutions - do not use the A.G.M. to promote their interests, preferring to put their points in private. Even when there are the upheavals... still the exception rather than the rule, incidentally - they are agreed on by the institutions in private meetings outside the A.G.M. The A.G.M merely ratifies these decisions formally.[36] [37]

Finch (1992b: p.185) commenting on this stated:-

> [i]nstitutional shareholders have historically made unremarkable use of the meetings and resolutions processes to work against incompetent management. Their approach has tended to be one of investigation "behind the scenes" and reliance on private discussions with chairmen and senior executives.

In June 1991 Norwich Union sought to oust the board of the environmental controls company, Trace.[38] The chairman of the board, Sir David Nicholson, referring to Mr. Michael Sandland, chief investment manager of Norwich

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[36] Amen (1994: pp. 49-50) considers the advantages of informal contact with institutional shareholders. He also recommends formalising these contacts.

[37] Useem et al (1993: pp.175-189) estimates that the next decade is likely to see institutional shareholders increase their involvement in corporate affairs.

[38] Sunday Times (1991).

Union, and the attempt to remove the board, stated:-

> Sandland wants to be seen as the white knight of corporate governance. It is politically motivated and it is vindictive. It is one thing to own shares in a company but they are trying to run the company. These people have no experience of industry and their power should be curtailed. The institutions have become arrogant and they need to be regulated.[39] [40]

Mr. Sandland felt that the action was justified and he stated in reply, "[c]ompanies are getting the message now that it is far better to pay attention to the first quiet phone call or letter and act of their own accord."[41] [42]

The Irish Stock Exchange also encourages the smaller shareholders to look to the institutions to exert

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[39] The institutions themselves are concerned about the level of access they have obtained into the managerial discretion. See Connon (1994: p.24) where it was reported that Scottish Widows one of the U.K.'s largest institutional investors is asking companies for a formal undertaking that they will not disclose price-sensitive information in the course of meetings with fund managers. The institutions are worried that the new insider trading legislation contained in the Criminal Justice Act 1993 would cover their activities.

[40] In the U.K. the Criminal Justice Act 1993 which took effect in early 1994 makes individuals "insiders" if they have price sensitive information through their work irrespective of the nature of their work. The Stock Exchange has published a guidance statement; Stock Exchange (1994). See also Smith (1994: pp.89-90) and Wotherspoon (1994: pp.419-433) for an analysis of the insider provisions.

[41] Norwich Union is one of the largest institutional investors and Mr. Sandland is also the chairman of the Institutional Shareholders Committee.

[42] See also Anant and Barr (1994: p.3) where they examine the increasingly activist behaviour of institutional shareholders in certain U.S. companies.

pressure on the directors.[43] [44]

The view of the Irish Stock Exchange (I.S.E.) and indeed the L.S.E. on this issue is that regulation of listed companies is a matter for the shareholders.[45] [46]

Further encouragement comes from The Irish Association of Investment Managers (I.A.I.M.) (1991: p.4) they state:-

> [g]ood informal communications between companies and investors/analysts are an integral part of a normal and healthy market. Because of the size of their shareholdings, and their fiduciary responsibilities, institutional investors are under a strong obligation to exercise their influence in a responsible manner. Formal methods of communication do not necessarily establish the type of direct relationship which enables directors and shareholders to obtain a deeper understanding of each other's aims and requirements.[47]

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[43] In Britain the Trade Secretary Michael Heseltine is quoted as saying that the big institutional shareholders should regulate the pay of executives; Anonymous (1994a: pp.49-50).

[44] While equivalent insider trading regulations exist in the Irish jurisdiction they have not been enforced. For a consideration of these provisions, see McCormack (1992: pp.105-111) and for an analysis of the problems regarding the insider legislation see, Lynch (1994: pp.189-192) and Linnane (1994a: pp.218-222).

[45] The General Manager of the Irish Stock Exchange Mr. Tom Healy quoted in Dalby (1994: p.3) stated "it is fair to say that in many cases it is only the large shareholders who are capable of taking responsibility".

[46] Buckley (1992) recommended the building of a strong relationship between the investment manager and the management of companies invested in.

[47] Companies in the U.S. are concerned with the increasing role of the institutions in the corporate environment. They are particularly concerned about the motivation and reasonableness of the activist institutional investors and their impact on corporate governance and management; Cordtz (1993: pp.24-28).

Sir Adrian Cadbury in his paper to the Institute of Directors in Ireland commented on this:-

> [t]here are a number of reasons for thinking that the institutions are looking at their shareholder role in a new light. First, there is the I.S.C. report on the Responsibilities of Institutional Shareholders in the U.K., to which I have already referred. This encourages the members of the I.S.C. to take a positive interest in the boards of the companies in which they have invested and to put their voting power to good use. Second, the institutions now own such a high proportion of U.K. equities that collectively they have a commercial interest in improving the way in which their companies are run, rather than selling out - given that they can only sell to each other. Third, the increasingly activist role of shareholders in the U.S. is likely to find its way over here, given the stake which American investors have in British industry. (1993: p.10)[48]

Lee and Tweedie (1981: p.138) surveyed 136 institutional investors regarding sources and use of financial information. A large percentage of those interviewed[49] visited the companies invested in.[50] The purpose of the visits were stated as the assessment of the ability of corporate management.[51] Commenting on these visits Lee

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[48] For a pro-shareholders activist approach, see Hagaman (1992: p.22).

[49] 94%.

[50] 50% of those that visited companies visited "frequently". No precise definition of "frequently" was provided in the report.

[51] The possibility that institutional directors might be considered shadow directors under the provisions of the Companies Act 1990 section 27 seems remote. In particular see RE HYDRODAN (CORBY) LTD. (1994) B.C.C. 161 where the influence needed to impose shadow director status was set at a very high level. See further, Bhattacharyya (1994: pp.151-152) and Campbell (1994:

and Tweedie (1981: p.144) state:-

> [c]ompany visits by institutional investors and stockbrokers are of obvious importance to them... We would, therefore, recommend that the investing community investigate this area with a view to establishing, more clearly than was possible in this study, the nature and purpose of such visits. In particular, it would appear to us to be an area which deserves some official attention, especially in view of the provisions of the Companies Act 1980, with a view to providing institutional investors and stockbrokers with accepted guidelines for such visits...

The managerial discretion of the board of directors is thus fettered by institutional input into the decision making process.[52] [53] The board are no longer acting in what could be objectively called the interests of the company and it must certainly be questioned as to whether they could subjectively believe their actions are in the interests of the company as an entity.[54]

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pp.609-614).

[52] This is not a recent development. Lord Shawcross stated "it is right that the institutions should increasingly interest themselves in the management of the companies in which they invest..." (Chairman of the Panel quoted in, Panel on Takeovers and Mergers 1978)
Also the Chairman of the Prudential Assurance Company, one of the largest institutional shareholders in the U.K. was quoted in the Financial Times (1970) saying that his company was always prepared to bring pressure to bear on the management of companies which were showing poor results.

[53] See further Gamble (1993: p.2) for a consideration of the institutional shareholders interference in managerial discretion.

[54] Bishop (1994: pp.SS16-SS17) concludes that institutional shareholders with close relationships to company bosses do not guarantee ideal corporate governance.

Faced with institutional pressure from within[55] and from the external environment,[56] [57] the director has no choice but to act in the financial interests of the institutions.[58] [59] Thus during the normal life of the company, the presence of the institutional investor erodes the model legal structure even more, through the additional input into the managerial discretion they have obtained.[60] That input comes with no added responsibilities.[61] They are still shareholders not

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[55] Through representative directors.

[56] Through extra-constitutional institutional input.

[57] Black (1992: pp.811-893) considers that the existing regime in the U.S. should be changed to facilitate shareholders activism. He sees institutional investors as a valuable constraint on managerial discretion. See also Hilton (1993: p.14).

[58] Ball (1990) points out that more institutional intervention is being used than is commonly supposed and that this is not a good thing.

[59] Agrawal and Mandelker (1992: pp.15-22) found that corporations with large institutional ownership are more likely to maximise shareholder wealth.

[60] Gage (1993: pp.11-12) found that institutional shareholders are invading board rooms and executive suites in an effort to boost stock prices by dictating corporate policy. To hold back investor interference, some corporations are looking for ways to direct their stock to ideal institutional shareholders. To manage investors more aggressively, some companies have begun using outside detective firms to track shareholders and find out their favourite types of stock or industries, hold and sell patterns, history of interference with management and any buying and selling moves. Corporations are using shareholder intelligence to send reassuring messages to nervous shareholders and to target potential investors sympathetic to management's long term goals.

[61] In the U.S. the Securities and Exchange Commission changed its rules in October 1992 in order to facilitate increased shareholder activism. See Silverstein (1993: pp.46-47).

directors and as such owe no duty to the company.[62] [63]

Take-over Situation.

The model company contains a separation of ownership and control. The control element is created in the registration procedure which also gives rise to the fiduciary duties owed by the directors as agents. From chapter two it can be seen that the board's power as a management organ has been degraded.[64] The above[65] has shown that the presence of the institutional investor has further degraded the management organ of the company. This section turns to examine a specific set of circumstance in which the degraded model legal company is all but destroyed, the take-over.[66]

> A "take-over" may be defined as a transaction or series of transactions whereby a person (individual, group of individuals or company) acquires control over the assets of a company.[67] (Blank et al 1979: p.3)

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[62] See chapter one, Equitable Considerations Concerning Members Voting Rights.

[63] Chernoff (1992: p.1) considers that increasing activism carries with it certain responsibility on the part of the institutions to maintain long-term positions in portfolio companies.

[64] See chapter two, Part 2.

[65] Chapter three, Normal Life of the Company.

[66] For a consideration of the theory that take-overs are a mechanism of disciplining corporate management, see Farrar et al (1988: p.520).

[67] Where the offeree company is a public company a take-over can occur, by agreement between the controllers of the companies, by purchasing the shares on the Stock Exchange and by means of

It is in these circumstance that the interests of the institutional shareholders and the company conflict.[68] The representative director is thus representing a view which is in conflict with his fiduciary duty. The informal institutional input into the discretion of the board also represents the institutional interest.

This though, may not be enough to secure control over even the degraded board.[69] [70] The City Code on Take-overs and Mergers[71] thus places control over the acceptance of a bid in the hands of the members.[72]

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a "take-over" bid.

[68] The interest of the institutions is to get the best price for their shares, not to accept or reject a bid which would benefit or not, the company. See 3.1 The interests of the institution.

[69] In the event of a successful take-over the board are likely to lose their positions.

[70] The status of the Code in the Irish jurisdiction is uncertain at present. The Panel on Take-overs and Mergers have ceased to act in the Irish Jurisdiction. See Graham (1993).

[71] The Code was issued by the City Working Party set up in 1959 and the Code was issued in March 1968. The Code is the main control over take-overs and mergers. The membership of the City Working Party represented the City associations and the institutions. The administration of the Code is undertaken by the Panel on Take-overs and Mergers. The Panel is made up of the representatives of the sponsoring organisations under a non-executive chairman and Deputy Chairman nominated by the Governor of the Bank of England. For a consideration of the work of the Panel and the regulation of take-overs in the U.K. generally, see Barc and Bowen (1988b: pp.1293-1325).

[72] As Gower (1979: p.696) states:-

> [t]he prime concern of the Code is the protection of the shareholders of the offeree company. This is secured, first, by requiring that the ultimate decision whether or not to accept an offer must rest with the shareholders themselves rather than with the management of the offeree company.

Ultimate control rests with the institutions who owe no fiduciary obligations to the company and who have a distinct interest other than the company's.[73] [74]

The Code ensures that the shareholders make the decision on whether the take-over should succeed rather than the management.[75] This by-passes the directors' duty to act in the "interests of the company" and leaves the institutions free to act in their own interests.[76] This can lead obviously to the institutions approving a take-over because it maximises the share price rather than being in the "interests of the company."[77]

The Code places stringent obligations on the offeree company's directors. It requires that shareholders be

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[73] Blank et al (1979: p.16) state:-

> [i]nsurance companies and pension funds are interested primarily in income and seldom sell any of their investments; however, as a company which attracts a take-over bid is in all probability one which is not obtaining the optimum return from its assets, they may well favour a take-over bid in respect of a company in which they hold shares.

[74] For a consideration of the present and likely future role of the Panel, see Calcutt (1990: pp.203-207).

[75] Other regulations impact on Take-overs. The Yellow Book (1994: Chr.2, s.6) states the importance of the Code and continues to regulate content of offer documents, listing particulars, timing of offers and inspection of documents. The Competition Act 1991, aims to prevent any restriction on competition. It amends the Mergers Take-overs and Monopolies (Control) Act 1978, and creates a competition authority to this end. See also Linnane (1994b: pp.319-320).

[76] A decision of the panel that finds that the Code has been broken will be accepted by the Stock Exchange Council as proof of a breach. The Stock Exchange is then open to take such action as it wishes.

[77] See Burr (1994: p.1) on the issue of institutional investors support of take-overs as maximising share price.

given sufficient information and advice to enable them to reach a properly informed decision.[78] Directors must also take competent independent advice and communicate it to the shareholders.[79] The directors are also entitled to circulate their own views.[80] The offeree directors are prohibited from taking any frustrating action without the approval of the shareholders in general meeting.[81] The board may not, without the approval of the shareholders in general meeting, issue any authorised but unissued shares, issue or grant options in respect of unissued shares, create or issue convertibles, sell, dispose or acquire assets of a material amount or agree to do so, enter into contracts other than in the ordinary course of business.[82] The directors should only act in their capacity as directors without regard to their personal or family shareholdings or their personal relationships with the company, taking into consideration only the interests of the shareholders as a whole and the interests of employees and creditors.[83]

Breach of the Code may lead the Panel to a number of

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[78] General principle 4 and Rule 23.

[79] Rule 3.1.

[80] Rule 25.

[81] General principle 7.

[82] Rule 21.

[83] General principle 9. While this principle looks to be an reasonable one, it is in fact attempting to redefine the considerations of the directors away from that of the corporate entity.

sanctions.[84] They may censure a party/advisor privately or publicly.[85] In serious cases the panel may recommend to the Stock Exchange that the facilities of the securities market be withheld from the offending company.[86]

If the board of directors breach the Code or attempt any defensive measures they may be open to an action under the Companies Act 1963, section 205.[87]

The net result of the Code would appear to be to empower the institutional shareholder to the detriment of the legal entity of the company.[88] [89] Sir John Clarke, formerly of Plessey P.L.C., considered that 35 fund managers had decided the take-over of his company. Fund managers:-

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[84] For an examination of the practical workings of the code, see Snaith (1990: pp.98-106).

[85] Press interest in take-overs and mergers makes the likelihood of a public censure a significant deterrent.

[86] The decisions of the Panel where held to be not open to judicial review (on the facts in this particular case): R V PANEL ON TAKE-OVERS AND MERGERS EX PARTE DATAFIN AND PRUDENTIAL-BACHE SECURITIES INC. [1987] B.C.L.C. 104. But for an argument that the decisions may be open to challenge, see Morse (1992: pp.596-599). For a consideration of the favourable treatment the Panel receives from the courts regarding judicial review and on how the various enforcement mechanisms available to the Panel work, see Ferran (1989: pp.349-352).

[87] See chapter two, 2.5 The Erosion of the Fiduciary Safeguards.

[88] For the Panel's viewpoint on their role see, Lord Alexander of Weedon (1990: pp.203-216).

[89] For a more critical analysis of the role of the Panel, see Morse (1991: pp.509-524).

> who did not know one end of a shop floor from another, who had no interest in the company or any knowledge of what it did, who had no interest in the employees of the company. Thirty-five people who had one interest alone: short term gain. Thus was the fate of a great company sealed. (Monopolies and Mergers Commission, 1989)

Thus once a take-over situation occurs the board transfers control of the legal entity to the general meeting.[90] The legal entity is no longer considered in the decision, as the members owe no duty to consider it's interests. Any semblance of the model company is thus removed.[91]

There is though one qualification on this. The board of directors may, if they believe that it is in the interests of the company oppose a take-over bid.[92]
The thesis now turns to consider the practicality of this qualification.

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[90] Laing (1990) considers the present take-over regime very destructive. He states:-

> [b]y the time it becomes evident that our totally free market in corporate control is seriously damaging to the nation, it will be too late.

[91] For an analysis of the advantages and disadvantages of take-overs to the economy and to the individual firm, see Ramsay (1992: pp.369-397).

[92] PEEL V L.N.W. RY. [1907] 1 Ch. 5.

CHAPTER FOUR: THE INTERESTS OF THE COMPANY.

4.0 The Interests of the Company.

In this chapter, the thesis considers the fiduciary duty of the director to act in the interests of the company.[1] The origin of this duty has been dealt with above in chapter two.[2] In this chapter the application of the duty is considered in the context of the overall question, does the duty protect the interests of the corporate entity? The thesis examines, first, how the courts have determined the interests of the corporate entity and second, how they have sought to determine whether the directors acted in accordance with that subjective duty. The delegation of the control power to the board carries with it a duty to act in the "interests of the company."[3]

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[1] For a consideration of the concept of loyalty arising generally, see Fletcher (1993).

[2] Chapter two, 2.1 The Model Fiduciary.

[3] The relationship between the directors and the company is described by Sharwood J. in SPERING'S APPEAL 71 Pa. 11; cited by Fuller C.J. in the U.S. Supreme Court in BRIGGS V SPAULDING (1891) 141 U.S. 132:-

> [t]hey are undoubtedly said in many authorities to be trustees, but that, as I apprehend, is only in a general sense, as we term an agent or any other bailee intrusted with the care or management of the property of another. It is certain that they are not technical trustees. They can only be regarded as mandataries, persons who have gratuitously undertaken to perform certain duties...

The test for the duty is subjective.[4] In RE GRESHAM LIFE ASSURANCE SOC. [1872] L.R. 8 Ch. 446, it was held that if the directors subjectively believe that what they are doing is in the interests of the company as a whole, the court will not interfere with their decisions.[5]

It is certain that directors must consider the "interests of the company" when exercising the managerial discretion delegated to them by the members in the articles of association. If they do not, the decision may be invalid.[6] In RE W.& M. ROITH LTD. [1967] 1 W.L.R. 432, a shareholder and director entered into a contract of service with one of the companies whereby on his death his wife would be entitled to a pension for life. The court decided that no consideration had been made as to whether the transaction benefited the company. The only reason for the arrangement was to provide for the widow. Thus the court held that the transaction was not binding on the company. Directors must consider the interests of the company if a decision is to be valid.[7]

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[4] Lord Greene M.R. in RE SMITH & FAWCETT [1942] Ch. 304 considered that directors must exercise their powers "bona fide in what they considered - not what a court may consider - is in the interests of the company and not for any collateral purpose."

[5] It may no longer be the case that the directors could act objectively to the detriment of the company. The judiciary have developed objective criteria to ascertain the subjective belief of the director which would preclude detrimental behaviour as unreasonable.

[6] See BISHOPSGATE INVESTMENT MANAGEMENT LTD. (IN LIQUIDATION) V MAXWELL (NO. 2) [1994] 1 ALL E.R. 261 (C.A.) and for a examination of the above case and the duty to act in the interests of the company generally, see Nolan (1994b: pp.85-88).

[7] See also RE LEE BEHRENS AND CO. LTD. [1932] ALL E.R. 889.

The question still remains as to what they should consider in order to constitute the "interests of the company." The corporation as an artificial entity lies at the core of the judicial quandary. To determine the "interests of the company" the judiciary are applying a mechanism which is geared towards natural persons, to an artificial entity.[8] [9]

An artificial entity by its nature poses legal problems.[10] It is difficult to describe or define the rights and duties of an artificial entity without using human metaphors, so the courts use a term like "the interests of the company."[11] This leaves open the

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[8] Mac Cann (1991a: pp.80-85) and Mac Cann (1991b: pp.104-109) considers that the company as a whole means the company as a separate entity but that this in turn means that:-

> [i]n determining what is for the benefit of the company as an abstraction one must have regard to the interests of the general body of shareholders, present and future, rather than the interests of individual or particular shareholders.

[9] For a consideration of how the judiciary have applied the duty, see Riley (1989: pp.87-93).

[10] For example see chapter one above at p.66 on the constitutional status of the legal entity.

[11] Dixon J. in MILLS V MILLS (1938) 60 C.L.R. 150 (Aust. H.C.) found that:-

> [w]hen the law makes the object, view or purpose of a man or body of men, the test of the validity of their acts, it necessarily opens up the possibility of an almost infinite analysis of the fears and desires proximate and remote which, in truth form the compound motives usually animating human conduct. But logically possible as such an analysis may seem, it would be impracticable to adopt it as a means of determining the validity of the resolutions arrived at by a body of directors,....

question as to what the company'(s) interests is/are.[12]

In determining the "interests of the company" the courts have strictly construed section 18 (2) of the Companies Act 1963. It reads:-

> [f]rom the date of incorporation mentioned in the certificate of incorporation, the subscribers of the memorandum, together with such other persons as may from time to time become members of the company, shall be a body corporate...

The Act itself thus describes the parts of the corporate entity as the directors and the members.[13] [14] Thus, logic would dictate that if the "interests of the company" are to be determined from its component parts, then the members would be the dominant element, as the duty is imposed on the directors.

Consideration was given to this issue by the Report of the Second Savoy Hotel Investigation (1954). There, a Board of Trade Inspector was appointed to report on the legality of the directors' actions in trying to remove an asset[15] from the company's control so as to take it beyond the reach of a take-over bidder. The report

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[12] In RE HALT GARAGE (1964) LTD. [1982] 3 ALL E.R. 1016 Oliver J. dismissed the concept of an abstract test of the benefit of the company in favour of a test to determine whether the exercise of power was genuine.

[13] Including future members.

[14] The same formula has been applied by the English judiciary since the 19th century; Finch (1991: pp. 87-119).

[15] The Berkeley Hotel.

suggested that the duty to the company is not fulfilled by the directors acting in the interests of a section of the shareholders.[16]

The Report continued that it was not enough to act in the short term interests of the company alone. Regard must be taken of the long term interests of the company. The basis for this is that the duty is not confined to the existing body of shareholders, but rather even future shareholders must be considered.[17] The long term view must be "balanced" against the short term interests of the present members. The shareholders' interest is the only one under consideration.[18] [19]

The Report of the Second Savoy Hotel Investigation, (1954) equates the "interests of the company" with the interests of the shareholders.[20] The only question at

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[16] For a consideration of the directors duty to act bona fide in the interests of the company, see FULHAM FOOTBALL CLUB V CABRA ESTATES PLC. (1992) B.C.C. 863. For an analysis of the above case and a consideration of the difficulties surrounding the duty to act "bona fide in the interests of the company," see Lowry (1993a: pp.576-585).

[17] See also PERCIVAL V WRIGHT [1902] 2 Ch. 421.

[18] In KOEHLER V BLACK RIVER FALLS IRON CO. (1862) 67 U.S. (2 BLACK) 715 the court considered that directors:-

> hold a place of trust, and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stockholders of the corporation.

[19] The Cadbury Committee (1992) considering directors duties only found a role for directors, shareholders and auditors.

[20] Lord Wilberforce in RE WESTBOURNE GALLERIES [1973] A.C. 360 discussed the relationship of the legal entity to the individual within it. He stated:-

> a limited company is more than a mere legal entity,

issue is how to balance the long term and short term interests of the shareholders.[21]

Lord Wedderburn of Charlton (1993: pp.220-262) stated:-

> [t]he shareholder's property in his share and the "interests of the company" as the shareholders' interests alone, became pillars of the modern law with no plurality of other interests acknowledged (such as those of the employees) as they have, in whole or in part, been accepted by neighbouring company laws as a natural and necessary part of their enterprise law...

Further to this it would appear that although there is technically a separate personality of the company, the directors will not be fulfilling their duty if they act on the basis of the economic advantage to the corporate entity. Evershed M.R. in GREENHALGH V ARDERNE CINEMAS [1951] Ch. 286 (C.A.) addressed the issue in connection with members voting in general meeting, where he stated:-

> the phrase 'the company as a whole' does not (at any rate in such case as the present) mean the company as a commercial entity as distinct from the corporators.[22]

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with a personality in law of its own:... there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.

[21] See the considerations of Hayek (1979: p.82) where he argues that directors should act in the interests of the shareholders alone. See also Friedman (1972: p.177).

[22] He also considered that the interests of the company meant the corporators as a general body. See also the decision of Dillon L.J. in LEE PANAVISION LTD. V LEE LIGHTING LTD. [1991] B.C.C. 620. For a consideration of the "elusive concept," see

The directors can for example recommend dividends to the members[23] rather than ploughing the profits back into the company to increase its size and wealth.

The extent to which the judicial definition has remained restricted is illustrated in PARKE V DAILY NEWS LTD. [1962] Ch. 927. The issues in the case arose out of the sale of the newspaper, the News Chronicle and Star. The Cadbury family, who controlled the selling company, wished to distribute the proceeds of the sale amongst the employees who would be made redundant by the sale. A shareholder sued to restrain them from doing so, arguing that the duty of the directors was to the shareholders. The directors argued that their prime duty was to the shareholders, but that the board must also take into consideration the interests of the employees. Plowman J.[24] replied to this argument:-

> no authority to support that proposition as a proposition of law was cited to me; I know of none, and in my judgment such is not the law.[25]

In HUTTON V WEST CORK RAILWAY CO. (1883) 23 Ch. D 654 a railway company whose undertaking had been

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Farrar (1987: p.55)

[23] Article 117.

[24] He clearly asserted that the benefit of the company means the benefit of the shareholders as a whole.

[25] Note that the Companies Act 1990, section 52 imposes a duty on the directors to have regard to the employee's interests. See chapter two, 2.5 The Erosion of the Fiduciary Safeguards regarding the impact of this duty.

transferred to another company and whose affairs were being wound up, could not pay gratuitous compensation to its former employees or to its directors for loss of employment. There was no express power to make the payments in its memorandum of association, and the power could not be claimed to be incidental to carrying out the company's object of running a railway. This was now unobtainable as the company's undertaking had been transferred. The payment could not be justified as being in the "interests of the company" by encouraging the employees to work hard in the future, and so increase the company's profits, because there were no profits to be earned after the company had ceased its own undertaking.

In NICHOLAS V SOUNDCRAFT ELECTRONICS LTD. AND ANOTHER [1993] B.C.L.C. 360 the interests of a parent company which was the majority shareholder in the subsidiary was held to be in the interests of that subsidiary.[26] In DAWSON INTERNATIONAL PLC. V COATS PATONS PLC. AND OTHERS [1989] B.C.L.C. 233 Lord Cullen stated "when directors were concerned with the shares of shareholders, they owed a fiduciary duty to them and so were obliged to act in their best interests."[27]

Grantham (1993: p.245) states:-

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[26] See Lowry (1994b: pp.160-165), Griffin (1994: pp.28-31) and Lower (1994a: pp.210-213) regarding parent companies activities involving their subsidiaries.

[27] Further to this in a take-over situation Lawton L.J. in HERON INTERNATIONAL V LORD GRADE, ASSOCIATION COMMUNICATIONS CORP PLC. AND OTHERS [1983] B.C.L.C. 244 stated "[w]here the directors must only decide between rival bidders, the interests of the company must be the interests of the current shareholders."

> [i]n the history of the modern company the shareholder has held a privileged position, for although the company's separate identity is a fundamental tenet of company law the shareholder's place as proprietor has only recently been questioned. It is perhaps not surprising therefore that for nearly a century the unanimous assent of shareholders has held the status of an overriding authority, able to cure procedural defects, overcome statutory requirements and validate almost any act within the capacity of the company.

The duty to act in the "interests of the company" has been judicially defined as acting in the interests of the shareholders.[28] [29]

In specific cases, though, there has been some movement towards other interests, such as creditors.[30] Street C.J. in KINSELA V RUSSEL KINSELA PROPERTY LTD. (IN LIQUIDATION) [1986] 4 N.S.W.L.R. 722 stated:-

> [i]n a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of the directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the

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[28] See also HOWARD SMITH LTD. V AMPOL PETROLEUM LTD. [1974] A.C. 821 for a consideration of the directors duty to act in the interests of the shareholders.

[29] In RE OLYMPIA AND YORK ENTERPRISES AND HIRAM WALKER (1986) 59 O.R. (2d) 254 H.C., the High Court of Ontario, referring to a take-over situation found that it was the directors' duty to take all reasonable steps to maximise value for all the shareholders.

[30] For a detailed analysis of this development, see Grantham (1991a: pp.1-18), Grantham (1991b: pp.576-581), Grantham (1993: pp.245-271) and Dawson (1991: pp.203-209).

creditors intrude.[31]

It was held in RE FREDERICK INNS LTD. H.C., UNREPORTED, 29 MAY 1990 that where a company is insolvent or threatened with insolvency, the directors in administering the affairs of the company, are under a duty to have regard to the interests of the creditors.[32]

That, though, has been the extent of the judicial demarcation.[33] During the lifetime of the company the judicial opinion has not yet conflated the "interests of the company" with the interests of the employees,[34] [35]

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[31] For the English equivalent, see THE LIQUIDATOR OF THE PROPERTY OF WEST MERCIA SAFETYWEAR LTD. V DODD AND ANOTHER, <u>THE TIMES</u>, LAW REPORT, 24 NOVEMBER 1987. For a consideration of this case and the position of a duty to the creditor generally, see Finch (1989: pp.23-25).

[32] See also the Australian High Court judgment, WALKER V WIMBOURNE (1976) 137 C.L.R. 1. For an examination of the evolution of the judicial recognition of creditors interests, see Kettle (1994: pp.91-95) and Petkovic (1989: pp.166-170).

[33] Even the effectiveness of this concession has been questioned, particularly regarding the lack of any definition of when the directors have to have regard to their interests. See Hawke (1989: pp.54-60) there he concludes:-

> the directors, acting in the interests of the company, can be rest assured that, as long as the company remains on the right side of "doubtful solvency," any consideration for creditors' interests need only be minimal.

[34] Although regard must be had to their interests under the Companies Act 1990, section 52 it is a subordinate interest to the members. Of note here is the inference by Costello J. in IN THE MATTER OF SELUKWE LTD. H.C., UNREPORTED, 20 DECEMBER 1992 that the interests of the employees may predominate in an examinership.

[35] In RE WELFAB ENGINEERS LTD. [1990] B.C.L.C. 833 the directors of an insolvent company resolved that the company's undertaking should be sold. The directors sold the undertaking at a lower price than could have been obtained, as the acceptance

the creditors,[36] the consumers of the company's products, or even the general public interest.[37]

Thus, to summarise, during the life of the company the equitable duty of directors to act in the "interests of the company" has been judicially defined as meaning, not the company as an entity, but the component parts of that entity. The relevant component parts of that entity consist of the members and the directors. The directors are the ones to whom the managerial power has been delegated. That power is not unfettered, it has attached to it a duty of loyalty. That duty is expressed conventionally as the duty to act bona fides in the "interests of the company".

The duty is aimed at the directors and so their interest as a component of the entity is negligible.
The members are thus the dominant interest in the corporate entity. The directors must balance the long and short term interests of the shareholders in order to serve the "interests of the company." Thus the judicial definition of the interests of the corporate entity comprehends the interests of the members this in turn

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of the lower bid would secure the employees jobs. The court in weighing the interests of the creditors and the employees found that the directors had not breached their duty of loyalty by favouring the employees' interests.

[36] See RE WINCHAM SHIPBUILDING BOILER AND SALT CO. (1878) 9 Ch. D 322, WILSON V LORD BURY (1880) 5 Q.B.D. 518 and KUWAIT ASIA BANK E.C. V NATIONAL MUTUAL LIFE NOMINEES LTD. [1990] B.C.L.C. 868.

[37] See EVANS V BRUNNER MOND & CO. (1921) 1 Ch. 359 for an argument that the directors may have a duty to act in the public interest.

further restricts the discretion of the director and erodes the model company.[38] Directors do not owe a duty to act in the interests of the corporation as a separate legal entity.[39] There is no distinction between the interests of the members and the corporate entity. They are one and the same: thus SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) is further eroded.

4.1 The Profit Rationale.

This discussion of the case law indicates that the dominant element of the interests equation is the interest of the shareholders. This replicates the traditional economic theory where the assumption is that the directors make supply and output decisions to maximise profits.[40] It is this seeming parallel between the economic theory and the judicial definition of the

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[38] Ferrara (1992: pp.341-365) considers that there are legitimate corporate interests separate from shareholder's interests. The hostile take-over market of the 1980's and the growth in numbers and influence of large institutional investors has increased the conflict between these interests. Despite the growing demands from institutional shareholders for a greater emphasis on maximizing market price, corporate obligations should be cast in terms of enhancing earnings over a reasonable period.

[39] For an analysis of the extent of the directors' duty to the company itself, to individual shareholders, to company employees and the extension of the duty in limited circumstances to creditors, see Mac Cann (1991f: pp.3-8) and Mac Cann (1991g: pp.30-35).

[40] Hirshleifer (1980: p.479) discusses this with regard to the "Fisher Separation Theorem" which deals with the neo-classical model of the company and maintains that the only legitimate purpose of the corporation is profit maximisation.

interests of the company that this section of the thesis seeks to examine.[41] [42]

Placing the shareholders' interest in a dominant position within the "interests of the company" carries with it an assumption that the shareholder aims to get a return on his investment, profit.[43] Traditional economic theory assumes that companies behave in a profit maximising manner.[44] The law, while assuming that the companies aim is profit, has not entirely accepted profit maximisation as the legal reality.

Bowen L.J. in HUTTON V WEST CORK RAILWAY CO. (1883) 23 Ch. D. 654 at 672, states:-

> [a] railway company, or the directors of the company, might send down all the porters at a railway station to have tea in the country at the expense of the company. Why should they not? It is for the directors to judge, provided it is a matter which is reasonably incidental to the carrying on of the business of the company; and a company which always treated its employees with draconian severity, and never allowed them a single inch more than the letter of the bond, would soon find itself deserted -

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[41] For further consideration of the traditional theory, see Baumol (1977) and Marris (1964).

[42] See Begg et al (1991: p.102) where they argue that companies attempt to maximise profits. Also see Sloman (1991: p.139) for the traditional economic theory on profit maximisation.

[43] Nisbet (1994: pp.154-156) considers that the managers are assumed to be working for the shareholders.

[44] Friedman (1953: p.22) states:-

> [u]nless the behaviour of businessmen in some way or other approximated behaviour consistent with the maximisation of returns, it seems unlikely that they would remain in business for long.

> at all events, unless labour was very much more easy to obtain in the market than it often is. The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company...

Thus Bowen L.J. accepts that directors can justify decisions which do not bring a measurable profit to the shareholders, once they argue that some benefit will accrue at some later stage. Taking the "cakes and ale" example, directors can justify expenditure on employee entertainment by arguing that it benefits the company in some way, for example it may encourage employees to be more productive and encourage loyalty.

Bowen L.J.'s judgment is also moving away from the economic assumption that the only legitimate function of a company is to maximise profits. The implicit assumption both from Bowen L.J. and The Report of the Second Savoy Hotel Investigation (1954) is that decisions which do not appear to bring profit to the shareholders can be justified as being in the long term interests of the shareholders or as balancing the interests of the present and future shareholders.

The Bowen L.J. judgment and The Report of the Second Savoy Hotel Investigation (1954) are not entirely turning away from any economic basis for their rationale. Coase (1937: pp.386-405) points out that individuals within companies do not behave in a profit maximising manner.[45] They may, for example, accept a position within the company which is lower paid than that obtainable outside the company or even elsewhere within the company, but which carries greater responsibility or job satisfaction.[46]

The separation of ownership and control also dilutes the drive for profit maximisation. The owners no longer run the company, they pay directors to carry out that function. Those directors, if we apply the Coase (1937: p.386) example, may behave in a manner not consistent with profit maximisation.[47] They may, for instance, make decisions based on the desire to see the firm grow in size, thus increasing their salary, as the larger the firm, the higher the directors' salaries.[48] They may also place great emphasis on research and development which effect future profits, but which do not maximise profits. Begg et al (1991: p.102) state:-

> [a]lthough the shareholders clearly want the maximum possible profit, the directors who actually make the decisions have the

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[45] See Duxbury (1991: pp.300-311) regarding the work of Coase. For a modern statement of Coase work and the relationship between owners and controllers, see Grossman and Hart (1986: pp.691-719). For an over view of the economic theories regarding control in corporations, see Mintzberg (1983: pp.119-162)

[46] See also Sloman (1991: p.244) and Alchian (1950: pp.211-221) for alternative theories to profit maximisation.

[47] See also Begg et al (1991: p.102).

[48] See Williamson (1974) and Koopmans (1957: pp.140-141) regarding controllers' motivation in decision making.

> opportunity to pursue different objectives. Do the managers and directors have an incentive to act other than in the interests of the shareholders?[49] [50]

The thesis now turns to consider the wider development of the judicial application of economic theory to the directors' duty to act in the "interests of the company."

The purpose or function of the company has been variously defined as either profit,[51] employment[52] or social.[53] In implying a purpose to the company, the

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[49] Baumol (1959: p.27) suggests that rather than achieve maximum profits the directors will attempt to achieve the minimum profit level acceptable to the shareholders to keep them from exercising their powers of dismissal. Chandler (1977: p.10) stated "in making administrative decisions, career managers preferred policies that favoured the long-term stability and growth of their enterprises to those that maximized current profits." For further consideration of this view, see Galbraith (1967: p.171).

[50] Williamson (1974: p.19) stated:-

> [t]he justification for the profit maximisation assumption is its usefulness, and whereas this may be substantial for some purposes, it may be less valuable for others.

[51] See above on maximisation of profit.

[52] See Gower (1979: p.66) on Industrial Democracy and also The Bullock Committee (1977).

[53] Henry Ford in DODGE V FORD MOTOR COMPANY (1919) 204 MICH. 459; 170 N.W. 668 suggested that the interests of the shareholders should be totally subordinated to those of the employees, consumers and the general public. He stated:-

> [m]y ambition is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business.

judiciary have recognised the "profit" motive as the singular factor in defining the "interests of the company".

Profit must accrue to someone, so the judiciary have had to decide which of the component parts of the company gets the "profit."[54] The company itself is made up of complex relationships. Shareholders, directors, employees, creditors and consumers all have relationships with the company which could objectively be considered as part of the "interests of the company."

The shareholders have been singled out by the judiciary as the recipients of the "profit" of the company, and thus the dominant interest in any definition of the "interests of the company."[55] But concessions must be made to the other interests within the company.[56] They must also receive "profit". The employees receive wages, pension and educational benefits. The creditors receive "profit" through payment from the company. This is necessary to generate the further profit for the

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[54] In SALOMON V SALOMON & CO. LTD. [1897] A.C. 22 (H.L.) Lord Watson said:-

> [a]ny person who holds a preponderating share in the stock of a limited company has necessarily the intention of taking the lion's share of its profits without any risk beyond loss of the money which he has paid for, or is liable to pay upon his shares.....

[55] See above 4.0 The Interests of the Company.

[56] See Gower (1979: pp.62-66) for a consideration of the company's social responsibilities.

shareholders.[57]

The courts have maintained the approach that "profit," when defining the "interests of the company", means "profit" for the owners; this much is clear.[58] The judicial definition of the members interests' includes the long term interests of the members. "Profit" for the owners can thus be calculated long or short term and may not be dependent on measurable factors.[59]

If "profit" is defined in the short term, then the duty of the directors to act in the "interests of the company" is a restrictive one. The short term definition equates to maximisation of profit. Directors can only make decisions which they believe will bring the maximum available "profit" to the owners. This would be impractical and would not allow the directors any scope for long term planning.[60]

If "profit" is defined in the long term, then the duty is less restrictive. It can allow decisions which do not immediately bring "profit" to the owners. Examples of this are donations to charity which will increase the good will and public standing of a company, expenditure

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[57] It is justifiable as being in the interests of future shareholders.

[58] See above 4.0 The Interests of the Company.

[59] For example how do you measure the effect on future profit of a donation to charity or expenditure on employee working conditions and education.

[60] See Bean (1993: pp.24-35) where the difficulties of the role of manager in maximising wealth when there are a number of choices available and his fiduciary status are examined.

on labour relations, research and development, health and safety, and employee education, which will all bring "profit" in the long term.

The Report of the Second Savoy Hotel Investigation (1954) which has been mentioned above, found that the directors must have regard to the long and short term interests of the shareholders. A balance must be found between these long and short term interests. Thus decisions which do not appear to bring profit to the present shareholders can be justified as being in the interests of future shareholders.

That definition of "profit", with its long term element, allows decisions which can in fact bring "profit" to others. Charitable donations by companies, and gratutious payments to their employees represent a tangible short-term "profit" to the recipients. From the point of view of the company those payments are "beneficial" or "profitable" only in an intangible sense, both in the short and long term.

It would appear that the judiciary have redefined "profit" and who that "profit" should enure to in order for the directors to comply with their duty to act in the "interests of the company." "Profit" in the long term may be dependent on considerations which are not measurable in the short term if at all. Thus the judicial definition of "profit" is intangible.

This forces first a re-definition of "profit" and second a re-definition of who it should accrue to. The judiciary appear to allow directors to make decisions which bring no tangible profit to the shareholders.[61] These may be justified as being in the long term interests of the company.[62] Thus the definition of "profit" the judiciary are applying contains an element of social responsibility which is not measurable in any tangible sense.

If the assumption is also that "profit" must accrue to the owners, when in fact this is not entirely true, a re-examination of ownership is necessary.

Decisions of directors which make donations to charity, employee benefits, and similar peripheral payments are allowable legally. The ostensible grounds for this is that profit (albeit intangible or long term) enures to the company. The real explanation may be different. Such peripheral disbursements may be explained as exemplifying the power and control of the board. As such, the general meeting might be disposed to query the untrammelled exercise of this power.

There is thus scope within the judicial definition of the interests of the company to allow profit to accrue to elements other than the shareholders.

In the next section the thesis examines how the judiciary is divided as to how far this judicial re-definition of profit and ownership goes. It also examines how the market environment for listed companies has

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[61] For example a donation to charity.

[62] Per Bowen J. above.

restricted the directors' ability to make decisions which do not bring short term profit to the shareholders.

4.2 When to Apply the Duty.

Having attempted to define the component aspects of the interests of the company, the judiciary have set about formulating a test which will ensure that the owners' investment is looked after correctly. The cases concern first; the subjective belief of the director and second; the interests of the company.

The subjective nature of the duty means that the belief of a particular director must be ascertained. In order to do this the courts have introduced objective criteria.

The Subjective Belief.

> The difficulty in ascertaining motives or purposes, and how far they are genuine, is notorious. "The Devil himself knoweth not the thought of man," said Brian C.J. in 1477. Here there is not one man, but a Board of seven men.[63]

The duty in RE SMITH AND FAWCETT [1942] Ch. 304 is wholly subjective; thus any attempt to examine whether a director complied with that duty must also be an attempt to ascertain the subjective belief of a particular

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[63] Sir Robert Megarry V.-C. in CAYNE & ANOTHER V GLOBAL NATURAL RESOURCES PLC. Ch. D., UNREPORTED, 12 AUGUST 1982.

director.[64] A definitive statement on this method of examining the director's intention is found in HINDLE V JOHN COTTON LTD. (1919) S.L.R. 625 at 630:-

> [w]here the question is one of abuse of powers, the state of mind of those who acted, and the motive on which they acted, are all important, and you may go into the question of what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in the discharge of their powers in the interest of the company or were acting from some bye-motive, possibly of personal advantage, or for another reason.[65]

Another test which has been applied introduces a further element of objectivity. The director, himself, may subjectively assert that he acted in the interests of the company, but his statement must be examined as to whether the decision was reasonable.[66] Berger J. in TECK

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[64] The basis for introducing an objective test can be seen in the words of Bowen L.J. in HUTTON V WEST CORK RAILWAY CO. (1883) 23 Ch. D. 654 where he states:-

> [b]ona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.

[65] See also HAMPSON V PRICE'S PATENT CANDLE CO. (1876) 45 L.J. Ch. 437; RE DAVID PAYNE & CO. LTD. [1904] 2 Ch. 608 and HENDERSON V BANK OF AUSTRALASIA (1888) 40 Ch. D. 170.

[66] In BURR V HARRISON AND OTHERS, (C.A.) CIVIL DIVISION, UNREPORTED, 25 MARCH 1994 Hoffmann L.J. stated:-

> [i]f no rational board could honestly have thought that carrying on the business was in the interests of the company, the conclusion

CORPORATION LTD. V MILLAR (1972) 33 D.L.R. (3d) 288 applies this test. He states:-

> [t]he directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose.[67]

Another attempt at a set of criteria was expounded by Kirby P. dissenting in DARVALL V NORTH SYDNEY BRICK & TILE CO. LTD. (NO.2) (1989) 7 A.C.L.C. (Court of Appeal of New South Wales) 659 at 676. He stated what he considered to be the general principle:-

> although not conclusive, the court can look at the declared intentions of directors in order to test their assertions (which will often be self protective) against the assessment by the court of what, objectively, was in the best [sic] interests of the company at the relevant time.

This requires that the decision be a reasonable one and that it be objectively in the best interests of the company.[68] Thus, again, there is the presumption that there is an obtainable economic benefit to the company.

> must inevitably follow that the board acted from some improper motive of their own.

[67] See also the judgment of Evershed M.R. in GREENHALGH V ARDERNE CINEMAS LTD. [1951] Ch. 286 (C.A.).

[68] As opposed to just in the interests of the company.

In order for the board to fulfil this test, which is a further attempt to ascertain the subjective belief of a director, the board must show that the best option was chosen.

In CHARTERBRIDGE CORPORATION. V LLOYDS BANK [1970] Ch. 62, the directors of a company, which formed part of a group, considered the interests of the group as a whole rather than giving consideration to the separate "interests of that company alone." The court held that if this occurs, the proper test:-

> in the absence of actual separate consideration must be whether an intelligent and honest man in the position of a director of the company concerned could.... have reasonably believed that the transactions were for the benefit of the company.

In RE OLYMPIA AND YORK ENTERPRISES AND HIRAM WALKER (1986) 59 O.R. (2d) 254 (H.C.) the High Court of Ontario considered the subjective nature of the duty:-

> how is the Court to determine their purpose? In every case the directors will insist their whole purpose was to serve the company's interest. And no doubt in most cases it will not be difficult for the directors to persuade themselves that it is in the company's best interests that they should remain in office. Something more than a mere assertion of good faith is required...If they say they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief.[69]

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[69] See also the U.S. Court of Appeals, Second Circuit in NORLIN CORP. V ROONEY [1984] FED. SEC. L. REP. (para) 91, 564 regarding reasonable grounds.

The point must not be lost here that the evolution of the objective standard is purely a method of ascertaining the subjective belief of a particular director.[70] [71] As we shall see from the next section the objective tests of the interests of the company differ in emphasis.

Defining the Objective Interests.

The element of objectivity which has been introduced by the judiciary in attempting to ascertain the directors' belief also impacts on how the judiciary define the interests of the company. The Report of the Second Savoy Hotel Investigation (1954) contains a statement of the balance to be maintained by directors between the long and short term interests of the shareholders. This balance is by its very nature hard to maintain and the courts themselves produce decisions which do not maintain that balance.[72]

The case law seems to follow two distinct lines of thought. In the first, exhibited in CHARTERBRIDGE CORPORATION. V LLOYD'S BANK [1970] Ch. 62 at 74, and in

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[70] In the U.S. once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders; SCHWARTZ V MARIEN (1975) 37 N.Y. 2d. 487.

[71] In CAYNE & ANOTHER V GLOBAL NATURAL RESOURCES PLC., Ch. D., UNREPORTED, 12 AUGUST 1982 Sir Robert Megarry V.-C. considered that the objective tests were of little use if the director could not be cross examined as to his belief.

[72] How do you define the interests of future shareholders?

ALEXANDER V AUTOMATIC TELEPHONE COMPANY. [1900] 2 Ch. 56 at 72 this definition of the duty follows that in RE SMITH AND FACWETT [1942] Ch. 304. This defines a duty of good faith to the company. That duty is only imposed where the director seeks to advance interests other than those of the company. Thus the director is free to make decisions based on a long term benefit to the company.[73]

The second line of thought is represented by the requirements detailed in ABERDEEN RAILWAY CO. V BLAIKIE BROS. (1854) 1 Macq. (H.L.) 461 and TECK CORPORATION LTD. V MILLAR (1972) 33 D.L.R. (3d) 288.[74] [75] This looks at whether the "interests of the company" are being served.[76] Thus, the board must achieve the best interests of the company, in order to fulfil their fiduciary

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[73] He does not have to choose the best option available.

[74] For a further analysis of TECK CORPORATION LTD. V MILLAR (1972) 33 D.L.R. (3d) 288, see EXCO CORP. V NOVA SCOTIA SAVINGS & LOAN CO. (1987) 35 B.L.R. 149 where Richard J. stated:-

> [e]ven the test laid out by Berger J. in the Teck case requires further refinement if it is to be applied generally. When exercising their power to issue shares from treasury the directors must be able to show that the considerations upon which the decision to issue was based are consistent only with the best interests of the company and inconsistent with any other interests.

[75] See also RE ALBERTA LTD. AND PRODUCERS PIPELINE INC. (1991) 80 D.L.R. 4th 359.

[76] See also the judgment of Wilson J. in WHITEHOUSE V CARLTON PTY. LTD. (1987) 162 C.L.R. 285.

duty.[77] The way in which the courts have examined these standards within the two lines of thought are also fundamentally different.

In the first line, the court looks to see if "some" benefit accrued to the company, if it did, then the director's decision must be reasonable, and so the duty is complied with. Applying this test, decisions of the board regarding charities, pensions and night baseball[78] have been upheld, even though the benefit which accrued to the company was not as great as other decisions by the directors would have allowed. With this test the director's decision does not have to be the best choice available, it only has to lead to "some" benefit accruing to the company.[79]

The test, while excluding options for the directors which do not benefit the company, leaves the choice of beneficial options to the directors. Thus, the directors may choose the least beneficial option and still comply with their fiduciary duty.

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[77] This would parallel the economic theory on maximisation of profit.

[78] SHLENSKY V WRIGLEY (1968) 237 NE.2d. 776.

[79] An extreme example of this first line of thought is the judgment of Kenny J. in P.M.P.A. INSURANCE CO. LTD. V NEW IRELAND ASSURANCE CO. LTD., H.C., no official transcript exists; reported IRISH TIMES, OCTOBER 23, 1975 where he stated that the management of a company entrusted to the directors:-

> would not be interfered with unless it was in breach of the articles of association or was dishonest or grossly incompetent.

In SHLENSKY V WRIGLEY (1968) 237 NE.2d. 776 the Illinois Court of Appeal upheld a board decision which was not aimed at maximising the company's profits. The directors of a baseball team did not wish to install floodlights for night games as they believed that baseball was a day-time activity. They justified their decision on the basis that the night games would lower the property values of the houses in the neighbourhood. This in the long term would reduce the crowd attendances at the night games. It must be said that the benefit to the company in that case was extremely tenuous, but yet, it comes within the test in HINDLE V JOHN COTTON LTD. (1919) S.L.R. 625 above. Thus, social responsibility by the company to the detriment of profit could constitute a benefit to the company and thus be in the "interests of the company."

In summary, the overall philosophy behind this first train of thought by the judiciary is its aim to arrive at the subjective intention of the board. To do this the court limits its function to ensuring that the directors' do not exercise their discretion other than in the interests of the company. The best interests of the company of is of no real concern, as long as some benefit accrues. This "hands off" approach by the judiciary can only be explained in terms of a judicial understanding, that the world of business makes particular subjective demands on directors. The judicial role in a business environment is not, therefore, to impose liability on the basis that the option the directors choose, while beneficial to the company, was not the most beneficial.[80]

It should be noted that the decisions exemplifying this train of argument eschew the maximization of profits as the sole goal of a company. Accordingly the judiciary allow a certain amount of flexibility to directors with regard to "peripheral" payments; and though they may not directly and immediately enure to the benefit of shareholders, the judiciary will sanction such payments if it deems that the directors believe the company will be thereby advantaged.[81]

The second train of thought that has been applied looks objectively at the range of choices available to the directors and chooses the "best" option. If this option was not the one chosen by the directors, then they have not complied with their duty.[82] The "best" option is

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[80] See the Supreme Court of Delaware in SMITH V VAN GORKOM (1985) 488 A.2d. 858 for the leading statement of the U.S. formulation of a Business Judgment Rule. For a consideration of the take-over regime in Delaware generally, see Lamb (1994: pp.283-285), Cary and Eisenberg (1988: pp.1088-1293) and Knepper (1978: pp.227-228). For a survey of the federal and state law on take-overs in the U.S., see Hazen (1990: pp.465-607).

[81] It must be noted that those decisions are still justified as being in the long term interests of the shareholders or in the interests of future shareholders.

[82] See REVLON INC. V MACANDREWS AND FORBES HOLDINGS INC. (1986) 506 A.2d. 173 the Supreme Court of Delaware held that once a decision to sell the company was made the directors role is changed "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." When examining whether the directors behaved bona fide the criteria is not whether the board intended to serve the corporate interest but whether the best result was achieved i.e. the highest price.

defined purely in financial terms and so equates to the board maximising "profit" on all its decisions.[83] [84]

The court here makes two assumptions, that the directors do not act against the interests of the company and that they will act in the "best" interests of the company. Gower (1979: p.576) adopts this approach when he states that "directors must act bona fide, that is in what they believe to be the best interests of the company." Inherent in this assumption is the need to establish a best option, one which maximises the profit available. This involves the court assessing the choices the board faced and evaluating them on their merits. The court's function can only be fulfilled when it has ascertained the best option at the time the directors made their decision.

The court's function has now changed and it is, itself, exercising the managerial discretion that was formerly the ambit of the board.[85] This approach by the

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It must be noted though that prior to a decision to sell being made the directors are still "defenders", see the decision of the Supreme Court of Delaware in PARAMOUNT COMMUNICATIONS INC. V TIME INC. (1989) 571 A.2d. 1140.

[83] See DARVALL V NORTH SYDNEY BRICK & TILE CO. LTD. (No.2) (1989) 7 A.C.L.C. (Court of Appeal of New South Wales) 659 above.

[84] See also MILLS ACQUISITION CO. V MACMILLAN INC. (1988) A.2d. 1261 where the directors were held by the Supreme Court of Delaware to have breached their duty of loyalty because they had a positive duty to accept the highest bid.

[85] This raises the question of the need for a fiduciary duty at all if it can supplanted by judicial intervention.

judiciary with the implicit threat of intervention carries before it definitive criteria with which the directors must comply.[86] The best option must be chosen or else the duty will not be fulfilled and liability will be imposed on the directors.[87] Thus in BELL V LEVER BROS. [1932] A.C. 161 and SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER [1959] A.C. 324 (H.L.) the courts applied this second line of thought and found that the directors had not acted in the best interest of the company.[88]

In the U.S. jurisdiction a clear judicial decision which weighed the two trains of thought on the director's duty and came down in favour of the second, is DODGE V FORD MOTOR COMPANY (1919) 204 MICH. 459; 170 N.W. 668. There, Henry Ford, who had control of the board of directors, stated that it was the policy of the Ford Motor Company not to pay in the future any special dividends. He intended to plough back into the company all future earnings of the company, save a small dividend. His declared aim was that the general public should benefit from the company's good fortune.

The court had to consider, on the one hand, an

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[86] see Sealy (1992b: pp.229-231).

[87] An example of this can be seen in the U.S. where the Delaware courts not only consider good faith, dilligence, etc, regarding directors decisions but may also exercise their own "independent business judgment". See further Block and Prussin (1981).

[88] Applying this train of thought directors may not be bound by a contract to take a course of action after deciding that course of action is no longer in the company's interests, see Mercer (1993: pp.5-6).

argument that the corporation had a social responsibility and, on the other, that the shareholders' interest in profit should be served. The trial court ordered Ford Motor Company to declare a dividend of $19.3 million, an immense amount equal to half the company's cash surplus as of July 31, 1916. The Michigan Supreme Court affirmed the following piece of the trial court's decree:-

> [t]here should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders. A business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain the end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.

It can be seen from the above that there are two distinct methods of applying the directors' fiduciary duty to act in the "interests of the company." The first approach by the judiciary offers a more pragmatic set of tests. It carries the disadvantage of not really being a definitive set of criteria and allowing the directors themselves to determine the extent of their own duty. The second imposes control and financial responsibility on the directors. It carries the disadvantage of imposing liability on the directors where the result of their decision has not maximised the benefit to the company.[89]

The Take-over Situation.

In the preceding chapter the erosion of the model company was examined from the perspective of the take-over situation. The directors may, if they believe that it is in the interests of the company, oppose a take-over.[90] [91] Outright opposition to a take-over, by the board of directors is difficult.[92] It is the choice of bidder by the board of directors which usually causes the duty to be questioned.[93] We shall see that the above

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[89] This line of thought raises the possibility of liability being imposed on the basis of hindsight. A decision which results in failure whether through incompetence, bad luck or economic factors, may carry with it the weight of judicial hindsight and liability for breach of fiduciary duty.

[90] See CAYNE & ANOTHER V GLOBAL NATURAL RESOURCES PLC., Ch. D., UNREPORTED, 12 AUGUST 1982 for an example of when directors may legitimately oppose a take-over. See also Barnard (1992: pp.474-507) for a consideration of this point.

[91] In TECK CORPORATION LTD. V MILLAR (1972) 33 D.L.R. (3d) 288 the Supreme Court of British Columbia held that where directors of a company seek, by entering into an agreement to issue new shares, to prevent a majority shareholder from exercising control of the company, they will not be held to have failed in their fiduciary duty to the company if they act in good faith in what they believe, on reasonable grounds to be in the interests of the company.

[92] The interests of the shareholder being paramount brings about this situation. The board would usually look for another bidder who was less hostile. See RE OLYMPIA AND YORK ENTERPRISES AND HIRAM WALKER (1986) 59 O.R. (2d) 254 H.C.

[93] In RE ALBERTA LTD. AND PRODUCERS PIPELINE INC. (1991) 80 D.L.R. 4th 359 the Saskatchewan Court of Appeal stated:-

differing judicial definitions of the interests of the company make it difficult for the directors to challenge a take-over.

First, the "interests of the company" is defined in terms of the shareholders interests, present and future. The present shareholders are likely to favour a take-over as it brings large financial rewards, the future shareholders are likely to be those bidding to take-over the company. Thus the duty seems to be weighted in favour of a take-over.

The discretion of the directors comes into question in situations where they reject the highest bid in a take-over. The shareholders then challenge that decision as not acting in the interests of the company.[94] Thus depending on the train of thought followed by the judiciary the directors have or have not complied with their duty.

In SCOTTISH CO-OPERATIVE WHOLESALE SOCIETY V MEYER

> when a corporation is faced with susceptibility to a take-over bid or an actual take-over bid, the directors must exercise their powers in accordance with their overriding duty to act bona fide and in the best interests of the corporation..... If, after investigation, they determine that action is necessary to advance the best interests of the company they may act, but the onus will be on them to show that their acts were reasonable...

[94] In an acquisition situation directors also have a duty to be honest and not to mislead the shareholders when giving advice regarding the acquisition; per Brightman J. in GETHING V KILNER [1972] 1 ALL E.R. 1166. In DAWSON INTERNATIONAL PLC. V COATS PATONS PLC. AND OTHERS [1989] B.C.L.C. 233 this duty was termed a secondary one.

[1959] A.C. 324 (H.L.) Lord Denning was of the opinion that "when the realignment of shareholding was under discussion, the duty of the three directors of the company was to get the best possible price for any new issue of its shares."[95]

In HERON INTERNATIONAL V LORD GRADE, ASSOCIATION COMMUNICATIONS CORP PLC. AND OTHERS [1983] B.C.L.C. 244 the Court of Appeal maintained that the board:-

> owed a duty to the general body of shareholders...to obtain for the shareholders the opportunity to accept or reject the best bid reasonably obtainable.

On the other hand Hoffmann J. in RE A COMPANY [1986] B.C.L.C. 382 stated:-

> I cannot accept the proposition that the board must inevitably be under a positive duty to recommend and take all steps within their power to facilitate whichever is the highest offer.

In the Australian case of HARLOWE'S NOMINEES LTD V WOODSIDE (LAKES ENTRANCE) OIL CO. (1968) 121 C.L.R. 483 the High Court stated:-

> [t]he ultimate question must always be whether in truth the issue was made honestly in the interests of the company. Directors...may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant

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[95] See also the comments of Lord Wright in LOWRY V CONSOLIDATED AFRICAN SELECTION TRUST LTD. [1940] 2 ALL E.R. 545.

> purposes, is not open to review by the courts.[96] [97]

Further Barwick C.J. in ASHBURTON OIL N.L. V ALPHA MINERALS N.L. (1971) 123 C.L.R. 614, (HIGH COURT OF AUSTRALIA) stated:-

> [d]irectors who are minded to do something which in their honest view is for the benefit of the company are not restrained because a majority shareholder or shareholders holding a majority of shares in the company do not want the directors so to act.

The judiciary has consistently applied both trains of thought examined above, even in a take-over situation. The rejection of the highest bid represents the first train of thought, where once some benefit accrues to the company the duty is complied with. The highest bid represents maximisation of profits and the second train of judicial thought. The uncertainty regarding which version of the duty prevails creates great difficulties for directors and further erodes their managerial discretion.

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[96] See also MILLS V MILLS (1938) 60 (C.L.R.) 150 (AUST. H.C.) where Latham C.J. stated that directors were:-

> not required by the law to live in an unreal region of detached altruism and to act in a vague mood of ideal abstraction from obvious facts which must be present to the mind of any honest and intelligent man when he exercises his powers as a director.

[97] See also RICHARD BRADY FRANKS LTD. V PRICE (1937) 58 C.L.R. 112.

4.3 Conclusion.

While there would appear to be scope within the judicial definition of the "interests of the company" for directors to balance the long and short term interests of the shareholders, or even just to take a long term view, public limited companies in the market place have difficulty taking such long term views.

Firstly, the directors are subjected to pressures from the institutional shareholders who wish for decisions to be made on a maximisation of profit basis.[98] Those directors may have been appointed to the board to represent the institutions' maximisation of profits view.[99]

The pressures on the directors are re-enforced by a market place which considers maximisation of profits as the sole function of a public limited company. Thus, directors who aim for corporate growth or place emphasis on research and development will find that there is a negative effect on the company share price.[100] Begg et al (1991: p.102) consider this and state:-

> [e]ven if the shareholders cannot recognise that profits are lower than they should be,

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[98] See chapter three, 3.1 The Interests of the Institutions.

[99] See chapter two, 2.4 Directors Appointed to Serve Another Interest.

[100] Again, see chapter three, 3.1 The Interests of the Institution.

> other firms with experience in the industry may catch on faster. If profits are low, share prices will be low. By mounting a take-over, another company can buy the shares cheaply, sack the existing managers, restore profit-maximising policies, and make a handsome capital gain as the share prices then rise once the stock market perceives the improvement in profits.

Thus, non-compliance with the market expectation of profit maximisation will be punished by the market and eventually resolved through a take-over. The market itself is regulating the legal duty of the directors to ensure one outcome, profit maximisation.

Further, the shareholders within the company can create other pressures on the directors to maximise profits, by introducing a remuneration system which ties the directors' interests to that of the shareholders.[101] This is done through giving the directors share options which are large enough to create such a concurrence of interests.[102] The directors, themselves, have a personal interest in the maximisation of profit.[103]

It can be seen from the above that the judicial formulation of the "interests of the company" is weighted

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[101] Healy (1985: pp.85-107) has shown that remuneration schemes do impact on managerial decisions. See also Aisenbrey (1993: pp.56-57) for a further examination of this point.

[102] See Liebowitz (1992: p.5) for an examination of how senior managers were given a greater ownership stake in the firm to align their interests with those of C.S. First Boston's other institutional shareholders.

[103] See Marsh (1990: p.53) and Larcker (1983: pp.3-30).

in favour of the shareholders' interests. Within that formulation the judiciary have on occasion allowed directors a discretion to define the shareholders' interests in the long term. The directors may thus make decisions which benefit the employees, creditors and general public to the detriment of the shareholders. This, the thesis suggests, is no longer possible for public limited companies operating in the marketplace today. The director's discretion to do other than maximise profits has been subverted through a market system that punishes directors who fail to deliver maximum profits to the shareholders.

Central to the issue of defining the interests of the company, is an examination of the concept of a separate interest of the company. In looking at the origins of this concept the thesis has already looked at SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) and the principles expounded there. Three distinct points arise from this case. First, that the company is a legal person separate and distinct from its members. Second, the company is not an agent of its members. Third, the motives of those who formed the company are not material to its subsequent rights and liabilities.

It is the first and third points which are of particular interest to this thesis. The separation of the legal personalities of the members and the company created an artificial legal person with rights and obligations which are separate from those of the members.

The third point emphasises this, and notes that the artificial legal entity has rights and liabilities. If there are within a company structure two separate legal entities, that is to say the members and the company itself, with separate rights and liabilities, there is a potential for those rights and liabilities to clash.

In such circumstance, the company's rights and liabilities are protected by the directors' duty to act bona fide in the "interests of the company". The problem for the judiciary in enforcing that duty has been how to define the interest of an artificial entity and when to apply the duty. In defining the interest of the entity, the judiciary have been consistent in defining the "interests of the company" in terms of its constituent parts. While this may be a logical progression, it does not take account of situations where the component parts have differing interests. The case law treats the interest of the dominant component, the shareholders, as paramount. The concept of a separate interest of the company has essentially been lost. There is no difference between the members' interests and that of the corporate entity. SALOMON V SALOMON & Co. [1897] A.C. 22 (H.L.) no longer has any application.

The two lines of judicial thought on when the duty applies further diminish the concept of a separate interest of the company. The first with its pragmatic "hands off" approach gives the directors free reign with their managerial discretion as long as some benefit accrues to the company. The second looks to examine the decisions in terms of greater financial benefit to the company. The first provides too much scope for the directors to act with a lack of bona fides as long as some benefit falls to the company. The second is purely based on maximisation of profits and so has no place for the employees' interest or non-profit orientated benefit.

The two approaches serve the institutional shareholder and further erode the model company. The institutions are the dominant shareholders and, as such, the judicial definition of the "interests of the company" focusing on the shareholder, equates to their interest. The first line of thought on the application of the duty by the judiciary serves the institutions, as they have an input into the managerial discretion of the directors through the institutional briefings and representative directors. The second line of judicial thinking on when to apply the duty also serves the institutions as the best interest of the company is defined in terms of maximisation of profits.

CHAPTER FIVE: CONCLUSIONS.

5.0 The Subverted Model.

In this chapter, the thesis brings together the conclusions of the body of the thesis. It examines a particularly clear example of the eroded model. The conclusion that the model has been eroded is inescapable. The thesis then turns to the general question of reform, first examining the problem and then suggesting solutions for both private and public companies. The thesis then concludes that the importance of the thesis is in the recognition of the eroded model.

The hypothesis of the eroded model company was set out in chapter one, Part 1. There the model company was described in terms of its component parts, the decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.) the memorandum, articles of association, the Companies Act 1963, section 25 and the decision in FOSS V HARBOTTLE (1843) 2 Hare 461. Those component elements were then examined in isolation in Part 2 and it was posited that the individual components of the model company had been eroded thus making the model unworkable.

The format of chapter one was again repeated in the second chapter dealing specifically with the board of directors. There the model board of directors was described and the erosion of the managerial discretion examined. The chapter concluded that the board of directors had been degraded to a secondary organ through the members' power to influence managerial discretion, the presence of representative directors, and the erosion of the fiduciary safeguards.

In chapter three, the presence of the institutional investor was examined in terms of the eroded model company. The chapter concluded that the institutions have interests other than the company's to serve, and can obtain input into the managerial discretion through institutional briefings and representative directors. The model company is thus further eroded.

Chapter four examined the directors' duty to act in the interests of the company. The chapter concluded that the interests of the company have been judicially defined as being the interests of the shareholders. The directors' discretion to act is thus further eroded and the concept of a separate interest of the company lost. The model company has been eroded and no longer exists.

The Eroded Model: An Example.

The eroded model can be seen clearly in MULTINATIONAL GAS AND PETROCHEMICAL CO. V MULTINATIONAL GAS AND PETROCHEMICAL SERVICES LTD. AND OTHERS [1983] 2 Ch. 258. In 1970 three international oil companies, incorporated in the United States of America, France and Japan respectively, entered into a joint commercial venture for the purchase, transportation, storage and sale of liquified petroleum gas, liquified natural gas and similar products.

The three oil companies contemplated chartering and acquiring suitable tankers for the joint venture, which was to be conducted from London through the plaintiff company, a Liberian corporation formed for the purpose of the joint venture. The plaintiff company was originally to have run its business from London. However, on the advice of tax counsel that the plaintiff company should not carry on business in the U.K., the three oil companies formed the first defendant company in the United Kingdom. The defendant company's purpose was to act as the plaintiff company's agent and, acting as agent, to advise the plaintiff company about business prospects, give it financial information, perform routine management work and put into effect decisions made by the plaintiff company, which in fact had no place of business in the United Kingdom or elsewhere.

The three oil companies were the sole shareholders in both companies, the directors of which were employees and nominees of each of the three oil companies appointed with the intent that they should run the two companies for and in the interests of the three oil companies. The plaintiff company's directors held all their relevant board meetings outside the United Kingdom. The plaintiff company began trading in 1971 with a capital of $ US25m, mostly represented by vessels or interests in vessels.

It ran into financial difficulties and in January

1978 was ordered to be wound up with an estimated deficiency of nearly £114m. As a result, the first defendant also ran into difficulties and was ordered to be wound up with assets of only £34,000. The losses sustained by the plaintiff company were alleged by its liquidator to have been caused by the highly speculative decision made by the plaintiff company's directors to build or acquire six tankers for trade in the spot oil market. The liquidator alleged that the decision in regard to the six tankers could not properly be regarded as falling within the scope of reasonable business judgment. However, the liquidator did not allege bad faith.

The plaintiff company brought an action against the first defendant company, and also against its directors, the plaintiff company's directors and the three oil companies (the foreign defendants) claiming damages for negligence and alleging that the first defendant's directors were negligent in preparing inadequate and insufficient budgets, forecasts and information for the plaintiff company's directors, and that the plaintiff company's directors and the three oil companies were in turn also negligent in failing to appreciate those deficiencies as they ought to have done before acting on the basis of the material supplied.

While the issue in the case was the alleged negligence, the judges dealt with what they termed "the company law point." Lawton L.J. considered this:-

> [t]hese oil companies were the only shareholders. All the acts complained of became the plaintiff's acts. The plaintiff, although it had a separate existence from its oil company shareholders, existed for the benefit of those shareholders, who provided they acted intra vires and in good faith, could manage the plaintiff's affairs as they wished. If they wanted to take business risks through the plaintiff which no prudent businessman would take they could lawfully do so. Just as an individual can act like a fool provided he keeps within the law so could the plaintiff, but in its case it was for the shareholders to decide whether the plaintiff should act foolishly. As shareholders they owed no duty to those with whom the plaintiff did business... when the oil companies acting together required the plaintiff's directors to make decisions or approve what had already been done, what they did or approved became the plaintiff's acts and were binding on it... It follows, so it seems to me, that the plaintiff cannot now complain about what in law were its own acts.

Dillon L.J. considered the same points in greater detail, he stated:-

> the business and affairs of Multinational were, at all times material to this action, under the control of the joint venturers. Further (as is pleaded more particularly in paragraph 32 below) the Multinational Directors acted at all material times in all relevant matters in accordance with the directions and at the behest of the joint venturers and, accordingly, the powers of directing and managing the affairs of Multinational in relation to the matters hereinafter complained of were vested in and were exercised by the joint venturers...
>
> The heart of the matter is therefore that certain commercial decisions which were not ultra vires the plaintiff were made honestly, not merely by the directors but by all the shareholders of the plaintiff at a time when the plaintiff was solvent. I do not see how there can be any complaint of that. An individual trader who is solvent is free to make stupid, but honest, commercial decisions in the conduct of his own business...

> The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders...
>
> The shareholders, however, owe no such duty to the company. Indeed, so long as the company is solvent the shareholders are in substance the company.

He concluded:-

> If the company is bound by what was done when it was a going concern, then the liquidator is in no better position. He cannot sue the members because they owed no duty to the company as a separate entity and he cannot sue the directors because the decisions which he seeks to impugn were made by, and with the full assent of, the members.

The majority judgments of Lawton L.J. and Dillon L.J. affirm the elements of the model company as entirely eroded.

The importance of this decision is that the shareholders were able to run the corporate entity against the interests of that entity.

There was no separation of ownership and control. No board or general meetings were held. The directors and shareholders met jointly to exercise control.

The directors were representatives of the oil companies. They were appointed specifically to run the company in the interests of the oil companies. The shareholders owed no duty to the company as an entity.[1]

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[1] See PHILLIPS V MANUFACTURERS' SECURITIES LTD. (1917) 86 L.J. Ch. 305 and also chapter one, Equitable Considerations Concerning the Members Voting Rights.

The directors did owe a duty to act in the interests of the company. This though, was absolved by the shareholders' input into the managerial discretion.[2]

As such the directors and shareholders were free to make "foolish" and "stupid" decisions while owing no duty to the corporate entity.[3] All the aspects of the legal entity have been eroded.[4]

5.1 Reform.

> The limited liability corporation is the greatest single discovery of modern times. Even

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[2] Effectively the directors duty is being relieved by the members in general meeting; see chapter one, The Residual Power of the General Meeting.

[3] They were also held not to owe a duty of care to the corporate entity.

[4] Of note here that the dissenting judgment of May L.J. recognises the eroded model company. He states:-

> the directors of both the plaintiff and Services were employees and the nominees of each of the three joint venturers respectively and were so appointed with the intent that all of them should run each of the two companies for and in the interests of the joint venturers.

He concluded:-

> Salomon's case and the subsequent authorities make it clear that a limited company is a person separate and distinct from its members, even though a majority of the latter have the power to control its activities so long as it is not put into liquidation and whilst they remain members and a majority. Once, however, the joint venturers ceased to be able to call the tune, either because the company went into liquidation or indeed, though it is not this case, because others took over their interests as members of the company, then I can see no legal reason why the liquidator or the company itself could not sue in respect of the cause of action still vested in it.

> steam and electricity are less important than the limited liability company.

While the above statement of N.M. Butler, President of Columbia University,[5] may seem a touch excessive it does raise an interesting comparison. The scientific process builds on the initial discovery. Other modifications and inventions arise from the continual learning process which arises from the original concept.

By contrast the limited liability company arose in essentially its modern form in 1844 and 1855.[6] [7] 150 years have passed and little has been done to update the structure of the limited liability company. Sealy (1984: p.1) discusses this:-

> [i]f the history of the steam engine subsequent to its discovery had followed a pattern similar to that of the limited company over the same period, every train leaving Paddington station today would be restricted to a speed of four miles per hour, and would still be preceded by the legendary man walking with his red flag.

This thesis has been about that model company that came into existence 150 years ago. It has shown that the model may be legislatively stagnant but in the absence of legislative change the judiciary have imposed change. The difficulty with this has been that it was not a judicial

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[5] Quoted in Diamond and Orhnial (1982: p.42).

[6] Joint Stock Companies Acts 1844 and 1856.

[7] See Formoy (1923), Shannon (1966) and for the origins of companies generally, see Griffith (1994: pp.105-112).

attempt to deal with the entire model, rather it was an attempt to redefine particular elements of the model in light of the changing circumstance before them.[8] [9] The result of this has been the erosion of the model company.[10]

The Problem.

Professor Ballantine (1946: pp. 41-42) considered the aims of company law:-

> [t]he primary purpose of corporation laws is not regulatory. They are enabling Acts, to authorise businessmen to organise and to operate their business, large or small, with the advantage of the corporate mechanism. They are drawn with a view to facilitate efficient management of business, and adjustment to the needs of change.

The model company does not unfortunately fit this description. The task force which set about the reform of company law in Canada[11] stated:-

> [w]e set out to design a scheme of law that was clear, workable and, above all, written for the

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[8] McGlynn (1994: pp.301-307) states:-

> [a]t present, the principles of company law are inconsistently applied producing doctrinally irreconcilable and inconclusive case law.

[9] For an examination of the present role of the judiciary and recommendations for the future, see McLachlin (1994: pp.260-269).

[10] Gower (1980: p.115) considered that English companies legislation was "in a far worse mess than it had been at any time this century."

[11] Dickerson et al (1971).

businessmen who will operate under it, not for the corporation lawyer. Accordingly, the Act simplifies and codifies where ever possible. We have sought to eliminate the obsolete and anachronistic, and to remove the trivially arcane.[12]

The authorities would seem to agree that company law should serve those who use it.[13] The model company does not and so has been eroded.[14] The difficulty with this is that its replacement serves only the dominant interest, the shareholders.[15]

Grantham (1993: p.264) states:-

> [t]he advent of incorporation necessitated a change in form but the shareholders continued in their role of proprietor. Whether this

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[12] They also stated further at para. 20:-

> There is....a belief that corporation law belongs to the legislatures which enact it and to the officials who administer it. It does not.

[13] The Cohen Committee (1945: Cmnd. 6659, para 5) stated:-

> [w]e are satisfied...that the great majority of limited companies....are honestly and competently managed. We have bourn in mind the importance of not placing unreasonable fetters on business.

[14] For an interesting discourse on why regulatory regimes do not work, see Baldwin (1990: pp.321-337). There he finds that rules do not work when those willing to comply do not understand what compliance involves and those less willing to comply are not informed or stimulated in the right way. It must be suggested that this analysis fits the present regulatory regime for corporations. Effective rulemaking is the answer and as he states "[i]mproved rulemaking will come through paying regard to the issue rather than by clinging to the notion that rules shape the world."

[15] For a consideration of some of the difficulties arising from the present model, see Jaffey (1994: pp.22-26).

> remains true today however is less clear. Since the rule first appeared late last century the underlying conception of the company has shifted towards a view of it as representing the interests of a wider range of groups.

Gower (1979: p.62) considered that social responsibility may also be a function of the modern corporation.[16] He stated:-

> [a]nxieties relating to mergers and concentration and to the increasing amounts of public money being invested in companies have been accompanied by a discussion of the social responsibility of companies. The suggestion that a company has social responsibilities seems to imply that it should not be its sole, or perhaps even its primary, aim to make profits for its shareholders, an implication which has led a leading "free-enterprise" American economist to dub the suggestion "pure unadulterated socialism."[17]

The model company no longer serves those who use it, the shareholders and managers. Further, company responsibility has evolved to a point where there are other elements of importance within the greater corporate structure which the model legal structure does not represent such as creditors, employees, customer and general public.[18]

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[16] See also Xuereb (1988: pp.156-172).

[17] For a consideration of the other interests within the corporation, see Davies (1992: p.85).

[18] In 1973 the Confederation of British Industry, suggested that a public company must pursue profit but it must also act "like a good citizen in business" : Confederation of British Industry Company Affairs Committee (1973: p.23). See also Note (1994b: pp.1941-1958) for a U.S. approach to reform of the

The model company has been judicially redefined to serve the dominant interest, the shareholders. This must be corrected by a redefinition of the model company to include all the interests which make up the modern corporation.[19] Only then can it be said that there is a separate legal entity distinct from its members. In attempting a redefinition of the model company the thesis distinguishes the private and public corporation.

Private Companies.

We have seen above in chapter one that the dominant form of incorporated business in Ireland and the U.K.[20] is the private company. This is surprising as the model company is not designed for use by a small businessman.[21] Indeed the original intention of the Act was not that of use by small companies.[22] Kahn-Freund in Renner et al

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present corporate structure.

[19] Lord Templeman (1990: pp.10-14) discussed the development of company law in the U.K. over the previous 40 years. He considers that the greatest failing has been the exclusion of the employees from the existing structure.

[20] For figures on the number of U.K. private companies see Department of Trade and Industry (1993).

[21] There are no official figures on the number of companies which could be defined as small but a survey conducted by Freedman and Godwin (1994) suggested that 90% of private companies could be defined as such.

[22] Lord Redesdale stated:-

> some protection should be inserted, as a protection to poor persons, preventing very small Companies being set up under the Bill, for, otherwise petty Companies of all kinds would be set afloat...

(1976) considered that the limited company was for the purposes of raising capital for major capitalists embarking on risky ventures.[23] This intention was distorted by the "calamitous decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.)" so that "company law has come to annex the functions of the law of partnership." He further suggested:-

> [i]nstead of, or in addition to, altering the legal consequence of company formation, one might make the formation of companies more difficult and more expensive, and thus reduce the number of companies and especially small companies. By doing so, Parliament might go some way towards restoring to the limited company its original function, and to the partnership its proper place in business life. Kahn-Freund (1944: p.54).

The use of the corporate form by small businesses is unsuitable as the structure of the company is really only conducive to a large company with a large number of shareholders.[24] Freedman (1994: pp.555-584) considered the use of the corporate structure by small businesses. She found that the structure of the corporation could create a burden on the small businessman, particularly through the procedural requirements for meetings and notices of meetings.

Freedman further found that small businessmen

Hansard (1855).

[23] See also Formoy (1923).

[24] See Gower (1979: p.14).

perceived that one of the benefits of incorporation was to confer prestige, legitimacy and credibility on the venture.[25] They thus incorporated when a partnership or sole trader would have been a more suitable form.[26] She concluded that:-

> [a]n increase in barriers to incorporation at the outset, as opposed to an increase in recurrent running costs, should result in fewer dissatisfied businesses in the long run. This could be a long-term saving for business owners and the wider business community. The corporate form brings burdens and privileges to the small business. For those who cannot utilise the privileges, the burdens will always be too great. But a flexible general company law can serve a wide range of firms and be moulded to facilitate the operation of their businesses.

The corporation has become a popular vehicle for small businessmen, whether or not it is suitable. It is likely to continue as such in the future. The model company does not provide for the various needs of the small business and indeed company law in general does not provide for the small businessman.[27] As such the model company needs to be redefined to distinguish first, between public and

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[25] Historically the main motivation behind incorporation has been tax; Griffith (1994: pp.105-112).

[26] This would also help to explain why businessmen incorporate when the main benefit, limited liability, is negated through personal guarantees provided to the lending institutions and the growth in liability insurance, see Finch (1994a: pp.880-915).

[27] Indeed Sealy (1984: p.5) suggests that the business community as a whole is ill-served by company law.

private companies[28] and second, between the needs of particular types of private companies.

This thesis suggests that a suitable revision of the law regarding private companies could be accomplished through a tiered set of articles of association and accompanying regulations.[29]

Thus a businessman who wishes to incorporate would have a choice of articles on incorporation. A choice of three sets of articles would be available. Set one would be suitable for a small business with no separation or minimal separation of ownership and control. Thus the articles would have minimal formal procedural requirements for meetings etc. Set two would be tailored to the medium sized private company, where the company is a vehicle for capitalization and therefore some separation of ownership and control exists. Again a streamlined procedural requirement would exist.

The third set would relate to the large private company where there is effective separation of ownership and control. The company could support the full regime of the existing model company with the recommendations regarding public companies applying.[30]

Accompanying each set of articles would be certain

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[28] Besides the minimal distinctions between the articles of association at present.

[29] Which could be accommodated through the existing company structure.

[30] See below recommendations regarding the law for public listed companies.

exemptions from burdensome statutory requirements. For example, the set one articles could be accompanied by an exemption from the statutory audit. Set two would have a partial exemption and set three minimal if any exemption.

Public Companies.

It is one of the contentions of this thesis that the private and public company are fundamentally different. The fundamental difference between the two relates to their shareholdings. Shares in private companies are held by private individuals whereas the vast majority of shares in public limited companies are held by institutions.[31] This fact alone creates such a difference between the two types of legal entity as to make them entirely different creatures.

Institutional shareholders have a need for information and input into managerial discretion. The erosion of the model legal company and its replacement by a shareholder-dominated structure has led in the case of the public limited company to the legal entity being run in the interests of those institutions rather than the interests of the company.

Corbett and Mayer (1991) define the corporate environment present in the Anglophone countries as "outsider" systems. The defining characteristics of this system are:-

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[31] See chapter three, 3.1 The Interests of the Institutions.

(1) dispersed ownership and control,
(2) separation of ownership and control,
(3) little incentive for outsiders to participate in corporate control,
(4) a climate where hostile takeovers are not unusual, and they can be costly and antagonistic,
(5) the interests of other stakeholders are not represented,
(6) low commitment of outside investors to the long term strategies of the company,
(7) takeovers may create monopolies.

It can be seen above that a key factor in this definition of an "outsider" system is the separation of ownership and control. This characteristic focuses on the model structure and not the market control structure which has evolved.

The market has evolved a structure whereby the control element is not delegated upwards to the board as article 80 provides, but is instead placed in an extra-constitutional organ called "institutional briefings." Institutional briefings occur between the management and the institutions and it is here that the control and ownership functions are initially exercised, and subsequently implemented as a consequence of these briefings. The general meeting no longer exercises any real ownership or residual control function.

The market has evolved a structure whereby ownership and control is mixed. Thus the market model exhibits some of the characteristics of the "insider" system which are common in Japan and Germany. The characteristics of which Corbett and Mayer (1991) defined as:-

(1) concentrated ownership,
(2) the association of ownership and control,
(3) control by related parties such as banks, partners and employees,
(4) absence of hostile takeovers,
(5) the interests of stakeholders are represented,
(6) the intervention of the outside investors is limited to periods of clear financial failure
(7) insider systems may create collusions and cartels.

It can be seen that the market control structure is really a pragmatic hybrid of the two systems. The point should be noted that the institutions in both "insider" and "outsider" systems have the same power. The difference between the two systems being that the German and Japanese systems have evolved in a rigid and structured manner, whereby each stakeholder has clearly defined responsibilities to go with its power. The institutions in the Anglophone countries have no responsibility to those stakeholders[32] within the market place, their only responsibility being to the fund they control.

The Reconstructed Model.

It is with this issue that the rest of this chapter is concerned. In attempting to provide a solution to the erosion of the model company, this thesis poses a distinct choice. It could recommend a complete codification of the company law system in order to deal

[32] Employees, creditors, and general public.

with the erosion of the company or the thesis could offer a pragmatic settlement within the existing framework.[33] The former is an unlikely solution so this thesis has opted to attempt a pragmatic resolution.[34]

The starting point in this solution is the "calamitous decision in SALOMON V SALOMON & CO. [1897] A.C. 22 (H.L.)."[35] This thesis contends that the decision, despite the above comment and the judicial attempts to erode it, provides the answer to the eroded model. The restructured model begins with the separate legal entity as the foundation. As a separate legal entity it has a definable interest. That interest is definable in terms of the component parts of the modern corporation; the shareholders, the managers, the employees, the creditors,[36] and the general public interest. No one interest should dominate.

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[33] Miles (1994: pp.202-205) considers that the "problems can be better resolved through the adoption of a different company structure."

[34] A lesson learned from Professor Gower's legislative work in Ghana.

[35] See Kahn-Freund in Renner et al (1976) above p.204.

[36] Grantham (1991a: pp.1-18) considering the directors duty to act in the interests of creditors, stated:-

> [t]he courts' move to establish creditor protection in this way, it is suggested, involves not merely the reversal of a single rule, but a quite radical change in what is meant by "the company." For example once shareholders are displaced as owners, and the normative force of that position is lost, there are grounds, as have been noted above, to rethink the rules concerning shareholder ratification of managerial action, and indeed shareholder voting in general. It may even require a relaxation of the directors' obligation to pursue maximum profit.

The Directors have a duty to act in the interests of the company.[37] That duty can only be fulfilled if equal consideration is given to each element of the entity's definable interests.[38] How could this work? The board structure would reflect the company's interests. Thus there would be an employee,[39] [40] [41] creditor, and public servant[42] on the board as well as the shareholders and management. The shareholders would elect the management and their representative directors on a proportional representation basis. Thus while there are representative directors on the board their influence would be tempered

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[37] For a consideration of how this duty to the company would apply see GAIMAN V NATIONAL ASSOCIATION FOR MENTAL HEALTH [1971] Ch. 317.

[38] Flynn (1991: p.117) states:-

> [t]he process of reconceptualising the rights and duties of management and those groups traditionally situated outside the model of the company employed in our law opens possibilities for redrawing domestic relations in the company.

[39] Consideration is already taking place on employee representation at a European level. For the original proposal see Employee Participation and Company Structure (1975, E.C. Bulletin Supp. 8/75) for the position at present see European Company (Societas Europaea) [1991] O.J. C176/1. See also Quinn (1989a: pp.268-270) and Quinn (1989b: pp.307-308) for an analysis of the European Community programme on harmonisation of company law. The outlook for implementation of the Company Law Directives at present is bleak, see Andenas (1994: pp.121-122) and Bovis (1994: pp.213-214).

[40] For an examination of how a Societas Europaea would work see, Khan and Lowe (1990: pp.33-34) and for a consideration of the likely impact of the Draft Fifth Company Law Directive, see Boyle (1992: pp.6-10).

[41] For the U.S. position on employee participation in management decisions see, Note (1994a: pp.678-695).

[42] Rotating each year.

by the representative directors of the minority in general meeting and the other directors.[43]

The difficulties in applying the duty to act in the interests of the company would be made less convoluted if the decisions are made with the participation of the interests of the company.[44] [45]

Provision would also be made for the special information needs of the institutional investor. A sub-committee of the board could be appointed to deal with shareholders' information.[46] Access to this sub-committee

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[43] Du Plessis (1993: pp.224-229) in recommending reform of company law in South Africa considered the contrasting interests groups within the corporation. He stated "[t]he most successful company law will be that one in which equilibrium can be achieved between these divergent interests."

[44] Decisions of the board would need a quorum necessary to represent the interests of the company.

[45] See Hatherley (1992: p.85) where he considers that the network of accountability relationships that exist between stakeholders in a company needs to be reassessed in the context of the non-committed ownership phenomenon that has caused many company auditors in the U.K. to work in a vacuum.

Institutional shareholders, who account for the great majority of shareholdings on The Stock Exchange, see themselves as managing a portfolio and feel no need for a long term commitment to any given company, its management, strategy, or operations. He considers further that the traditional notion of ownership by, and accountability to, shareholders alone should be replaced with a principle of accountability to committed stakeholders. These could include long term shareholders, long term bankers and possibly suppliers, employees, and customers who are committed to the company. Shareholders who do not have a long term commitment are replaced by stakeholders who do. Rethinking the conception of the company may be the key element in moving away from short termism and toward the regeneration of U.K. business.

[46] If this proved too cumbersome a shareholder liaison officer could be appointed to deal with shareholder information. He could have access to the board through a non-voting position at board meetings.

would also be available to private shareholders.[47] Implementation of this reconstructed model would require limited statutory intervention.

The Take-over.

The take-over provides unique difficulties regarding the model company. The take-over is in essence about the shareholders right to sell his shares to whomever he wishes. The law at present places control over that decision in the hands of the shareholder. The difficulty arises in that the shareholders owe no duty to act in the interests of the company. Thus the interests of the employees, creditors and general public do not impact.[48] This is not correct.[49] The solution to this problem is to take the decision out of the hands of the shareholders and into the board which represents the interests of the

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[47] For a consideration of a balanced investor relations programme see Lees (1994: p.5). There he describes the corporate constituencies as institutional shareholders, broker's analysts and small shareholders.

[48] At a European level submissions have been made regarding the 13th Directive on Takeovers, that the interests of employees and the general public be considered in any proposed takeover; Dine (1991: pp.83-89). For a consideration of the difficulties which face this directive before it will be implemented, see Andenas (1993: pp.113-114).

[49] Much of the traditional literature regarding the conflicting interests in a take-over, focuses on the conflict between management and the shareholder and thus the regulatory regime is aimed at these two groups. For example see Berle and Means (1933) and Helm (1989). For an argument that there is a public interest involved in a take-over, see Bradley (1990: pp.170-186). There she concludes that the public interest is not well served by the present regime.

company.[50] The constitutional difficulties raised by this action will, it is argued, be tempered by the public interest in doing so.[51] [52] [53] [54] [55]

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[50] In Italy for example the shareholders right to vote is limited where there is a conflict of interest. "The sacrifice of the company's interest is not justified even where all the shareholders are unanimous in wanting to inflict damage on the company with a view to personal gain;" CORT CASS. OCTOBER 25, 1958, NO. 3471.

[51] Of particular interest here is the decision of the Privy Council on appeal from the Supreme Court of Mauritius: GOVERNMENT OF MAURITIUS V UNION FLACQ SUGAR ESTATES CO. LTD AND GOVERNMENT OF MAURITIUS V THE MEDINE SHARES HOLDING CO. & ORS-APPEALS NO.S 35 & 36 OF 1990. There the issue was a statutory provision which would deprive shareholders of their voting rights without compensation. The provision was challenged on the grounds that it was unconstitutional. The Constitution of Mauritius guaranteed the right of the individual to protection of property, and from deprivation of property without compensation. The Privy Council upheld the statutory provision on a number of grounds including; the company is a creature of statute and the rules applicable to a company can be altered by statute. See also Koenig (1994: pp.30-32).

[52] And also in that, the shareholders have representation on the board that makes the decision.

[53] See also the judgment of Oliver J. in RE HALT GARAGE (1964) LTD. [1982] 3 ALL E.R. 1016 where he moves towards accepting that shareholders are not free to vote as they wish. He stated:-

> if this is right it leads to the bizarre result that a meeting of stupid or deranged but perfectly honest shareholders can like Bowen L.J.'s lunatic director, vote themselves, qua directors, some perfectly outlandish sum by way of remuneration and that in a subsequent winding up the liquidator can do nothing to recover it.

[54] See also Ussher (1986: pp.55-56) where he posits that the shareholders have by their agreement to take a shareholding in the company delegated their constitutional rights of property to the company as an entity.

[55] Such an action would be less draconian than the results of the Companies Act 1963, section 204, regarding the compulsory acquisition of the shares of a minority. For the English position regarding this issue see, Mercer (1992: pp.139-141).

5.2 In Summation.

This thesis set out to demonstrate the erosion of the model company. It has done that. The importance of the thesis is in its recognition of the eroded model. In essence the recommendations for reform contained above provide but an addendum to the essence of this thesis.

In summation, the words of Megarry J. in GAIMAN V NATIONAL ASSOCIATION FOR MENTAL HEALTH [1971] Ch. 317 at 335 suffice:-

> [w]here there is corporate personality, the directors or others exercising the powers in question are bound not merely by their duties towards the other members, but by their duties towards the corporation....
>
> In the case of a company, whether limited by shares or guarantee, a new legal entity comes into existence, namely, the company; and many of the powers have to be exercised for the benefit of that entity. This distinguishes a company from an ordinary club, which is not a legal entity distinct from its members; and although a trade union, of course, possesses some of the characteristics of corporate personality, it is not a corporation either. The conversion of a club into a limited company, too is no mere formality, but a change of substance.