

Division of powers between shareholders and directors



QUESTION

“ The orthodox view in Corporate Law is that the ownership of the company is vested in the shareholders, whereas the management of the company is the exclusive preserve of the directors. But this sharp distinction does not always apply in every instance.”

Discuss in relation to the division of powers between shareholders and directors.

INTRODUCTON

The principle of division of powers aims at separating the ownership and control between the shareholders and directors in a company. Historically, the directors have been viewed merely as agents of the shareholders of the company with whose actions they were to comply with. Later, the law moved towards the decline of the powers of the shareholder thereby making both the shareholders and directors an integral part of the company and they both having substantial roles in handling the company's affairs. This principle has been settled by Lord Clauson in the 1943 case of *Scott v Scott*, where it provided the constitutional provision regarding the company's management. This case established that the power of management was given to the directors and held that shareholders should not intervene in the powers of the directors.[1] This was also affirmed by the statement of Buckley LJ in case *Gramophone and Typewriter Ltd v Stanley*, saying that directors do not act as the agent of the shareholder when carrying out his director duties of the company and under company law he does not owe a duty to the shareholder.[2]

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One of the main issues of company law systems is how power is allocated between the board of directors and shareholders in handling companies affairs. On several occasions, there is a need for an interference or there are situations where there will be an overlap of powers between the members and directors. These overlaps usually come up because of a disagreement between the shareholders and the directors as to what is best for the company. The power of the directors to manage the affairs of the company has been established by the principles in the decisions of the court and entrenched the shareholders with the power to vote, appoint directors and vote on matters that does not involve the management of the company.[3]

This paper examines the situations in which the principle of division powers is not strictly adhered to, also looking at the law in this area and the possible troubles they can run into. It moves further to discuss the situations in which shareholders can intervene in the duties of the directors, looking at the issues of who can use the corporate name in litigation, considering the rule in Foss and Harbottle and its exceptions. It also examines the situation where the directors do not exist or in deadlock and cannot act, and finally looks at the reserve powers of the shareholders mainly considering their power to give directors instructions.

SHAREHOLDERS INTERVENING WITH THE DUTIES OF DIRECTORS

The legal powers to act on behalf of the company is available to the board of directors and these powers are fused with that of the company and are not allowed to exercise any activity the company cannot perform.[4]They are subject to the restrictions that the company's constitution places on the

company. A common situation where there might be an intervention of powers of the director by shareholders is in a case involving the use of the company name in litigation. This can be found article 3 of the model articles for both private and public companies.[5]The decision to start or end a legal proceeding falls under the general powers of management of the company's business and these powers are reserved for the directors. Although it has been expressed in the model articles, this area of law has been somewhat controversial. One of the leading cases here is *John Shaw & Sons Ltd v Shaw*[6], where Greer L. J stated that "...If powers of management are vested in the directors, they and they alone can exercise power." His decision here means that the directors exercised their powers properly and that the general meeting could not usurp this power. Critics of the rule of division of powers have considered the view of Judges in older cases such as *Marshall's Valve Gear Co Ltd v Manning Wardle and Co Ltd*[7]where the members of the company made a claim in the company's name and the directors disagreed with their resolution and tried to strike out their claims but were not allowed. Based on the Companies Clause Consolidation Act 1845 governing statutory companies, Neville J concluded that the members had the power to make a claim in the company's name, with the aim of preventing directors from acting in a conflicting manner to the member's ordinary resolution.[8]*Breckland Group Holdings Ltd v London and Suffolk properties Ltd*, which was of similar facts to the *Marshall's* case drew the curtains to the issue[9]and took the view that directors only should exercise such powers.

Despite this law the shareholders are not completely without influence, they still have what we might call their most important power which is the fundamental right of the shareholders to dismiss the directors by an ordinary resolution. This provision was introduced in the Companies Act 1948 and currently available by the Companies Act 2006, s168. The purposes of these actions are to provide a guarantee that the shareholders can dismiss directors by an ordinary resolution and for the purpose of providing justice to the directors. The view that the shareholders can dismiss the director was supported in John Shaw case in the words of Greer LJ saying,

“ the only way in which the general body of shareholders can control the exercise of the powers vested by the articles in the directors is by altering the articles, or if opportunity arises under the articles, by refusing to re-elect the directors whose actions they disapprove.”[10]

This process requires a special notice given to the directors as an opportunity for them to defend their case to the general meeting. These powers are very important to the shareholders as this means they have an effective method of handling the companies policies and activities of company's directors.[11]This is necessary as it provides the directors with a good reason to serve the best interest of the company after they have been appointed.[12]The other situations in which the shareholders can exercise managerial functions of litigation include a situation where the board is in deadlock and the exception to rule in Foss v Harbottle.

BOARD IN DEADLOCK

Under certain circumstances the members can carry out the duties of the directors. A situation where the board of directors are in deadlock and unable to act, or when their meetings are inquorate. In the case of *Alexander Ward and Co. Ltd v Samyang Navigation Co. Ltd*, this case established the principle of residual authorities “ in the absence of an effective board”[13]. In this case the company articles stated that the company’s business shall be managed by the directors “ who...may exercise all such powers of the company as are not by the Ordinance or by these articles required to be exercised by the company in general meeting”.[14]They argued that in the absence of directors, the company was incapable of taking legal action and this was rejected by the House of Lords. The principle of residual authority is important because it empowers the shareholders to make their own decision in place of the directors’ decision.[15]A similar decision to this was seen in the case of *Foster v Foster* and it was established there that for the reason of transacting business the members can act as agents of the company in the absence of directors.[16]In the nineteenth century, there were the assumptions that the principle of residual authority in this area of law will be hard to defend but the more recent case of *Barron v Potter* has removed all doubts.[17]In *Baron*, the company’s business was at a standstill as a result of the failure of one of the directors to show up at work. The decision of Warrington J stated that in the absence of the ability of the directors to appoint a new director in the present case, the company’s general meeting has the power to do so.[18]

RULE IN FOSS AND HARBOTTLE

When there is an issue to be brought before the court, can the shareholders make a suit? The answer to this question was settled by the Rule in *Foss v Harbottle* and this leaves a negative answer subject to certain exceptions. The rule states that the court does not have the jurisdiction to interfere with the internal affairs of the company and in order to redress a wrong done to the company it should be brought by the company itself.[19]The rule makes provision for the directors or the majority shareholders at the expense of the interest of the minority shareholders. When the minority shareholder tries to bring a case to the court concerning wrongs done to the company, he is met with the defence that the company is the proper plaintiff or that it is a matter of internal management.[20]There are exceptions to the Rule in *Foss* and these rules were made to give the minority shareholders can have a chance to institute legal proceedings. The first exception to the rule is that of *Ultra Vires* and *Illegality*, where the act complained of is wholly *ultra vires* the company or association.[21]In this situation, a shareholder can bring action to the court when an illegal or some *ultra vires* act occurs. The shareholder can take an action for a declaration or injunction to restrain the act in question, for himself or he could represent the other shareholders on his side of the argument.[22]The second exception is that on *Special Majorities*, “Where the issue is such that it could not ‘ validly be done or sanctioned by a simple majority of the members...but only by some special majority”.[23]In the case of *Edwards v Halliwell*, the trade unions rule required a two-thirds of majority of the members to increase subscription but the purported to do it by ordinary resolution. Jenkins L. J considered that a company in which its directors had broken the company’s regulations by performing an act that requires validation by a special resolution without one. In such a scenario, <https://assignbuster.com/division-of-powers-between-shareholders-and-directors/>

the rule will not apply.[24]In the decision in *Quin and Axtens, Ltd. V. Salmon*, the rule in *Foss* was set aside, in this case the Article 80 provided that any resolution concerning the acquisition and letting of premises, should not be valid unless a notice has been given to each managing director. Salomon dissented from the decision of the directors but a simple majority of the shareholders passed a resolution confirming the decision.[25]It was held that Salomon had the right to an injunction to restrain the directors and the company from acting in a contrary manner to the provisions of the article, on behalf of himself and other shareholders on his side.[26]

The third exception to the rule is that of Personal rights, where " the personal and individual rights of membership of the plaintiff have been invaded," the Rule " has no application at all." [27]The shareholders have right which are pulled out from the article of association and some of these rights are statutory which arise from the act.[28]In the case of *Edwards v Halliwell*, the court established that every shareholder of the company had personal right to prevent adjustments in rates of contribution to the trade union and in the case of *Pender v Lushington*, the articles enforced the right of shareholders to vote on company affairs, whether he votes in favour of the majority or minority, and an individual can sue in respect to this right.

[29]The last exception to the rule will be considering here is " Fraud" by those in control.[30]This involves actions carried out that amount to fraud which is usually done on the minority shareholders, which is caused usually by an abuse of power by the directors.[31]The exception here has been made to protect the minority shareholders in which they can bring a minority shareholder action to the court on their behalf and on the behalf of other

shareholders. Fraud can also constitute to what the general meeting cannot ratify. When a breach in fiduciary duties occurs, and cannot be ratified by the by the director it means that the director has acted in bad faith.[32]If a negligent act by the wrongdoers is benefited from, the authorities have suggested that it can be viewed as fraud on the minority.[33]

THE SHAREHOLDERS RESERVE POWEERS

The Companies (Modern Articles) Regulation 2008 applies to the new companies registered under the Companies Act 2006. It states out the division of powers between the members and the directors of the company. The Article 4 contains the reserve powers of the shareholders, stating that: (1) The shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action. (2) No such special resolution invalidates anything which the directors have done before the passing of the resolution.[34]There are certain obstacles that the shareholder may face in this approach. A possible setback could include the general meetings power to give directions to the board has been interpreted as subordinate to the powers of directors[35]as seen in the case of *Scott v Scott* where the constitution of the company gave powers to the general meeting to give directions to the board by ordinary resolution and it was held that the powers of the general meetings power doesn't qualify to the powers of the director. [36]It was also established that shareholders could give directions to the board but it does not have a binding effect.

Gower suggests that the Article 70 of Table A recognises the general meeting may influence the future powers of the directors by passing a

special resolution.[37] Does this mean that by a special resolution the shareholders in the General meeting can restrict the future powers of the directors? Can the special resolution restrict or give a go ahead from entering a transaction? This has left many questions unanswered. Some have taken the view that the resolution of the directors does not change and remains valid as the director's resolution; the special resolution would only prevent the directors from acting upon it.[38] So, if the directors have come to a resolution of not entering a certain transaction, the shareholders under article 70 Table A could pass a certain resolution compelling them to enter the transaction.[39]

The law in this area has often been criticized as being illogical because the law requires that when a director acts in an ultra vires manner these acts can be ratified by the shareholders but in a case where the shareholders need the directors to act in advance they must alter the articles of the company.[40] There have been some suggestions to this area of law, that shareholders may give directions to the directors to act beyond their powers, but within the powers of the company either before or after an ordinary resolution has been passed.[41] It could be argued that this will give way for an alteration to the articles by a majority vote.

An example of a circumstance in which the directors act on the permission of the shareholders includes the allotment of shares. The section 551 of the Companies Act 2006 provides that by an ordinary resolution the members can grant this resolution even if the company's articles have to be altered in order for this to take effect.[42]

CONCLUSION

The lines between the division of the powers of the directors and the shareholders in UK law has been blurred and lacks a very sharp distinction. The law has experienced a decline in the shareholder's power, though not making them powerless but compare to the directors their powers have been restricted. The area of cooperate litigation which has been settled as a management power of the director has made room for the shareholders in the exception to the rule of Foss and Harbottle, allowing the minority shareholders to bring legal action to the court on his own behalf and the behalf of those in favour of his decision. The removal of directors has also been one of their vital powers, when the directors have acted in a manner not at the company's best interest.

In the absence of the directors or when the board is in deadlock the shareholders have the powers reverted to them and they can make company management decisions. The reserve powers of the shareholders have been argued to have substantial impact on the of the decision of the board where acting as a direct instruction from the shareholders or acting as a general supervisory set of rules. The themes discussed have demonstrated the approach of the court and law in this area of law, and show that the sharp distinctions between the powers directors does not apply in every instance.

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