

9. Prevention of Oppression and Mismanagement

The Majority Rule (Foss vs. Harbottle)

Two shareholders brought an action against directors charging them with 'concerting and effecting various fraudulent and illegal transactions, whereby the property of the company was misapplied, alienated and wasted'. They claimed damages from defendants. The court dismissed the action on the following two grounds, which is known as basis for majority rule.

Basis of majority rule

1. Proper plaintiff is the company

- The court held that the damage was caused to the company and this only the company was the aggrieved party. As such, the suit could be brought by the company and not by any individual shareholders.
- Where a damage or injury is caused to the company, it also affects its members. Yet they, are not entitled to maintain a suit because mere injury is not enough. Since the directors owe no duty to an individual member but to the company as a whole, an individual member can not be a proper plaintiff.

2. Unproductive litigation

- The wrong done to the company could be ratified by the company. As such, the award of damages by the court would have been futile as the majority had the powers to ratify the alleged breach of duty and it could be decided not to recover the damages, thus, litigation would have proved worthless.

Justification and advantage of the rule in Foss vs. Harbottle

1. **Proper plaintiff:** majority rule recognizes and supports the concept of separate legal entity of the company. i.e., a company is an entity separate from its member so company can bring action only not its member.
2. **Unproductive litigation:** if the wrong done to the company can be ratified by the company, it would be futile to have litigation except with the consent of the majority.
3. **Multiplicity of suits avoided:** if every individual member is allowed to institute a suit for a wrong done to the company, it would result in countless number of suits.
4. **Recognition of 'will of majority':** the well accepted rule that the will of majority must prevail has been followed and reaffirmed by the principles laid down in Foss vs. Harbottle.

Exception

- Where the directors, who also do not control the majority shareholding, misuse their powers for their personal gains, the minority has no right to sue them as per 'majority rule'. Thus, to protect the minority certain exceptions to the majority rule have been developed

1. *Ultra vires* and illegal act

- #### 2. **Fraud on minority:** where the majority misuses its power to defraud or oppress the minority, an action can be brought by an individual member. For example, if majority divides the whole assets of the company, and passes a resolution that everything must be given to them and that minority should have nothing to do with it, any member can take action against it. Illustrative cases of this exception are as follows:

- a. Majority diverting the profits of the company to another company in which they are majority shareholders.
- b. Compulsory acquisition of shares of a minority shareholder.

3. **Wrongdoers in control:** where wrongdoers in control, the majority will have a right of action since otherwise the grievance would never reach the court, for the wrongdoers would never allow the company to institute a suit.
4. **Breach of fiduciary duties:** the directors and promoters owe fiduciary duties to the company. If they make a secret profit, there is a breach of duty and they can be compelled to account for the profits made by them.
5. **Requirement of special resolution:** where act requires special resolution by special majority than such act must be passed by special resolution with full majority simple majority is not sufficient.
6. **Infringement of rights of a member:** where wrong is done by a company, the company shall be the aggrieved person. Similarly, where the personal rights of an individual member are infringed, he becomes the aggrieved person and so he can take action for the enforcement of such rights. He can insist on the strict compliance of provision of the Act.

Exception under companies act

1. Variation of class rights
2. Reconstruction and amalgamation
3. Investigation into affairs of the company
4. Prevention of oppression and mismanagement
5. Other statutory rights

Oppression (Section 397)

The term 'oppression' has not been defined by the Act. Whether the conduct of the affairs of a company is oppressive or not will depend upon the facts and circumstances of particular case. The conduct can be said to be oppression only when it is burdensome, harsh and wrongful. Oppression involves an element of lack of probity and fair dealings to a member. Mere concerning of shares, non-declaration of dividend and building up reserves do not amount to oppression.

1. Condition for claiming relief from oppression:
 - a. Oppression, or prejudicial to public interest
 - b. Oppression in the capacity of member: the oppression complained must affect a person in his capacity as a member of the company. Oppression in any other capacity, e.g., as a director or a creditor is outside the purview of this section. Thus, where the majority directors override the minority directors, relief under section 397 is not available.
 - c. Continuity of oppression
 - d. Justification of winding up: the application must make out a *prima facie* case that the degree of oppression is so severe that there is just and equitable ground for winding up of the company.
 - e. Winding up prejudicial to applicants: the applicants satisfy the CLB that through it is justified to wind up the company, but winding up would be unfairly prejudice the applicants.
2. Eligibility to make an application: as prescribed under section 399.
3. Order by the CLB: if company affair are oppressive to member or prejudicial to public interest than, it may make necessary orders for ending the matters complained of.
4. What amount to oppression?
 - a. Oppression must be continuous; conduct must be burdensome, harsh and wrongful; lack of probity of fair dealings must be shown.

- b. There must be visible departure from the standards of fair dealing.
- c. A persistent and persisting course of unjust conduct must be shown.
- d. Forcing risky objects amounts to oppression.
- e. Isolated acts do not amount to oppression.
- f. Only members can complain oppression.
- g. Unwise act do not imply oppression.
- h. Oppression in case of a family company.
 - ✓ Removal of a director of one group, even of as per section 284, amounts to oppression if the company was formed with a view to run it as a quasi partnership.
 - ✓ Appointing additional directors in a family concern to marginalize the authority of the other group amounts to oppression.
 - ✓ Increasing the number of directors and upsetting balance in the board, when two groups were equally represented in the Board, will amount to oppression if one group is reduced to minority in board.
 - ✓ In a family company, any change in shareholding without mutual agreement is an act of oppression, issue of shares to one group to the detriment of other group and appointing additional directors from one group is oppression.
 - ✓ Increase in capital to secure increase in voting strength by increasing the holding of one group, when there no need of any funds, amounts to oppression.
- Proceedings under section 397 cannot be barred or defeated by any provision in the articles or any agreement.
- Relief against oppression is available only in those cases where the court regards it just and equitable to wind up the company.

Mismanagement (Sec 398)

An unwise and inefficient management does not amount to oppression, though it may amount to mismanagement under section 398. Where the company is run overriding the wishes and interest of the majority of shareholder involving the company into costly litigation, the management can be said to be prejudicial to interest of the company.

Condition for claiming relief from mismanagement

1. *Mismanagement or prejudice to public interest.*
 - a. That the affairs of the company are being conducted in manner which is,
 - ✓ Prejudicial to public interest; or
 - ✓ Prejudicial to the interest of the company.
 - b. That due to a 'material change' that has taken place in the management or control of the company, it is likely that the affairs of the company will be conducted in manner-
 - ✓ Prejudicial to public interest; or
 - ✓ Prejudicial to the interest of the company.
- **'Material change'** in the management or control will be deemed to have taken place if there is an alteration in
 - ✓ The company's BOD; or
 - ✓ Manager; or
 - ✓ The ownership of the company's share; or

- ✓ Any other manner whatsoever (but not including a change brought about by, or in the interests of, any creditors, debenture holder or any class of shareholder)
2. *Continuity of mismanagement required*: where the wrong contemplated were against a past director, the application was not maintainable U/S. 398. If a director responsible for mismanagement is removed, mismanagement ends, and therefore application under section 398 is not maintainable.

Eligibility to make an application

It can make only by the members. But member's eligibility is required as per section 399.

Orders by CLB

If the CLB is satisfied that the condition prescribed in section 398 are satisfied, it may make necessary orders for ending the matters complained of. The CLB has been vested with the powers as listed U/S. 402, 403, 404, and 407.

What Amounts to mismanagement?

- Where the VC of grossly mismanaged affairs of the company and had drawn considerable amounts for his personal purpose, that large amount were owing to the government towards charges for supply of electricity, that machinery was in a state of disrepair, these are sufficed evidence of mismanagement.
- Where the assets of the company are sold without complying with the requirements of section 293 at low prices, it was to be a case of mismanagement.
- Violation of the condition of the memorandum by the person-in-charge of the management of affairs of the company would amount to mismanagement.
- Serious disputes among the directors resulting in serious prejudice to the interest of the company amounts to mismanagement.

Rights to apply under section 397 and 398 (Section 399)

Important for practical

1. Eligibility

a. Members

- i. Company having a **share capital**. Members eligible to apply shall be lowest of the following:
 - ✓ 100 members; or
 - ✓ 1/10th of the total number of members; or
 - ✓ Members holding not less than 1/10th of the issued share capital of the co.
 - ii. Company having **no share capital**. The application made by at least 1/5th of total number of members
- For both above situation CG has a discretionary power to permit a lesser number of members to file an application. However, before authorizing any member as such, the CG may require the member to furnish such security, as the CG may deem reasonable.
- ##### b. The Central government: itself make an application (sec 401)

2. Validity of an application – condition to be fulfilled

- a. the applicants must have paid all the calls and other sums due on their shares
- b. the applicants must hold the requisite number of shares at the time of filing the application.
- c. Joint holders of shares are conducted as one member only.
- d. Section 399 requires that the application should be made by requisite number of members. It does not require that the member must be a holder of equity shares only. Thus, a preference shareholder, being a member, is also entitled to make an application to the CLB.

3. Application by members – certain cases

a. Definition of members (section 41)

- i. He agrees in writing to become a member; and
- ii. His name is entered in its register in this regard;
 - Where shares are held in depository system, the beneficial owner is treated as member not a depository.
 - A person is entitled to shares but whose name has not been entered in the register of member can not apply.
 - Where a person has obtained a decree for rectification of register of members of the company to have his name entered in it, he may make an application although his name is not entered in the register of members.
 - A person in whose favour share certificates have been issued can exercise the rights as a member notwithstanding the omission of his name from the register of member.
 - A holder of share warrant is not a member of the company. So he is not eligible to make an application

b. Members ceasing to be members – consequences

- Where after making of the application, the applicant's name was struck off from the register of members on the ground that the transfer was unstamped etc., the application continued to remain valid.

c. Consent to make an application

- Any one member may make an application to the C:B on behalf of all the members by obtaining the prior consent of other members in writing.
- Consenting members have to apply their mind both to the allegations and relief sought. Mere consenting to an application is not enough if the style of consent shows non-application of mind.

d. Withdrawal of consent – consequences: the consent to be given by shareholder is reckoned at the beginning of the proceedings. The withdrawal of consent by a shareholder during the course of proceedings does not affect the maintainability of the application

- e. Section 399 neither disentitles a majority of members to make an application, nor requires that application shall be made by minority members only.

4. Notice to the CG:

- The CLB shall give notice to the CG of every application made u/s 397 or 398. The CG has the right to make a representation in respect of the application and the CLB shall take into consideration such representation before passing final order.
- The notice need not be given if the application is dismissed. But, if the application is admitted for hearing, both the CG and the company must be informed.

Powers of CLB to prevent oppression and mismanagement (Section 402, 403, 404 & 407)

The CLB has been vested with powers of wide aptitude to grant relief from oppression and mismanagement. These powers are explained as below.

1. Specific powers (Section 402)

- a. Regulation of company's affairs
- b. Purchase of shares of a member.
- c. Purchase of shares of a member and reduction of share capital.
- d. Termination or modification of agreement with director/manager.

Consequences for such powers (Section 407): where any such agreement is terminated, set aside or is modified, the following consequences shall follow:

- i. Vacation of office:
- ii. No compensation for loss of office
- iii. No similar appointment for 5 years in the company.
- e. Termination or modification of an agreement with third parties
 - i. An agreement with a third party shall be terminated or set aside after giving due notice to the party concerned; or
 - ii. Any agreement with a third party shall be modified if the third party gives its consent to such modification.
- f. Setting aside fraudulent preference: an order setting aside any transfer, delivery of goods, payment, execution or other act relating to property, made or done within 3 months before the date of the application. Such an order shall be made only if the circumstances suggest that the transaction would have been *deemed to be a fraudulent preference* in an insolvency proceeding against an individual.
- g. General relief: an order in respect of any other matter for which it is just and equitable that a provision should be made, i.e., in addition to the above powers, the CLB may make such orders as it thinks fit for giving relief in respect of the matters complained of.

2. Powers to make an interim order (Section 403)

3. Power to alter memorandum or articles (Section 404)

- a. Alteration by CLB to be effective: the CLB is empowered to make any alteration in the memorandum or articles of a company and such alteration shall have the same effect as if duly made by a resolution of the company.
- b. Further alteration to require permission of CLB: any further alteration by the company would have to be constant with the alterations as already made by the CLB and can be effective only if permission of the CLB is obtained.
- c. Filing of copy of order of CLB: the company shall file with the registrar a certified copy of every order of the CLB, which has the effect of altering the company's memorandum or articles, or which grants permission to the company to alter the memorandum or article in future.

Appointment of directors by the CG (Section 408)

Section 408 empowers the CG to appoint nominee director on the board of directors of a company if such an order is made by the CLB. The procedure in this regard is as follows:

1. Reference or application to the CLB

The CLB has no *suo motu* power to make an inquiry and pass order for the appointment of nominee director. It can do so only if-

- a. A reference is made by the CG; or
- b. An application is made by not less than 100 member of the company; or
- c. An application is made by members holding not less than 1/10th of to total voting power of the company.

➤ The company, against whom an application or reference is made, is not entitled to any hearing at this stage.

2. On receipt of the reference or application, the CLB shall make such inquiry as it deems fit.

3. The CLB may pass an order under this section if it is *satisfied* the following conditions are fulfilled:

- a. The affairs of the company *are being conducted* in manner which is prejudicial to any member of the company or interest of the company or public interest.
- b. It is necessary to make the appointment of one or more personas as director of the company so as to-
 - i. Prevent the current state of affairs of the company; and
 - ii. Effectively safeguard the interest of members or the company or public interest.

4. Nature of orders of CLB and appointment of nominee director by the CG

- a. The CLB may order the appointment of certain number of directors on the board of the company. The directors so appointed by the CG shall hold office for such period, not exceeding 3 years, as may be specified by the CLB; however the appointment can be extended for 3 years if the same conditions are still persisting.
- b. The CLB may direct the company to make appointments of directors on the basis of 'proportional representation' as contained in section 256. The additional directors shall hold office until new directors are appointed on the basis or proportional representation.

5. Provisional applicable to nominee directors

- a. In reckoning 2/3rd or any proportion thereof, any director appointed by the CG shall not be taken into account.
- b. No director appointed by the CG shall be required to hold the qualification share.
- c. No director appointed by the CG shall be required to retire by rotation
- d. These directors can be removed by the CG only.
- e. The CG may require theses directors to report to the CG with regards to the affairs of a company.

6. Where the CG appoints directors or additional director u/s 408, no change in the BOD shall have any effect so long as the directors or additional directors appointed by the CG remain in office. However, such a change may be made after confirmation of the CLB.

Powers of CLB to prevent change in BOD (Section 409)

Section 409 seeks to prevent abrupt changes in the management of companies. It or prevents well-run companies from passing into the hands of unscrupulous and ambitious financiers whose object is to traffic in the shares of well-managed companies for their own personal gain. However, if person competent to manage the company acquire the shares of the company, the CLB would not ordinarily invoke its powers. These section is not apply to privet company. These provisions are explained as below:

1. The complain can be made by any of the following person
 - a. The MD
 - b. Any other director
 - c. The manager

As is evident, the benefit of section 409 is not available to the members of the company.
2. The complaint must state that-
 - a. A change in the ownership of any share held in the company has taken place or is likely to take place,
 - b. As a result of such change, a change in the BOD is likely to take place; and
 - c. If the change is allowed, it would affect prejudicially the affaires of the company.
3. After making an inquiry, if the CLB is satisfied that it is just and proper to do so, it mat direct that-
 - a. Any resolution passed or;
 - b. Any resolution that may be passed; or
 - c. Any action taken; or
 - d. Any action that may be taken,

To effect a change in the BOD, shall not effect unless confirmed by the CLB.
4. The order of the CLB shall have effect notwithstanding any thing contained to the contrary contained in any other provision of this act or in the MOA or AOA of the company or agreement or resolution.
5. The CLB may make an interim order until completion of the enquiry and final order.