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UNIVERSITY
OF
GLASGOW

MAJORITY RULE AND MINORITY SHAREHOLDER
PROTECTION IN JOINT STOCK COMPANIES IN
ENGLAND AND IRAN

ATAOLLAH RAHMANI

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Abstract

Principally, Joint stock companies are governed by the principle of majority rule, which means that while they are formed and continue to work through participation of every shareholder, only those who hold a majority of voting shares can make decisions in companies. The principle relies on contract and is often supported by company law. In the main, it is advantageous to companies, the Judiciary and the economy. It facilitates collective action, allows management to focus on the daily running of the company business and encourages corporate financing, which is decisively important for corporations. It also saves, by curbing minority actions, the courts' time and the public budget. In one sense, however, it can also be dangerous to the rights and interests of minority shareholders. Using the majority rule, majority shareholders may fix for themselves private benefits or adopt policies which are poor and consequently harmful to companies. Such danger could discourage likely investors from investing their capital in companies and might undermine one of the main purposes of the corporation as an institution introduced by law and business practice to solve problems encountered in raising substantial amounts of capital. This research seeks to study in the light of English and Iranian company laws difficulties deriving from application of the majority rule for minority shareholders and possible ways and mechanisms which can be used to sensibly curb the occurrence of such difficulties. To this objective, it identifies four factors which can explain how and why the rule is liable to abuse by majority shareholders and examines the mechanisms provided by company laws of England and Iran which attempt to strike a balance between the rule of majority and interests of minority shareholders.

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Introduction

Although its management makes most decisions within companies, almost any act of a company can be ratified by a resolution adopted by majority of its shareholders. Any such resolution would then be considered to be the decision of the whole company, and not merely a decision made by a specific group in the company. This is a fundamental principle known as the principle of majority rule. The rule is normally accepted by company members in their constitution and often prescribed by the company laws of most countries.¹ It is generally seen as advantageous to companies, the Judiciary and the economy at large. For companies, it facilitates collective action², allows management to focus on the daily running of the company business³ and encourages corporate financing which is decisively important for corporations.⁴ As regards the judiciary, it saves, by curbing minority actions, the courts' time and the

1 Cooper v. Gordon, (1869), LR 8 Eq 249, Per Stuart V.C.; See Davies, P.L., "Gower's Principles of Modern Company Law", (1997), 6th ed., London, Sweet & Maxwell, at pp 585-587, 705.

2 Hager Mark M., "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory", *University of Pittsburgh Law Review*, (1989), Vol. 50, Pittsburgh, at p 633.

3 Griffin Stephen, "Company law: Fundamental Principles", (1996), 2nd ed., London, Pitman, at pp 299-300; Farrar John H., "Company Law", (1991), London, Butterworths, at pp 318-319; Cheffins Brian R., "Company Law: Theory Structure And Operation", (1997), Oxford, Clarendon Press, at pp 14-16.

4 Black Bernard S., "Is Corporate Law Trivial?: A Political and Economic Analysis", *North-Western University Law Review*, (1990), Vol. 84, No 2, Chicago, North-western University Law School, at p 552; Bebchuk Lucian Arye, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", *Harvard Law Review*, (1989), Vol. 102, Cambridge, Mass., Harvard Law Review Publishing Association, at pp 1830-1.

public budget.⁵ To the economy, the rule helps companies to prosper and the more companies prosper, the better the economy and the society are served.⁶

Yet, in one sense the rule can also be unjust, since it requires a concentration of power in the hands of the majority, who may exercise it abusively. A majority decision can be ignorant of minority shareholders' interest and even taken honestly can involve poor strategies that are harmful to companies.⁷ The abuse possibility can increase when the rule is put together with certain company law principles which coordinate to isolate and trivialise minority shareholders in companies. The idea that company is a separate person in law and it is the company itself that can as a proper plaintiff take action in relation to any claim against individuals who have committed wrong against the company and that a shareholder would be barred from complaining before the courts in respect of corporate actions confer almost all the corporate power to the majority. The courts, on their part, have also shown reluctance to deal with claims where a shareholder is in dispute with the majority shareholders, generally taking the view that disputes of this kind should be settled in general meetings. They tend to note the separate personality principle and to emphasise that a minority shareholder is not entitled to exercise rights that inhere in the company itself. Such rights principally fall within the power of the majority shareholders who can exercise them freely. Even if the courts want to hear minority shareholder disputes, practical difficulties which exist on the path of the plaintiff will discourage him. Usually the suspected wrong involves

5 *Mac Dougall v. Gardiner* (1875), 1 Ch.D. p 13 per Melish L.J.; *Gray v. Lewis*, (1873), 8 Ch App, 1035, at p 1051 per James L. J.; See also Pettet Ben, "Company Law", (2001), Harlow, Longman, at pp 227-8; Griffin (above, note 3) at pp 301-2.

6 MacNeil, Iain, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory", *Journal of Corporate Law Studies*, (June 2001), Oxford, UK, Hart Pub, at p 117; Cheffins (above, note 3) at pp 18-19.

complex issues relating to company operations and its financial matters which are difficult to understand and where a shareholder is able to assess such matters, he can be denied access to the information needed. Directors can always refuse to give the required information, taking the argument that the demanded information involves commercial secrets. The costs of taking action contrast to its probable benefits can be disproportionate and thus can constitute a further disincentive for a minority plaintiff.⁸

If abuse of right by the majority is possible, then arguably, the law is deficient because it fails to ensure controllers will commit no abuse. Such possibility could discourage likely investors from investing their capital in companies and might undermine one of the main purposes of a company as an institution, in that Posner⁹ and others¹⁰ have suggested that a company is primarily a device introduced by law and business practice to solve problems encountered in raising substantial amounts of capital.¹¹

The possibility of abuse of rights by majority shareholders against rights and interests of minority shareholders in companies has focussed attention of the regulators on devising some mechanism which could sensibly and fairly resolve, in one way or another, the majority/minority conflict and strike a desirable balance between the rule of majority, on the one hand, and protection of minority shareholders, on the other. However, those mechanisms have struggled to achieve optimum effect because of the

7 Rajak Harry, "Source Book of Company Law", (1995), Bristol, Jordans, at p 530.

8 Farrar (above, note 3) at p 442; Parkinson J. E., "Corporate Power and Responsibility", (1993), Oxford, Clarendon Press; New York, Oxford University Press, at pp 241-6.

9 Posner Richard A., "Economic Analysis of Law", (1992), Boston, London, Little, Brown, at p 392.

10 Farrar, John H., "Company Law", (1985), London, Butterworths, p 6.

11 Cheffins, Brian R., "Minority Shareholders and Corporate Governance", *The Company Lawyer*, (2000), London, Oyez Publishing Limited, Vol. 21, No 2, p 41.

difficulty in reconciling two seemingly contrary goals. Either, they lay excessive emphasis on majority rule and give insufficient attention to the protection of minority shareholder rights which resulted in unjust enrichment by majority shareholders at the expense of minority shareholders.¹² Or conversely, they impose overly intrusive measures for the protection of minority rights which have led corporations to witness slowing down or cessation plus escape of substantial investors from company sector.¹³

Like elsewhere, English and Iranian corporation laws have noticed the conflict between majority and minority rights and have attempted to resolve it. While both regard the majority rule as a key principle, they have tried differently to resolve a possible conflict of the rule with minority shareholders' rights. As to the former, the law emphasises on the rule of majority which is found in the famous *Foss* case¹⁴ and which has been supported by subsequent cases¹⁵, meanwhile, it also acknowledges that minority shareholders must have some voice so as to prevent the former making abuse of rights. Consequently, it confers on minority shareholders strong protection to address the issue of abuse of rights by the majority¹⁶ and in doing so it is not particularly concerned about directors' involvement in the wrongdoing.¹⁷ As to the latter, while the law supports governance of majority shareholders, which is stated in the Joint Stock

12 The point was well explained by Sealy who speaks of the task of the lawmakers to strike a delicate balance in the relationship between the majority and minority shareholders. [Sealy L.S., "Cases and Materials", (2001), London, Butterworths, Chap 10 at p 477].

13 Parkinson (above, note 8) p 19.

14 *Foss v. Harbottle* (1843) 2 Hare 461.

15 *Mac Dougall v. Gardiner* (1875), 1 Ch.D.13; *Burland v. Earle* (1902), AC 83, PC, p 93-94, per Lord Davey; *Mozley v. Alston* (1847) 1 Ph 790; *Macaura v. Northern Assurance Co. Ltd.* (1925), AC 619; *Lee v. Lees' Air Farming Ltd.* (1961), AC 12.

16 These protections include 'bona fide for the benefit of the company as a whole', derivative action, just and equitable winding up, and unfairly prejudicial remedy which will respectively be considered in Chapters three and five below.

Companies Act 1969, Sections 86-88¹⁸, it tends to focus on the idea that executive rather than controlling power might involve abuse.¹⁹ Hence, its solutions concern in great part to the shareholder/management conflict rather than that of the majority/minority. It only confronts the issue of majority abuse of rights against minority shareholders where a wrongdoer director/shareholder wants to vote in the general meeting to ratify their own misconduct.²⁰ However, the possibility of abuse is not exclusive to directors as it is possible to imagine a case of abuse where a director is not involved. Majority shareholders may commit abuse through passing of unjust and discriminatory resolutions, thereby diverting the company's assets and its profits to themselves. It is also possible that they relieve wrongdoer directors from liability on some personal and self-interested grounds at the expense of the company and its minority shareholders. In such cases, minority shareholders often have no internal or external recourse. The majority rules within the company and the courts tend not to entertain minority claims irrespective of their merits. Constitutions may further restrict a shareholder's choice to exit from inhospitable companies and there might even be no market for corporate shares where companies are private.

This research seeks to study difficulties deriving from application of the majority rule for minority shareholders and the mechanisms introduced by the company laws of

17 Though, in practice, it is often the case that a wrongdoer director involves in the wrongdoing. See Wedderburn K. W., "Shareholder's Rights and The Rule in Foss v. Harbottle", (1958), *Cambridge Law Journal*, Cambridge, Cambridge University Press, p 97.

18 Corresponding to Persian calendar year 1347. (Hereafter cited as JSCA).

19 Section 51 Trade Code 1933, (corresponding to Persian calendar year 1311 - Hereafter is cited TC); Sections 614, 615, 631, 663 and 667 Civil Code 1929, (corresponding to Persian calendar year 1307 - Hereafter is cited CC); Sections 129, 130, 131, 133, 142, 143 JSCA.

20 Section 129 JSCA.

England²¹ and Iran which attempt to strike a balance between interests of minority and majority shareholders. It aims to carry out a three-fold job. First, it tries to show the wrongdoing opportunity that an inflexible and rigid understanding of the majority rule may yield in favour of the majority shareholders, which, in turn, will result in an appreciation of the problems that might arise for minority shareholders. Second, it examines the existing reconciliation mechanisms in the two company laws of England and Iran in order to identify their strengths/weaknesses hereby to provide recommendations to improve those mechanisms. Third, it highlights strengths of certain English company law measures regarding this relationship which might be of use to its Iranian counterpart in that they help the Iranian company law to establish not only efficient but also just working framework within which both the majority and minority groups are benefited.

The research is divided into five Chapters; each addresses a question which is pertinent as to pursuing one of the above-mentioned objectives. As to the first objective, Chapters one to four are relevant, as they generally clarify and examine, from varying aspects, the very concept of the majority rule. The intention is to show how and under what circumstances majority shareholders could make opportunistic use of the majority rule against minority shareholders' interests in corporations. Chapter five and one section in Chapter three, which concerns limiting freedom of shareholder voting, seek to pursue the second objective. They generally concern demonstrating and

21 By English company law, I refer to statutory law as well as common law relevant to companies which are in operation in England, as distinguished from the company laws of other three constituent countries of the United Kingdom; i. e. Scotland, Wales and Northern Ireland. The main source of reference is, however, the Companies Act 1985 which applies (with certain reserves for Scotland) in all constituent countries excluding Northern Ireland.

examining the mechanisms which currently exist in English and Iranian company laws and which are meant to provide certain minority protections that prevent abuse of power by majority shareholders. In the end and in pursuit of the third objective, the research will complete by: summarising the gist of issues discussed in each Chapter; displaying strengths and weakness of the two systems plus providing some recommendations; and highlighting the ideas, and mechanisms which exist in the English company law that could be useful to learn by the Iranian company law.

To achieve the first objective, I shall discuss four issues. The first issue, to be considered, concerns justification of the majority rule in corporations. The rule, as we shall see, can act against the autonomy of dissident minority shareholders. Using the majority rule, majority shareholders can conspire against minority interest or they may simply adopt foolish policies that are prejudicial to the company and its shareholders. Company law theorists tend to support governance of majority rule, while being potentially liable to abuse. Why and how they do so can explain why minority shareholders should tolerate certain risks associated with control by the majority and in part sheds light on the question of what is the source of some of minority difficulties that stem from the majority/minority conflict in corporations. The question of justifications for majority rule is discussed in Chapter one. The Chapter reviews three most influential theories (political, economic and doctrinal) developed by scholars of company law to appreciate the majority rule. Further, as the corporate governance structure can be relevant to explain how the majority rule is justified and what sort of problem minority shareholders face and because different structures may generate different justifications and in turn cause different minority problems, the Chapter compares corporate governance structures which exist in English and Iranian corporations.

The second issue, which is worth consideration, relates to scope of majority rule. The issue is important for the purpose of my first objective, as it demonstrates the field of application of majority rule. It also helps one to understand where minority difficulties could stem from and where the help of law is more required. This is because the question of field concerns with determining areas and circumstances in which the rule of majority can apply. When the field is clear, one can easily judge whether or not an act of majority is forceful and binding against minority shareholders. As the rule has no application on areas which fall outside such field, it can generate little difficulties for minority shareholders. An abusive exercise of power by the majority shareholders in such areas can be responded adequately through a shareholder action. These aside, minority shareholders can be put into misery in areas and in respect of issues which fall within the powers of majority shareholders. The same may also occur when the field is not clear. The courts tend not to hear minority allegations, which are normally categorised as internal shareholder disputes. The question of field; i. e. determination of what powers majority shareholders enjoy, is something which must be answered in the light of corporate constitutions and laws relevant to companies. The question is subject of my consideration in Chapter two. The chapter is divided into two sections. Section one concerns legal rules and the intention is to explain relevance of such rules in making the framework within which the majority rule works. By legal rules, I refer in this section, to rules that derive from general laws which are binding on companies as a matter of public order and regulation rather than being a matter of minority protection. As the latter issue will be discussed later in Chapter five, I will avoid repeating that discussion here. Section two considers the relevance of corporate constitutions and specifically concerns examination of four constitutional mechanisms that coordinate to shape the rule of majority's field of application. These mechanisms

include internal division of power, ultra vires issues, special majority requirement and personal rights.

The third issue, to be considered, concerns nature of majority rule. It is, in fact, about demonstrating and examining the way in which the majority rule works. The intention is to show how majority shareholders can abuse the mechanism of majority rule in order to benefit themselves. Generally speaking, the rule works through the mechanism of voting. The mechanism allows shareholders to vote on matters which affect them collectively, but final decision is taken as a matter of principal by a majority resolution of the shareholders which relies on the 'one share, one vote' rule. This mechanism, which is considered as being a respect for capitalism, also allows shareholders to exert their voting rights freely. Once voting, a shareholder assumes no duty to regard interests of other shareholders and can cast their votes in a complete self-interested manner. The result is that shareholders who possess more shares can apply absolute control over corporations; a control which is often too dangerous to be tolerated by minority shareholders. The question of nature of the majority rule is discussed in Chapter three and has fivefold. The first fold demonstrates how private ordering can affect the voting mechanism. The second fold considers the question of whether the voting mechanism plays any controlling function. Assuming that the voting mechanism functions as a control device, the third fold concerns the question of whether shareholders who control corporations have any legal duty to consider minority interests. Given that majority control is quite often found in small rather than large companies and that majority and minority can comprise different groups as to different issues, the fourth fold relates to the question of whether the law is to relax in relation to the protection of minority shareholders in large companies. Finally, the fifth

fold considers the question of whether institutional shareholder voting can be relevant to reduce the majority/minority conflict in corporations.

The fourth issue that requires consideration concerns corporate directors' role as to the majority/minority conflict. Directors who take most decisions in corporations can as an independent organ exercise the entrusted power impartially, taking consideration of elements which best serve the interests of the corporations. Further, they, unlike shareholders, are under legal duties to take careful and disinterested decisions which benefit the company as a whole and which can be enforced by shareholders. At the same time, directors themselves can in varying ways be a source of abuse when certain conditions exist. Where one or few shareholders dominate a corporation, corporate directors can facilitate abuse of power by majority shareholders. Directors in such corporation are normally chosen and controlled by the dominating shareholders and often only majority shareholders can, as a matter of principle, enforce their duties. Hence, they are very unlikely to take side with a dissident minority shareholder. Where shareholders are dispersed, directors are likely to cause mismanagement. They may not want to pay proper attention to the companies' business and further can pursue policies that benefit not the company and its shareholders but rather directors themselves. Internal control in such companies is weak and the market may not discipline wayward directors adequately. Mismanagement affects shareholders equally and hence is not considered as a majority/minority issue. It is important, however, for the purpose of my discussion, as it explains why the concept of shareholder control, while being liable to abuse by majority shareholders, can outweigh control by management in corporations. A proper analysis of directors' role and duties can help the reader understand the importance of shareholder control in corporations and can uncover indirect factors, ways and circumstances through which such control can be

used opportunistically. It will further enable one to discover the source of some of minority difficulties and those of shareholders generally and it can also be useful to the lawmakers as they can learn and draft tailored laws in this matter. The question of directors' role is examined in Chapter four.

As I mentioned earlier, Chapter five and one section in Chapter three pursue the second objective. They examine mechanisms existing in current English and Iranian company laws which provide special protection for minority shareholders and which are provided to shareholders with the intention to curb abuse of power by the majority shareholders. The intention is to see how successful the existing mechanisms have been as to implementing their mission; i. e. reconciling majority and minority interests. As to the English company law, four mechanisms, two, with common law origin, and two, statutory, are relevant. The common law mechanisms include the 'bona fide for the benefit of company as a whole' rule which was introduced by the *Allen* case and which is discussed in Chapter three and the 'derivative action' which is the subject of my consideration along with the statutory mechanisms in Chapter five. As regards the former, the intention is to show how the common law, as distinguished from the statutory law, evolved in order to accommodate minority concerns into the voting mechanism. As regards the latter, the discussion seeks to demonstrate and examine how the common law has managed to specify and respond to circumstances within which certain abusive behaviours of majority shareholders are likely to occur. The statutory mechanisms which are exclusively discussed in Chapter five include the 'just and equitable winding up' and 'unfairly prejudicial' remedies. A number of questions which concern the remedies' natures, jurisdictions, conditions of availability, and utilities will be raised. As the latter remedy can have some clash with the 'no reflective loss' principle and with the derivative action, the discussion will consider the remedy's

relation with the two mentioned mechanisms too. The idea is twofold. First, it is meant to see what and how the Parliament has done to fill the gap which exist in common law as to preventing abuse of right by majority shareholders. Second, it seeks to determine whether the Parliament has been any successful to facilitate formation of a just and efficient reconciliation between the majority/minority interests in joint stock companies.

As to the Iranian company law, five mechanisms that provide either a general or special protection to minority shareholders against abuse of rights by majority shareholders will be examined. These include the 'no abuse of rights' which is a constitutional principle and provides a general protection, right to convene a shareholder meeting, cumulative voting, disinterested ratification and commencing corporate actions by shareholders which are company law provisions and which offer special protection to minority shareholders.

As this research involves consideration of the issue in the English and Iranian company laws and because the former, unlike the latter, enjoys strong minority protection which could be relevant to address the issue of abuse of rights by majority shareholders in Iranian corporations, I will follow a comparative approach in which the English company law is taken as the basic model. The intention is to take some lesson from the English company law that are useful to improve Iranian company law regarding its approach to the majority/minority issue. To this end, I have divided each Chapter, excluding Chapter two, into two parts. Part one concerns examination of the law in England and part two while examines the same issue in the law of Iran does some comparisons between the laws in the two jurisdictions. As to the Chapter two, the same approach is pursued unless there will be no division into two parts. The

discussion and comparison in this Chapter are integrated. Much of the discussion in each Chapter goes to the English part, as it is the basic model and because otherwise could have hurt briefness of the research by covering many issues that were in fact similar.

Two questions regarding the method of this study, which I need to address before the very study starts, are to see whether it is possible to extend English approach to its Iranian counterpart and, if the answer is positive, whether the English approach is worth learning from? As regards the first question, it is important to note that there are undeniable socio-economic as well as legal differences between England and Iran that might blur the prospect of any extension.²² England is a western country that follows a market economy based on capitalism. This means the commerce in England is considerably left to the private sector and the market is largely seen as a self-regulator of its activities. In this context, so far as commercial actors keep in line with complying with their contractual rights and duties and play fair, there will generally be no other limitation. Also, its legal system belongs to the common law family, which is generally described as a judge-made law system meaning that judges may create law by referring the earlier judges' decisions.²³ Although the superior source of law is statute, certain areas of law are essentially the creation of the judges and in areas where the law is not fully indicative there is also an important dimension of judicial creativity in the task of statutory interpretation, which enables the courts to remedy statutory gaps.²⁴

22 These differences will be discussed more in Chapter one. See below at I.2.

23 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law" (2001), 18th ed., London, Blackstone, p 22; Holborn Guy, "Legal Research Guide", (2001), London, Butterworths, p 161.

24 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law" (2003), 19th ed., Oxford, Oxford University Press, at 0.3.2.3.

In contrast, Iran is a developing country whose economy is partly government directed and partly market driven, adjusted in accordance with Islamic mandatory rules. This means the law concerning commercial activities in Iran is not that much facilitator. The government monopolizes many areas of commercial activities²⁵ and even supervises the private sector in the remaining areas that are not within its monopoly.²⁶ Legally, it relies on a system that most resembles systems in the civil law camp. Its law is mostly contained in codes enacted by the Parliament in the early twentieth century and since then amended from time to time. The code is the definitive source of law, and the courts have no power to fill in gaps in statutes on their own initiative or by reference to earlier decisions. That is for the Parliament to do.²⁷ Judges, however, are of power to interpret the existing code making use of general principles of law and rules of Islamic law in order to resolve a particular dispute in case of silence, obscurity or inconsistency in the statutes.²⁸ Albeit, judges can consult with the earlier judges' decisions and Islamic law jurists' opinions, but they cannot copy each other or earlier decisions or proceed by way of analogy. These are strongly prohibited by statutes²⁹ and Islamic law rules.³⁰

25 Activities in relation to these areas include all sorts of huge and mother industries, foreign trade, large mines, banking, insurance, power production and supply, dams, water supply channels network, radio and TV, post, telegraph and telephone, aeroplanes, vessels, air and sea industries, roads, rail roads. [Article 44 Constitution of Islamic Republic of Iran 1980, (corresponding to Persian calendar year 1358 - hereafter cited as CIRI)].

26 Art 22 CIRI.

27 This is principally to ensure separation of powers between the Legislative and the Judiciary. See Osooli Mohamad, "Methods of Interpretation of the Codes in Private Law", (1973), Doctoral Thesis, University of Tehran.

28 Section 3 Civil Procedure Act 2000, (corresponding to Persian calendar year 1378 - hereafter is cited CPA).

29 Section 3 CPA.

30 Islamic law rules (*Shari'ah* law) in this research refer to such rules as understood and defined by the Shari'ah scholars (Jurists) in the Shiah camp; to be precise, Shiah Jafary School which is the prevailing creed among Iranians (see Chapter one below at I.2); as distinguished from that

Taking these systematic differences as barrier, one may doubt the possibility of a likely extension. However this is to be rejected by looking at striking similarities between the two systems, especially in terms of social and economic needs. Both systems permit the use of company device and regard it as the responsibility of government to exercise through company law a measure of control over the activities of companies. Most importantly, company laws in the two jurisdictions share similar concerns in relation to achieving balance between majority interests and those of the minority shareholders.³¹

As regards the second question, there are sound reasons suggesting that English approach is worthy of consideration by the Iranian company law. While English approach gives power to majority shareholders, it acknowledges the possibility of majority abuse of right and offers corresponding devices to protect minority shareholders and this is suggestive to the Iranian company law. Second, English approach seems fit with areas such as Iran where companies tend to have a controlling shareholder. Most joint-stock companies in Iran are either small private companies or public companies substantially owned by the state and its dependant institutions.³²

of the Sunni camp (with its four main Schools; i. e. Hanafi, Hanbali, Maliki, and Shafi). While in the latter analogy (*Qiyas*) is a source to be used besides the other three sources (the *Qur'an*, the *Sunna* of the Prophet Mohammad, and the *Ijma* or consensus of the community of scholars) to comprehend *Shari'ah* law, in the former, the use of analogy is strongly prohibited. See Mohammad Ebn Yazid Ghazvini "Sonan Ebn Majed" (787 A D), Vol. 2, Tehran, Amirkabir publication Para Judgment, p 776; MacMillen Michael J. T., "Islamic Capital Markets: Developments and Issues", (2006), *Capital Markets Law Journal*, Vol. 1, No. 2, 136 at 138, Oxford Journals, Oxford University Press.

31 See Lord Hoffmann's argument in the famous O'Neill case. There he speaks of the ways in which common law as well as civil law systems work to curb abuse of right cases. He demonstrates that while common law workes on a fact specific and case by case basis, its civil law counterparts developed a general principle of 'abus de droit' to deal with abuse of rights cases. He then concludes that this is only a different way of doing the same thing. [O'Neill and Another v. Phillips and Others, (1999), 2 All ER 961 HL at 969 per Lord Hoffmann].

32 Sotoodeh Tehrani, Hasan, "Trade Law", (1997), Tehran, Dekhoda Publication, vol. 2, at p 3.

Third, the existence of strong minority protection measures with prospect of various remedies available to minority shareholders in the company law of England may help Iranian company law to improve its weak minority protection measures through which optimum corporate investment and the development of a strong corporate sector is encouraged.

Chapter I: Justifications for Majority Rule

Why corporations work on the basis of majority rule and also why corporation laws often support the governance of majority shareholders have been matters of controversy among scholars of company law. Several theories have been developed to address those questions. Each theory has put emphasis on certain elements, but there has never been an agreement among them. How those theories emerged is a further interesting and pertinent issue which needs to be addressed. It is my intention in this Chapter to examine those theories and questions in the light of the English and Iranian corporation laws.

To this end, I shall raise and examine the question in respect of each jurisdiction separately; hence, discussion in this Chapter is divided into two sections. One deals with the examination of the issue in the English company law and the other takes the case of Iran. In the English section, which covers much of the discussion, I will explain how and why majority rule emerged and survived in English corporations. This will be done through a three-fold study that examines the political, economic and doctrinal factors which have been most relevant to found the rule of majority in English corporations. In the Iranian section, I will explain why majority rule did not emerge in business vehicles and, instead, has been imported to Iranian company law from continental Europe. A related, and of course a key, issue is to find some explanations for the question of why Iranian company law at the time of its original adoption chose to learn from the continental European model of laws rather than the Anglo-American model.

One issue to be borne in mind is that the focus of discussion in this Chapter will be on reviewing justifications for the majority rule in the majority/minority shareholder relationship. To put it simply, the Chapter seeks to find some answers to the question of why of majority and minority shareholders, only the former should have the final say. Therefore, the Chapter will assume that shareholders play a controlling function within corporations. This is done irrespective of the issues which have recently been raised and discussed by company law theorists and which have challenged in various ways the idea of shareholder control. These issues are inclusive, on the one side, of theories that deny shareholder control¹, and on the other side theories that support participation of non-shareholder interest groups in control of corporations.² These areas will be examined later in Chapters three and four and thus I do not intend, neither do I feel it necessary, to bring more into my discussion here. However, to the extent that it is pertinent, I need to remind the reader that the current company laws in both England and Iran have rejected such theories and persisted with the idea of shareholder control.³

1 These theories will be examined in Chapter three at III.1.4 below.

2 These theories will be examined in Chapter four at IV.1.1.B.3 below.

3 For England see section 309 (1) Companies Act 1985; Company Law Reform, "Modern Company Law for a Competitive Economy: The Strategic Framework" (London, DTI, 1998), para 2.5; Company Law Reform, "Modern Company Law for a Competitive Economy: Final Report" (London, DTI, 2001), URN/942 & URN/943, paras 1.52, 1.56–1.57, 3.51; Nolan RC, "Indirect Investors: A Greater Say in The Company?" (2003), 3 *Journal of Corporate Law Studies*, 73, at pp 73–7; Gower L.C.B., "Gower's Principles of Modern Company Law", 4th ed., London (1979), Stevens, at pp 553–4; For Iran, see this Chapter, at I.2 below.

I.1. The case of England

What justifies application of the majority rule in companies forms an interesting question, bearing in mind that a company as a body corporate is normally composed of two member groups of majority and minority shareholders who may have differing interests. A number of theories have been developed to address the question. To begin with, there is a political theory which tries to extend certain political ideas to the apolitical sphere of companies, using analogies between companies and states. Another is the economic theory which supports majority rule for its economic advantages. And finally, there is the doctrinal justification which has been developed by the courts and legal scholars to explain governance of majority shareholders in corporations. I respectively examine these three theories in the following parts.

I.1.1. Political approach

The political approach is a theory developed by those who view corporations politically to explain the relationship between shareholders and directors. The theory normally relies on some analogies between states and corporations in order to extend principles of political democracy from the former to the latter.⁴ By making analogy in

⁴ See generally Hill Jennifer, "Visions and Revisions of the Shareholder", *The American Journal of Comparative Law*, (2000), Vol. 48, Berkeley, Ca., American Association for the Comparative Study of Law, at pp 52–53; Buxbaum Richard M., "The Internal Division of Powers in Corporate Governance" (1985), *California Law Review*, No. 6, vol. 73, at p 1671, Berkeley, Calif., University of California, School of Jurisprudence; Selznick Philip, "Law, Society, and Industrial Justice", Russell Sage Foundation, (1969), at p 259.

respect of organisational structure and bureaucratic hierarchy⁵, concepts of participation⁶, membership/citizenship⁷, organisational objective⁸, division of powers, and decision-making machinery existing in both corporations and states⁹, this approach argues that a corporation requires some form of government, as does any entity composed of individuals. According to it, corporate citizens (shareholders) should be able to exercise control over decisions and conducts of corporate leaders (management) in the corporate community¹⁰ in order to ensure that the latter pursue the shareholder interest objective.¹¹ However, as shareholders are often numerous in modern corporations and because they as autonomous persons may have varying interests over how to manage corporate affairs and how managers should be controlled, they can easily fall into disagreement. As a result, the idea of shareholder control over management which is seen by the theory as desirable and necessary would be lost if such disagreements were to persist. To ensure that shareholders will be able to exert control effectively, the theory proposes a representative democratic

5 Latham Earl, "The Body Politic of the Corporation", in *The Corporation in Modern Society*, edited by Edward Sagendorph Mason (ed.) (1960), 5, Cambridge, Mass, pp 218-220; Bottomley Stephen, "From Contractualism to Constitutionalism: A Framework for Corporate Governance" (1997), *Sydney Law Review*, vol. 19, 277, Faculty of Law, University of Sydney, Sydney, at pp 288-298.

6 Buxbaum (above, note 4).

7 Pound John, "The Rise of The Political Model of Corporate Governance and Corporate Control" (1993), *New York University Law Review*, vol. 68, 1003 at pp 1007-1013, New York, New York University School of Law; Villiers Charlotte, "European Company Law-Towards Democracy?", *European Business law Library*, (1997), Aldershot, Ashgate, pp 197-205.

8 Mason Edward S., "Introduction", in *The Corporation in Modern Society*, Edited by Edward Sagendorph Mason, (1960), Cambridge, Mass, at p 11.

9 Brewster Kingman, "The Corporation and Economic Federalism", in *The Corporation in Modern Society* edited by Edward Sagendorph Mason (ed.) (1960), 5, Cambridge, Mass, at p 72.

10 See generally Ferran Ellis, "Company Law and Corporate Finance" (1999), Oxford, Oxford University Press, at p 246; Hill (above, note 4) at pp 52-53.

11 Buxbaum (above, note 4); Selznick (above, note 4) at p 259; Brewster (above, note 9) at 72; Mason (above, note 8) at p 11; Villiers (above, note 7) at pp 197-205; Pound (above, note 7) at pp 1007-1013; Latham (above, note 5) at pp 218-220; Bottomley (above, note 5) at pp 288-298.

form in which the rule of the majority is the applicable rule.¹² In such form, every shareholder irrespective of the size of their investment will have one vote to be cast in the shareholder meeting, just like the vote state citizens enjoy in political elections.

Political approach views the rule of majority in corporations as an adoption from democratic ideas. Before, corporations were governed with a unanimity rule. Since then, however, they have been treated like political bodies, which can work through a majority decision, and where unanimous voting is no longer a requirement.¹³ Political approach, therefore, justifies the rule of the majority, using the same arguments that are normally brought for majority rule in politics. Since the origin of arguments represented by this theory derives from the views developed by political thinkers, it seems helpful to consider the main arguments that have been brought for the principle of majority rule in politics.

I.1.1.1. Justifications for majority rule in politics

In politics, majority rule is described as a mechanism developed by democratic theory to solve what is called the collective action problem. In the dictionary definition, democracy is a government in which the supreme power is vested in the people.¹⁴ This suggests that the power of leaders, and their decisions and conduct, can only be justified so far as they reflect the popular wish. Clearly, the popular wish refers to all individuals and groups rather than a mere dominant group of individuals in the

12 See generally Buxbaum (above, note 4); Mason (above, note 8) at p11; Pound (above, note 7) at pp 1007–1013; Latham (above, note 5) pp 218–220; Bottomley (above, note 5) at pp 288–291; Brewster (above, note 9) at 72; Villiers (above, note 7) at pp 197-205; Hill (above, note 4) at pp 51–57.

13 See Chater three (below, at III.1.1).

14 Chambers Concise Dictionary, Edited by Schwarz Catherine, Edinburgh, Chambers, c1993.

society. In practice, however, it is difficult to establish the popular wish because it is not a single wish. Opinions and interests may disagree from one group to another. If people disagree in their opinion and interests, then there should be a mechanism through which they can overcome disagreements and make an ultimate decision which reflects the popular wish. This mechanism in the view of the democratic theory is majority rule which authorises the majority of the people of each generation to make ultimate decisions in the name of the population. The democratic theory in this way rules out two possible alternatives to majority rule, unanimity rule and rule by the few. In its view, unanimity is unworkable due to the problem of size, and can lead the society to fall into anarchy.¹⁵ Rule by the few, on the other hand, contradicts human reason for it requires assuming few people to have priority over the many.¹⁶ Thus the rule of majority inevitably becomes the next best alternative.¹⁷

A number of arguments have been developed to justify the rule of majority in democratic societies. For one, majority rule, it is suggested, springs from equal treatment to individuals. For another, it leaves unaffected the freedom of the greater number of people and hence is the next best alternative after unanimity. Furthermore, majority rule, it is said, improves the quality of decisions taken by the government. In summary, it is possible to classify the arguments for the rule of the majority into two categories:

15 See Locke, John, "Of Civil Government" (1632–1704), Introduction by Carpenter W. F. (1943), London, Dent, at pp 180,181; Dahl Robert A., "Democracy and Its Critics" (1989), New Haven, London, Yale University Press, pp 46, 167; Gewirth Alan, "Community of Rights" (1996), Chicago, London, University of Chicago Press, at pp 13, 14.

16 See Dahl Ibid., at pp 75–77.

17 Arblaster Anthony, "Democracy" (1987), Open University Press, pp 65, 67; Lively Jack, "Democracy" (1975), Oxford, Blackwell, pp 13, 17, 18; Dahl (above, note 15) at pp 49–51, 153;

I.1.1.1.1. Quantitative argument

The underlying idea of the quantitative argument is to prioritise the majority rule simply because it embraces more people who will then have more force.¹⁸ This viewpoint considers the majority to be composed of aggregations of individuals, each with an equal amount of power, who, when combined, wield much greater power. The bigger the size of the group the more power it possesses and the more merits it will have in governing the society. A recent example of the quantitative justification can be found in the famous “Social Contract” theory which argues that early individuals, living in the state of nature, came together and agreed with each other to unite into society, which is governed by the majority rule for mutual self-protection.¹⁹

The social contract theory, however, suffers from difficulties. Historically, the hierarchical societies in which social contract theorists lived, indicate that their members never actually convened to consent to a social contract.²⁰ Further, the theory is unable to provide any moral value as it simply relies on force.²¹ Above all, the theory is incapable of preventing a likely majority injustice as it fails to consider the risks

Commager Henry Steele, “Majority Rule and Minority Rights” (1943), London, Oxford University Press, p 9.

18 Smith T.V., “Compromise, Its Context and Limits”, Quoted in Spitz Elain, “Majority Rule” (1932), Chatham, N.J., Chatham House, at p 185.

19 Hobbes Thomas, “Leviathan” (1651), Menston, Scholar Press, Chap. xviii, Secs. 1 and 3; Rousseau, Jean Jacques, Social Contract, Translated by Cole J. D. H. (1923), London, Dent, pp 85–87; Locke John, “The Lock Reader: Selections From the Works of John Locke”, with a general introduction and commentary by John W. Yolton, (1977), Cambridge, Cambridge University Press, p 245; Locke (above, note 15) at pp 180, 181; For more detailed study of Hobbes’, Locke’s and Rousseau’s thoughts see Mims Edwin, The Majority of the People (1941), Chap. 1 “Sovereignty”, New York, Modern Age Books, at pp 10–47.

20 Frug Gerald E., “The City as a Legal Concept”, *Harvard Law Review*, (1980), Vol. 93, Cambridge, Mass, Harvard Law Review Publishing Association, p 1086.

associated with any absolute exercise of majority rule in societies (what is often termed as 'majority tyranny'). Most contemporary political writers agree to say that the likelihood of tyranny is one associated with the nature of power no matter who holds the power, one man, a few people or the majority.²²

I.1.1.1.2. Qualitative argument

The qualitative argument looks for a moral justification of the rule, something that could explain why one should feel a moral duty to obey the majority. It can, itself, be classified into two dimensions: substantive and procedural.

A) Substantive

Theorists in this category generally took the view that majority rule is desirable not only because it helps reach good results but also because it sufficiently comprises of good elements. They, however, viewed good elements differently. To Aristotle, who was perhaps the earliest theorist in this category, good elements meant collective wisdom. In his view, government by the majority is desirable because it benefits more than any other form of government from the collective wisdom of the people.²³ For Jeremy Bentham, it was a matter of interest maximisation. According to him, societies are composed of equal individuals who naturally tend to pursue their own happiness. A good form of government is the one that respects this natural desire in as many

21 Kendall Willmore, *John Locke and the Doctrine of Majority Rule* (1965), Urbana, University of Illinois Press, pp 113–119; Barker Ernest, *Reflections on the Government* (1942), Oxford University Press, at pp 35–36.

22 Dahl Robert A., "A Preface to Economic Democracy" (1985), Berkeley, University of California, at p 18; Alexis de Tocqueville *Democracy in America*, Chapter XV, available at the following website: http://xroads.virginia.edu/~HYPER/DETOC/1_ch15.htm; Villiers (above, note 7) at p 8.

people as possible, which is government by the majority of the people.²⁴ In the view of Hans Kelsen, freedom maximisation was the underlying good element. In his view, people naturally prefer to have the type of order that produces least restraints. A good order, thus, is the one that limits fewest people's freedom.²⁵ The good element in Barker's view was unanimity. The formula he suggested was "government by discussion", in which every citizen offers his opinion and through the exchange of opinions the final decision is made by the rule of the majority. Such a decision bears imprints from all the ideas proposed in the discussion process and hence becomes inherently right because it is not the decision of a mere majority, but is made by all for all.²⁶ For Hallowell, it was a simple matter of faith. In his view majority rule is justified simply because, and as far as, we believe in certain transcendental truths and common values on the basis of faith rather than reason.²⁷

B) Procedural

The underlying idea for those who value majority rule procedurally is to deny any substantive goodness for majority rule. From this viewpoint, majority rule is simply a good device, using which is most likely to lead the community towards good ends. Majority rule is not inherently good. If we view it as a good rule, it is simply for it is the

23 Aristotle's *Ethics and Politics*, Book VII, Vol.2, Translated from the Greek by Gillies John, 1797, London, at pp 185, 189, 323, 284, 285.

24 Bentham Jeremy, "An Introduction to The Principles of Morals and Legislation", Oxford, 1907, Ch. 1, para. 4.

25 Kelsen Hans, Quoted in Spitz Elain, "Majority rule" (1932), Chatham, N.J., Chatham House, at p 159.

26 Barker (above, note 21); A similar view has more recently been taken by Manin and Held, who argue that a legitimate decision is not one that necessarily follows from the will of all, but rather one that results from the involvement of all in the political process. [Manin Bernard, "On Legitimacy and Political Deliberation", *Political Theory*, Vol. 15, No. 3. (Aug., 1987), 338–368, Translated from French by Elly Stein and Jane Mansbridge, at p 352, Sage Publications Inc.; Held David, "Models of Democracy" (1996), Oxford, Polity, pp 301–302].

only available device that can effectively help people reaching justice and good ends. Thomas Jefferson was the leading thinker in this dimension.²⁸ According to him, people derive their power from God and they have a natural right, given to them by God, to exercise that power through a majoritarian government, which is the next best device. To Jefferson, the governance of the majority is justified for it is hard to imagine a case in which the majority of the people fall into intentional wrongdoings and corruption against society, while these are much more likely to occur in other forms of governance. Nevertheless, the majority may commit mistakes, but this is not a matter of much concern as it is impossible to eliminate human error completely.

I.1.2. Economic approach

Economists often support the majority rule for its efficiency-enhancing feature. Central to the most economic theories in analysing rules particularly rules concerning companies, is the concept of efficiency.²⁹ Rules matter only for and so far as they promote efficiency. As individuals naturally tend to pursue benefits rather than costs³⁰, they choose among alternatives a rule which is efficient; i.e. whose benefits exceed the costs. For example in the case of a simple two-sided contract, every party considers his personal interest, and when they are convinced after cost/benefit consideration that the contractual rule is going to maximize their joint gain, the agreement will be

27 Hallowell John Hamilton, "The Decline of Liberalism as An Ideology" (1943), Berkeley, Los Angeles, University of California Press, at pp 53–54.

28 See Jefferson (1743–1826) quoted in Spitz Elain, "Majority Rule", (1932), Chatham, N.J., Chatham House, at p 159.

29 An economist might define allocative efficiency as using resources in their best application with lowest possible cost. See generally Posner Richard A., "Economic Analysis of Law", (1992), Boston, London, Little, Brown, at p 3; Cheffins Brian R., *Company Law: Theory Structure and Operation* (1997), Oxford, Clarendon Press, at p 7; Maughan C. W. and Copp S. F., "Company Law Reform and Economic Methodology Revisited" (1999), *The Company Lawyer*, Vol. 21, No. 1, London, Oyez Publishing Limited at pp 20–21.

reached. In such case, the contract is efficient because every contract party is served by it. However in a more complex case there can be a contract between more than two persons who have an ongoing relationship and who must choose with a view to making profit a collective rule. In the latter case, the contractual rule may not at all times be beneficial for all persons involved. It may benefit some and hence be seen by those benefited as efficient, while harming some others who view it as being inefficient.

There are two varying approaches among economists on how to evaluate a collective rule. One approach argues that a rule is efficient when it benefits some party without producing cost for anyone. This so-called 'Pareto' efficiency model was introduced by Mr Vilfredo Pareto, a 19th century Italian economist. The other approach argues that a choice is efficient when it benefits only the greatest possible number of individuals. This is called 'Kaldor-Hicks' and was developed by the two 20th century British economists, Professor Nicholas Kaldor and John Hicks, who proclaimed that a particular change is efficient if, in aggregate, the benefits associated with the change exceed the costs. The latter which has attracted overwhelming support among economists rejects the former simply because, it argues, collective choices inevitably have adverse effects to the interests of some individuals and it is impossible to guard people against such effects.³¹

Application of the majority rule in companies can be described as being one of the consequences of entertaining the Kaldor-Hicks model of efficiency. Shareholders in

30 Bentham (above, note 24).

31 See Cheffins (above, note 29) at pp 14–16; Posner (above, note 29) at p 14; Gower (above, note 3) at p 554; Roe Mark J., "Corporate Law's Limits", Columbia University (2002), p 16 also

corporations adopt resolutions with a majority vote, which means such resolutions may leave only majority shareholders better off while allowing minority shareholders to feel worse off. Yet this is efficient because majority shareholders as persons who possess more shares in companies will be benefited more compared with those who have less investment. This extra financial motive will encourage substantial wealth-holders to appreciate the risk of investment in companies.³² Any sub majority rule can place control of majority investment in the hands of minority shareholders who may not show adequate care for majority interests and this is not efficient.³³ Minority shareholders, too, appreciate the risk of control by the majority shareholders as a matter of contract because they will obtain in aggregate more benefits than harm.³⁴ Any subsequent dissatisfaction on the part of minority shareholders will not cause a decline from the exercise of the majority rule in companies because with arrangements where one party is dissatisfied with how things have worked out, assets overall may

available at Social Science Research Network Electronic Library at <http://papers.ssrn.com/abstract=260582>.

32 Black Bernard S., "Is Corporate Law Trivial?: A Political and Economic Analysis", *North-Western University Law Review*, (1990), Vol. 84, No 2, Chicago, Northwestern University Law School, at p 552; Bebchuk Lucian Arye, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", *Harvard Law Review*, (1989), Vol. 102, pp 1830-1; MacNeil Iain, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory", *Journal of Corporate Law Studies* (June 2001), Oxford, UK, Hart Pub, p 117; Jensen C. Michel and Meckling William H. "Corporate Governance and 'Economic Democracy': An Attack on Freedom", in *Proceedings of Corporate Governance: A Definitive exploration of the Issues*, edited by C.J. Huizenga, UCLA Extension (1983), at pp 1-6 available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/ABSTRACT ID=321521>; Posner (above, note 29) at pp 91-6; See Cheffins (above, note 29) at pp 18-19].

33 Jensen & Meckling (above, note 32) at p 6; See also Easterbrook Frank H. and Fischel Daniel R., "The Economic Structure of Corporate Law", (1991), Harvard University Press, Cambridge, Mass. London, UK, Ch. 1 at p 409; Black (above, note 32) at pp 552, 555-6; Bebchuk (above, note 32) at pp 1830-1; Ferran (above, note 10) at p 246; Farrar John H., "Company Law", (1991), London, Butterworths, at p 222; Lee Hazen Thomas, "Silencing the Shareholders' Voice", *North Carolina Law Review*, (2002), Vol. 80, at p 1917 available from the Social Science Research Network at http://ssrn.com/abstract_id=329800; Lowenstein Louis, "Shareholder Voting Rights: A Response to Sec. Rule 19c-4 and to Professor Gilson" (1989), *Columbia Law Review*, Vol. 89, No. 5, New York, Columbia University Press, at pp 982-3.

still be transferred into more valuable uses. In such cases, other parties may gain more than what the disappointed individual has lost. Thus, contractual arrangements that favour majority rule ex ante will even ex post meet the Kalder-Hiks standard of efficiency.³⁵

Although economists confirm that original adoption of majority rule by corporations occurred with a view to democratic ideas, they emphasise, however, that the endurance of majority rule in corporations for so long has been caused by an efficiency consideration which resulted in the adaptation of the rule. Such adaptation is most manifested through a historical investigation of how the rule of the majority evolved in corporations. In a recent investigation, it has been shown that corporations have travelled three stages over time.³⁶ At the very early period of their introduction³⁷, they have been working with a rule of unanimous shareholder voting. Unanimous consent was, however, impractical because of its inability to allow progress and improvement and further, it was liable to abuse, as an individual member could opportunistically take advantage of the situation by withholding his consent in order to extract some

34 Manne Henry, "Some Theoretical Aspects of Share Voting in the Economics of Legal Relationships", *Columbia Law Review*, New York, Columbia University Press, (1964), Vol. 64, 1427.

35 See Posner (above, note 29) at p 14, Cheffins (above, note 29) at pp 15-16.

36 Dunlavy Colleen A., "Corporate Governance in Late 19th Century Europe and the United States, The Case of Shareholder Voting Rights" in *Comparative Corporate Governance: The State of the Art and Emerging Research* edited by Hopt K.J., Kanada H., Roe M.J., Wymeersch E. and Prigge S. (eds.), (1998), Oxford University Press, at pp 12-13; See also Carney William J., "Fundamental Corporate Changes, Minority Shareholders, and Business Purposes" (1980), *American Bar Foundation Research Journal*, Chicago, American Bar Foundation, at pp 69, 77-97; Hager Mark M., "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory", *University of Pittsburgh Law Review* (1989), Vol. 50, Pittsburgh, at pp 633-4.

37 The Russia Company was perhaps the earliest example; it was granted its charter in 1555, followed by the foundation of the English East India Company in 1600. [See Chaudhuri K.N., "The English East India Company" (1965), London, Cass, at pp 3, 26].

extra benefit for himself.³⁸ As companies grew in size and the need for changes became more common, companies and corporate laws replaced unanimity with majority rule. Yet, the new rule which worked on the basis of one vote for each shareholder³⁹, aimed at safeguarding individual shareholders as members of the corporation⁴⁰ rather than as owners of a portion of the corporate capital. In the eighteenth century a new practice emerged in Britain of giving the larger shareholders additional votes. Since then the general direction of change in the nineteenth century in Britain was from the more democratic alternative towards plutocratic power relations in which each share carried a vote. This practice is now widely accepted and normally is put in the form of a default rule in company laws of most countries.

Why corporations have travelled from adoption to adaptation in respect of majority rule can be answered in the light of differing features which have existed in between corporations and states. A democratic state relied on public recognition and legitimisation rather than private contracts. Such a state often pursued for the good of the public objectives other than mere profit maximisation. The state's membership could include every individual and body corporate that resided in its jurisdiction, and normally required no especial qualification from members. On the other hand, a corporation as a business vehicle relied on private contracts with a view to making

38 See Cheffins (above, note 29) at pp 17, 238; Bebchuk (above, note 32) at pp 1830-31; Schwarts Alan and Scott Robert E., "Contract Theory and The Limits of Contract Law", *Yale Law Journal* (2003), vol. 113, New Haven, Conn., Yale Law Journal Co., Yale University, School of Law, at p 3 also available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com>; Romano Roberta, "Answering The Wrong Question: The Tenuous Case for Mandatory Corporate Laws", *Columbia Law Review*, No. 7 (1989), Vol. 89, New York, Columbia University Press, at pp 1559-1601.

39 Ratner David L., "The Government of Business Corporations: Critical Reflections on the Rule of One Share, One Vote", *Cornell Law Review* (1970), Number 1, Vol. 56, Cornell University, Cornell Law School, at pp 3-5; Ferran (above, note 10) at pp 249-250.

profit for the contract parties, i.e. corporate members.⁴¹ In corporations, only shareholders were considered as members and other interested groups such as employees, customers, suppliers and directors were excluded. Also, corporations worked to maximise only their shareholders' wealth, as shareholders supplied them with the finance required for corporate operations.⁴² These differing features could have made the original adoption unworkable, ineffective and inefficient in the corporate context and hence they had to be addressed through adaptation which subsequently occurred most noticeably in respect of voting. Such adaptation distinguishably separated the majority rule that existed in democratic states and the majority rule that works in corporations.⁴³

40 Ratner (above, note 39) at p 6.

41 Hill Jennifer, "Public Beginnings, Private Ends: Should Corporate Law Privilege the Interests of Shareholders?", in *International Corporate Law*, Edited by Fiona Macmillan, Vol. 1 (2000) Oxford, Hart, at p 18 and Hill (above, note 4) at p 43; Mason (above, note 8) at pp 1, 5; Selznick (above, note 4) at pp 47-48; Farrar John H., "Company Law", (1985), London, Butterworths, at p 3; Hager (above note 36) at p 575; Cheffins (above note 29) at pp 17, 238; Jensen C. Michel and Meckling William H, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", (1976), 3, *Journal of Financial Economics*, Amsterdam, Holland, at 305; Easterbrook & Fischel (above, note 33) at Ch. 1; Easterbrook Frank H. and Fischel Daniel R., "Voting in Corporate Law", *The Journal of Law and Economics* (June 1983), Chicago, University of Chicago Law School, at p 401; Easterbrook Frank H. and Fischel Daniel R., "The Corporate Contract", *Columbia Law Review*, No. 7 (1989), Vol. 89, New York, Columbia University Press, pp 1430-5.

42 Roe Mark J., "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001), Harvard Law School, p 3, Social Science Research Network (SSRN), Electronic Library at www.ssrn.com (Working Paper No 019 ID 282703); Stout Lynn A., "Bad and Not-So-Bad Arguments for Shareholder Primacy", (2002), *Southern California Law Review*, Vol. 75, 1189; Leader Sheldon, "Private Property and Corporate Governance: Part I: Defining the Interests", edited by Fiona Macmillan Patfield (ed.), Kluwer Law International, London, (1995), pp 94-96; Gower (above, note 3) p 554; Manne (above, note 34); Farrar (above, note 33) at p 319.

43 Section 370(6) Companies Act 1985 and Art 54, Table A; See also Ferran (above, note 10) at p 320; Birds John & Others (eds.), "Boyle & Birds' Company Law" (1995), 3RD ed., Jordans, Bristol, p 210; Leader Sheldon & Dine Janet, "United Kingdom", in *The Legal Basis of Corporate Governance in Publicly Held Corporations*, (1998), 219 at p 233, Kluwer Law International.

I.1.3. Doctrinal approach

Generally speaking, there are four lines of arguments in case law and between company law scholars to justify the majority rule in companies. These are: 1) the business judgment rule; 2) the proper plaintiff principle; 3) the fear of multiplicity of actions; and 4) the internal management principle, which will be examined respectively below.

I.1.3.1. Business judgement rule

According to the business judgement rule (BJR), directors will not be held responsible for errors of judgement when they make business decisions in good faith. The argument relies on the policy consideration that since directors often must necessarily make judgements in uncertain business circumstances and on the basis of incomplete information, it will not be fair to blame them for their errors of judgements and for taking decisions that subsequently turn out to be bad.⁴⁴ Thus, the gist of the errors of judgements rule is to provide a safe harbour for directors of companies when they make honest business judgements, hereby further to stimulate directorial initiative and risk-taking in companies.⁴⁵ A full examination of the BJR is to be discussed elsewhere.⁴⁶

44 *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407 at 408 per Romer J; see generally Eisenberg, Melvin Aron, "The Duty of Care and The Business Judgement Rule in American Corporate Law" (1997), *Company Financial and Insolvency Law Review*, 185 Oxford, Mansfield Press, at p 195; Arsalidou, Demetra, "Objectivity vs Flexibility in Civil Law Jurisdictions and The Possible Introduction of The Business Judgement Rule in English Law" (2003), *Company Lawyer*, 24 (8), 228, London, Oyez Publishing Limited, at p 232; Davies P.L., "Gower and Davies' Principles of Modern Company Law", London, Sweet & Maxwell, (2003), 7th ed., Chapter 16, at p 436; Stapledon G. P., "Mismanagement and The Unfair Prejudice Provision", *Company Lawyer* (1993), 14 (5), 94-97.

45 Eisenberg (above, note 44) at p 191; Tunc, Andre, "The Judge and The Businessman" (1986), *Law Quarterly Review*, 102 (Oct), 549-554, London, Stevens and Sons; Arsht, Samuel S., "The Business Judgement Rule Revisited" (1979), *Hofstra Law Review*, Vol. 8, 93, Hempstead, N.Y., Hofstra University School of Law, at p 99; Branson, Douglas M., "The Rule That Is Not a Rule: The Business Judgement Rule" (2002), *Valparaiso University Law Review*, vol. 36, 631, Valparaiso,

What I am going to suggest here is that this rule, contrary to what some might argue, does not really constitute a justification for the rule of majority in companies. The reason simply lies in the nature of the shareholder/corporation relationship. Shareholders unlike directors do not act as agents of the corporation. They are more likely to be seen as owners of the corporation and because of that title they assume no duty of care and further they will not need the protection of the BJR. Therefore when shareholders decide, for example, to reappoint or dismiss a particular director, to ratify a director's breach of duties, to alter articles of association, to merge the company, to sell all assets or to dissolve the company, they do not need to exercise care.

Some company law scholars argued that the BJR is applicable not only to directors but also to shareholders where they make business decisions. For instance, Mayson, French and Ryan spoke of it as one of the reasons for the rule in *Foss v. Harbottle*⁴⁷ and in describing the current position of English company law on this issue proclaimed that 'a court will not review the merits of a lawful decision of members or directors of a company'.⁴⁸ As examples from case law, they referred to cases like *Shuttleworth v. Cox Brothers and Co. Ltd.*⁴⁹, *Howard Smith Ltd. v. Ampol Petroleum Ltd.*⁵⁰, *Carlen v. Drury*⁵¹ and the like⁵² none of them were really pertinent. The *Shuttleworth* case was related to

Ind., Valparaiso University School of Law, at pp 632, 636; Parkinson J. E., "Corporate Power and Responsibility", 1993, Oxford, Clarendon Press, at p 109.

46 See Chapter III (below, at IV.1.1.C).

47 *Foss v. Harbottle* (1843) 2 Hare 461.

48 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law" (2003), 19th ed., Oxford, Oxford University Press, at p 586.

49 *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9, pp 20-23 per Scrutton L.J.

50 *Howard Smith Ltd. v. Ampol Petroleum Ltd.* (1974) AC 821.

51 *Carlen v. Drury* (1812) 1 Ves & B 154.

52 *Lord v. Governor and Co. of Copper Miners* (1848), 2 Ph 740; *Inderwick v. Snell* (1850), 2 Mac & G 216.

resolving a dispute arisen between majority and minority shareholders on the issue of alteration of the company articles and the court rejected the claim because the dispute was a matter of internal management rather than business judgement. The Howard case was not a case of shareholders making business judgements but rather was a good example of not holding directors responsible for errors of judgement. In the third case, too, the disputed issue was essentially one of the internal matters to be settled internally and had nothing to do with the BJR.

Some American scholars have offered similar suggestions.⁵³ For example, Arsht took the view that 'to the extent a majority or controlling stockholder usurps the function of the board of directors by influencing or directing the directors' decision, such stockholder may have the benefit of the business judgement rule'.⁵⁴ This view, however, may work only if the controlling shareholder acts as a shadow director.⁵⁵ Yet, a controlling shareholder's exemption from liability in this case is not because he makes a qua member business decision, but rather for the fact that he makes the decision qua director.

I.1.3.2. Proper plaintiff principle

The procedural aspect of the majority rule is known as the proper plaintiff rule which was recognised by the courts through the famous *Foss v. Harbottle* case⁵⁶. It can be described as 'the elementary principle that A can not, as a general rule, bring an action

53 Lee Hazen (above, note 33) at p 1916.

54 Arsht (above, note 45) at p 111, para note 85.

55 Sections 214 and 251 Insolvency Act 1986; See also section 741 (2) Companies Act 1985.

56 *Foss v. Harbottle* (1843) 2 Hare 461.

against B to recover damages on behalf of C for an injury done by B to C'.⁵⁷ The proper plaintiff principle is one of the most important consequences of the property right, whereby only the owner of a piece of property has right to initiate action in respect of that property.⁵⁸ However, application of this general principle in the company law context is not so straightforward because in that context shareholders may simply wish to represent themselves as owners of the corporate property and its incident right of action. To correct this illusionary picture, company law supplements the proper plaintiff rule with another general principle of separate corporate personality⁵⁹, which recognises ownership right for the company itself rather than its shareholders.⁶⁰ The proper plaintiff rule has been maintained in many subsequent cases⁶¹ and is conventionally seen, as a matter of technique, decisive for commencing corporate claims.⁶² The Court of Appeal in the recent *Prudential*⁶³ case regarded it as being fundamental to any rational system of jurisprudence, having a wider scope and applying to any association, for example a trade union⁶⁴ or a building society⁶⁵ that can sue in its own name.

57 Law Commission, *Shareholder Remedies* (1997), Law Com, No 246, p 70; Hale, (above, note 56) at p 219.

58 Davies (above, note 44) at p 618; Sterling M. J., "The Theory and Policy of Shareholder Actions in Tort", (1987), *The Modern Law Review*, Vol. 50, 468, London, England, Stevens & Sons, at p 470; Hale, Christopher, "What's Right With the Rule in Foss v. Harbottle?" (1997), *Company Financial and Insolvency Law Review*, Oxford, Mansfield Press, 219-221.

59 *Salomon v. Salomon & Co. Ltd* (1897), AC (HL) 22.

60 Sealy L.S., "Problems of Standing, Pleading and Proof in Corporate Litigation", in *Company Law in Change* edited by Pettet, (1987), London, Stevens, at p 7; Wedderburn K. W., "Shareholder's Rights and the Rule in Foss v. Harbottle", (1957), *Cambridge Law Journal*, Cambridge, Cambridge University Press, at p 196; Farrar (above, note 33) at p 444; Pettet Ben, "Company Law" (2000), Harlow, Longman, at pp 227-8; Hale (above, note 58) at pp 219, 221.

61 *Mozley v. Alston* (1847) 1 Ph 790; *Macaura v. Northern Assurance Co. Ltd.* (1925), AC 619; *Lee v. Lees' Air Farming Ltd.* (1961), AC 12.

62 "I can not but think that...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..." [Foss v. Harbottle, (1843) 2 Hare 461 per Wigram VC].

63 *Prudential Assurance Co. Ltd v. Newman Industries Ltd. (No 2)* 1982, Ch, 204 p 210.

64 *Cotter v. National Union of Seamen* (1929), 2 Ch 58.

However, the separate corporate personality principle is clearly not intended to separate the personality of the company only from that of a minority shareholder. It also works to separate a corporation's personality from those of its majority shareholders. As a consequence, when we speak of the proper plaintiff principle as one of the foundations of the majority rule, we do not mean to take the majority shareholders as the proper plaintiffs who have the right of action. If that had been true, we would have denied the separate corporate personality of companies. As a legal person, a corporation acts through its representatives. Articles of association and company law prescribe the rules on which these representatives are elected, and determine the extents of their powers and the mechanisms on which they can make corporate decisions. Yet, majority rule and the separate personality and the proper plaintiff principles can coordinate to make commencement of any corporate action generally dependant on the wish of the majority who can influence corporate representatives indirectly. In that sense, the proper plaintiff principle can support the majority rule.

I.1.3.3. Fear of multiplicity of actions

The fear of multiplicity of actions is a policy-driven argument by which the courts support application of majority rule in companies. It generally reflects the fear of the judiciary of becoming involved in endless shareholder claims which take up the courts' time and waste public funds. The early manifestation of this fear can be found in the

65 Farrow v. Registrar of Building Society (1991), 2 VR 589.

judgement of James L. J. in *Gray v. Lewis* where he declared that 'if personal actions by shareholders were allowed there might be as many bills as there are shareholders multiplied into the number of defendants'.⁶⁶ The policy is to absolve the judiciary from having to take difficult decisions about matters of business and internal management of companies and thereby to save judicial resources. Yet, more benefits can derive from the policy. It is 'more convenient that the company should sue, instead of having any number of suits started and subsequently discontinued by individual shareholders'.⁶⁷ Shareholder actions might be fruitless for the simple reason that the company would convene a meeting, and pass a resolution to ratify the act in question. They could further increase costs for companies by imposing on them unwanted consequences of being involved in endless time consuming and probably business disruptive litigations.⁶⁸ They might also be used to harass the company through constant litigation. These can all be avoided by the courts' refusal to hear shareholder actions, which saves companies' and their shareholders' time and money, and allows companies to operate and focus on ongoing business without unnecessary interruption.⁶⁹

I.1.3.4. Internal management principle

The internal management principle is another source of justification upon which the courts abdicate their jurisdiction in favour of corporate internal forums.⁷⁰ It is, in fact, a consequence of enforcing company contracts, and generally means shareholder

66 *Gray v. Lewis* (1873), 8 Ch App, 1035, p 1051.

67 *Farrar* (above, note 41) at p 361.

68 *Mac Dougall v. Gardiner* (1875), 1Ch.D. 13 at p 25.

69 *Farrar* (above, note 41).

70 *Mayson Et. Al.* (above, note 48) at p 576.

disputes should be settled on the basis of internal rules at the internal forum in the company. Internal rules are mainly found in constitutions, and every member by subscribing to the memorandum of association agrees to their applicability.⁷¹ They regulate rules and methods by which shareholders' disagreements should be settled and provide an internal forum for such settlements, often in the form of a general meeting of shareholders. The development of the internal management principle as a legal principle can be seen as resulting from case law, where the courts, by their reluctance to hear disputes among shareholders, created the policy of non-intervention in favour of general meetings. Historically, it can be traced back to the old principle of internal settlement in partnerships that required partners to settle their disagreements internally.⁷² Early common law courts developed the principle by stating laudly that a 'court is not to be required on every occasion to take the management of every play house and brew house in the kingdom'.⁷³ Subsequently, this principle of partnerships was by analogy extended by the courts to companies in the famous *Foss* case.⁷⁴ The *Foss* case which was infact the first judicial confirmation of the majority rule in companies concerned two company shareholders who brought action against directors of the company in order to compel them to make good loss suffered by the company on the ground that the defendants had sold their own land to the company at a price in excess of its value. Wigram V.C. rejected the action taking the view that the objected transaction is a wrong to the company and so far as the company itself through its governing body of proprietors retains its functions, there will be no recourse for

71 Sections 14 (1) and 22 (1, 2) Companies Act 1985.

72 Wedderburn (above, note 60) at p 196.

73 *Carlen v. Drury* (1812), 1 Ves. & B 154 at p 158, per Lord Eldon.

74 *Foss v. Harbottle*, (1843) 2 Hare 461.

individual shareholders to take corporate actions.⁷⁵ The rule in *Foss* case was then supported by subsequent cases⁷⁶ and over time has become a fundamental principle of company law in England that requires settlement of internal disputes among shareholders through internal rules and procedures.⁷⁷ Accordingly, the courts do not hear such disputes unless the plaintiff shareholders can show that they have tried all the internal mechanisms which have proved to be working inappropriately or unconstitutionally.⁷⁸

I.1.4. Comments

Each of the three approaches involves some drawback. The political approach uses political arguments to explain governance of the majority in corporations which is meant to monitor activities of the corporate management. The use of political arguments is to mean that the approach relies on personality of corporate members rather than their capital. Why the majority should rule can be answered the same as is done in the politics. It should rule because allegedly it enjoys greater force, treats members as equal human beings, allows them to make maximum possible use of their freedom, and offers them with more benefits and better results. A criticism is that political arguments fail to work in any human association and group which do not rely on personality of group members.⁷⁹ In addition, as the approach relies on members

75 Ibid.

76 *Mac Dougall v. Gardiner* (1875), 1 Ch.D.13; *Burland v. Earle* (1902), AC 83, PC, p 93-94, per Lord Davey.

77 *North West Transportation Co Ltd. v. Beatty* (1887), 12 App CAS 589 per Richard Baggallay; *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9, at pp 20-23 per Scrutton L.J.

78 Mosteshar Said "Derivative Actions - A New Approach", *New Law Journal* (1983), London, Butterworth, at p 992.

79 Lowenstein (above, note 33) at pp 983-4; Jensen and Meckling (1983), (above, note 32) at pp 1-6; Black (1990), (above, note 32) at p 552; Bebchuk (1989), (above, note 32) at pp 1830-1.

rather than their capital, it often provides excessive protection for minorities that can be inefficient in business corporations.

The economic approach, on the other hand, justifies the majority rule, relying on the efficiency argument. According to it, majority rule is efficient because by granting corporate governance to those who supply a greater bulk of the corporate financial resource, it facilitates movement of capital towards corporations. Further, majority rule offers benefits to majority shareholders that outweigh any likely impairment of minority shareholders. The approach can be characterised by its complete reliance on private contracting and market mechanisms plus unwillingness in accommodating any legal intervention for the protection of minority shareholders. An important drawback with this approach is its capability to substitute interests of corporations with those of their majority shareholders, whereas a company as a legal person can have interests other than that of a mere majority.⁸⁰ Therefore, it is debatable that majority rule is desirable because it promotes efficiency in the company. In some circumstances it may act inefficiently especially where shareholders who sit in the majority camp seek to pursue self-interested policies.⁸¹ A further drawback, which is pertinent to jurisdictions whose corporations rely on external finance, is its capability to discourage shareholder financing in corporations. Recent empirical research by comparing legal rules across 49 countries has shown that there is a causal link between good legal protection for

80 See Chapter three below, at III.1.1.B.

81 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law", (2001), 18th ed., London, Blackstone, at pp 11-12; MacIntosh Jeffrey G., "Minority Shareholder Rights in Canada and England: 1860-1987", (1989), *Osgoode Hall Law Journal*, vol. 27, No. 3, Toronto, Osgoode Hall Law School, at p 564.

investors and existing of a strong company sector with investors wishing to take the risk of financing in companies.⁸²

The doctrinal approach justifies the rule using certain legal principles which are generally meant to benefit corporations and their shareholders, the judiciary and the society. The principles which all, in one way or another, support the governance of majority shareholders seek to encourage financing and risk-taking in corporations, save the public budget, facilitate private ordering in the interest of efficiency, and regulate the relationships between corporations, shareholders, and corporate directors. These are worthwhile objectives which are often achieved. Nonetheless, under certain circumstances operation of the principles can result in injustice to minority shareholders in corporations. This is mainly the case where 'the persons who control the company and the persons against whom the company has a cause of action are one and the same'.⁸³ In such cases a minority shareholder is not as a matter of principle able to pursue wrongdoers unless there is, not a simple disagreement, but the prospect of 'an imminent disaster to the company observable by all, or at least, most reasonable people'⁸⁴ that is, of course, very difficult to prove.⁸⁵ The business judgement rule saves a majority shareholder/director from liability for committing of mere negligence. When the alleged negligence constitutes a breach of either the duty of care or fiduciary, he/she will be safe from prosecution so far as the matter falls short of the concept of

82 La Porta Rafael, Lopes-de-Silanes Florencio, Shleifer Andrei and Vishny Robert W. (Hereafter is cited LLSV), "Legal Determinants of External Finance", (1997) 52 (3), *Journal of Finance*, New York, American Finance Association, pp 1131, 1132, 1149 and LLSV, "Investor Protection and Corporate Governance" p 29 available at Social Science Research Network (SSRN), Electronic Library at www.ssrn.com, (ID 183900 code 99092719).

83 Hale (above, note 58) at p 219.

84 Rajak Harry, "Source Book of Company Law", (1995), Bristol, Jordans, at p 530.

85 Sealy (1987) (above, note 60) at pp 4-7.

fraud. The internal management principle allows the wrongdoers to ratify their wrongs. When there is a dispute among shareholders, the principle goes no further than to solve the dispute in favour of the majority shareholders. The proper plaintiff principle too prevents any legal action to be taken as to corporate wrongs by minority shareholders. The judicial reluctance as to hearing of minority claims can further be a green light for controllers to do wrong in corporations. In summary, these principles when are put together can rigidly ignore minority shareholders' rights, making no distinction between fallacious and meritorious claims of theirs.⁸⁶

⁸⁶ Sealy (1987), (above, note 60) at p 7.

I.2. The case of Iran

The issue of justification for majority rule is relatively new issue in Iranian company law and has rarely been discussed among company law scholars.⁸⁷ The existing literature on company law often either neglects to address the issue, or if at all, tends to describe the law as it stands rather than to analyse and explain it. Although it points to majority rule as a distinctive character of companies as against traditional contracts and partnerships, it hardly raises the question of why majority shareholders should rule in companies. This is a key question that has been addressed by scholars of the western economies since the 17th century. In fact in such economies, majority rule has been a key element in the development of modern companies, while in Iran, it did not matter that much, though adopted by company law.

Speaking generally, the evolution of a rule of law in any legal system depends on social context and in particular on the underlying cultural, socio-economic and political elements of that system. Where the context is not apt for a particular rule to evolve, the rule will not emerge and as a consequence may not even matter. A historical/contextual examination of the development of Iranian modern law will show that Iranian society was not ready yet to generate an indigenous majority rule to be employed for its business vehicles. Before the Pahlavi period (1925–1978), the law in Iran was based on Islamic law⁸⁸ and it did not recognise companies that have separate personality and work with the majority rule. Islamic jurists and political theorists were reluctant to see business vehicles as separate persons. Such idea was capable to

87 See Sotoodeh Tehrani Hasan, "Trade Law" (1997), Tehran, Dekhoda Publication, vol. 2, pp 175-6.

88 Pasha-Saaleh Ali, "The History of Law" (1960), University of Tehran Publications.

threaten the ideal of undivided community advanced by Islam.⁸⁹ Further, democratic values which underlie evolution of modern companies in western economies, were yet unknown to the Islamic society of Iran. The idea that political power belongs to the people who can by majority rule make rules of their own for their collective affairs could sit uneasily with the teachings of Islam.⁹⁰ Islamic law required Muslims to conform the rules of Shariah that were already written by Allah. It denied legislative power from the ruler and only allowed him to make administrative regulations within the limits of Islam. Islamic rulers in Muslim societies viewed themselves as persons who have the mission and are entrusted with godly power to exercise the rules of Shariah as demonstrated in the holy Quran and other Islamic sources and as interpreted by qualified interpreters of the Islamic law.

Historically also Iran had never experienced democracy. Political regimes were always authoritative in nature and monarchy was the most typical form of government.⁹¹ Pre-Islamic Iranian kings were centres of absolute power that treated the people like their servants. The same was true of post-Islamic Iranian kings; except in the latter period kings ruled often formally in the name of Allah and were called as Nayeb ol Imam, one

89 "Hold fast, all of you together, to the cable of Allah, and do not separate, and remember Allah's favour unto you: how you were enemies and He made friendship between your hearts so that you became as brothers by his grace; and how you were upon the brink of an abyss of fire, and He saved you from it" [The Qur'an, 3: 103].

90 Gibb, H. A. R., "The Islamic Background of Ibn Khaldun's Political Theory", *Bulletin of the School of Oriental Studies*, University of London, Vol. 7, No. 1 (1933), 23-31 available at the following address: <http://links.jstor.org/sici?sici=1356-1898%281933%297%3A1%3ATIBOIK%3E2.0.CO%3B2-%23>.

91 Keddie, Nikki R., "Iran: Religion, Politics, and Society", *Collected Essays*, London, F. Cass, Totowa, N.J., Biblio Distribution Centre, (1980); Halliday, Fred, "Iran: Dictatorship and Development" Harmondsworth: Penguin, (1979); Lenczowski, George, "Iran Under the Pahlavis" Stanford, Hoover Institution Press, (1978).

who, according to the Shiah Jafary School⁹², serves Shariah law on behalf of the Prophet Mohammad and his twelve grandchildren on their absence.⁹³

Further, the idea that collective decisions can be made by a majority of shareholders in companies was in contradiction with the individualist nature of the Islamic law that recognised rights and obligations only for natural persons and required for party consent in civil transactions and business activities.⁹⁴ A contract could come into force and continue only so far as it could carry the consent of each contractual party. The free contracting principle, which is recognised in Islam, was short of the capability to render separate personhood to collective business enterprises and as a consequence members in such enterprises were treated as co-owners. Unanimity that required the consent of each member for every collective decision was therefore the only applicable, but not necessarily workable, rule and contractual efficiency was to mean the efficiency of a transaction for parties as understood and agreed by every party to that transaction.

Thus, the adoption of the law of modern corporations, that work through the majority rule, by Iranian Law could not follow a religious, cultural or political link, as these were not capable of allowing any gradual evolution of modern companies in Iran. In

92 Shiah Jafary School is the prevailing creed among Iranians which has also been officially adopted by the Iranian governments since the Safavids (907/1501); For a historical study see Alesandro Bausani, "Religion in Iran: From Zoroaster to Baha'ullah", *Iranian Studies*, Routledge, Volume 36, Number 1/March (2003), 103-160; Savory, Roger Mervyn, "Iran Under the Safavids" Cambridge, Cambridge University Press, (1980); Nasr S.H., "Religion in Safavid Persia", *Iranian Studies*, Routledge, Volume 7, (1974), 271; Keddie (above, note 91).

93 For further study of the School's thoughts see Ayatollah Ja'far Sobhani, "Doctrines of Shi'i Islam", Translated and edited by Reza Shah-Kazemi, Qom, Imam Sadeq Institute, (2003).

94 See generally Kuran Timur, "Why the Islamic Middle East Did not Generate an Indigenous Corporate Law", (2004), University of Southern California, Department of Economics, Los Angeles, at pp 12-19, available from Social Science Research Network (SSRN), Electronic Library at: <http://ssrn.com/abstract=585687> and from the Berkeley Electronic Press at

the absence of such links one may wonder why Iran did experience such adoption. One possible (and of course good) answer is to say that the case for Iran was perhaps a simple westernisation of the law applicable to the traditional partnership towards a transplantation of the idea of modern company as existed in the western economies of the time. Such westernisation began under Reza Shah (the founder of the Pahlavy monarchy) in the nineteen-twenties and thirties. Under his monarchy a great deal of change in law and institutions, similar to that of Turkey, occurred in Iran.⁹⁵ Iranian economy was about to experience a sudden industrialisation on the European model and companies could speed up the process of such industrialisation, as they did in the European model.⁹⁶ Major adoption both in form and contents occurred in respect of the Trade code⁹⁷ that introduced a separate section on companies and allowed public to incorporate companies.⁹⁸ This code took the company laws of France and Belgium as models, but ensured that it remains consistent with Islamic principles. The code was subsequently replaced by another Trade code⁹⁹ that except for joint stock companies still remains the applicable Trade code in Iran.¹⁰⁰ It divides companies into seven types¹⁰¹ and particularly in Section 72 prescribes the rule of majority. Mohammad Reza Shah, the son of Reza Shah, continued this trend towards westernisation. In 1969, his

<http://law.bepress.com/usclwps/lewps/art16>; Schacht, Joseph, "Islamic Law in Contemporary States", *The American Journal of comparative Law*, 133 at p 138.

95 But unlike the case of Turkey, Pahlavies' westernisation was in most cases subject to observation of the Islamic law, particularly the Shia Jafari School that survived by Art 2 of the 1925 amendment to the Constitution. See generally Kuran (above, note 94) at pp 16-19; Zagday M. I., "Modern Trends in Islamic Law in the Near, Middle and Far East", in *Current Legal Problems*, edited by George W. Keeton et al. (1948), Vol 1 London, at p 209.

96 See generally Kuran (above, note 94) at pp 10-12.

97 Trade Code 1926 (corresponding to Persian calendar year 1304).

98 Civil Code, which includes family law, the law of civil transactions and torts, was also adopted from the law of Europe. The adoption, however, was only in form rather than in contents which remained Islamic.

99 Trade Code 1933 (corresponding to Persian calendar year 1311) (Hereafter is cited TC).

100 Pasha-Saaleh (above, note 88) at p 278; Sotoodeh (above, note 87) at pp 11, 12.

101 Section 20 TC.

government proposed a new collection of 300 sections on the model of France to the Parliament in order to address deficiencies of the Trade code in respect of joint-stock companies. The new collection was passed¹⁰², and at the moment is the primary source of law in relation to the joint-stock companies in Iran. It reconfirms the rule of majority¹⁰³ in such companies and provides few minority protections.¹⁰⁴

One can assume that Iranian law has justified the rule of majority in companies in the same way as done by scholars in western economies. There are therefore Iranian company law scholars who speak of an analogy between democratic states and business associations and who require the rule of majority in order to enable corporate members monitor activities of corporate executives.¹⁰⁵ Likewise, it is said that the application of the rule is efficient because it ensures more benefits than harm to members. From a legal perspective also majority rule respects corporate autonomy¹⁰⁶, resolves shareholder disputes internally¹⁰⁷ and prevents shareholders from initiating corporate claims¹⁰⁸ which all are in the economics of companies and save the judiciary time and money.¹⁰⁹

102 Joint Stock Companies Act 1969 (corresponding to Persian calander year 1347), (Hereafter cited JSCA).

103 Sections 86-88 JSCA.

104 Sections 129 and 276 JSCA.

105 Sotoodeh (above, note 87) at pp 18, 114-5.

106 Sections 583 and 589 TC.

107 Sections 88 and 103 JSCA.

108 See sections 2 and 84 (10) Civil Procedure Act 2000 (hereafter is cited CPA).

109 Sotoodeh (above, note 87) at pp 121, 124; Hoseingoli Katebi, "Trade Law" (1994), 6th ed., Vol. 2, Tehran, Ganjedanesh Publication, at p 79; Azami Zangeneh Abdolmajid, "Commercial Law" (1974), 4th ed., Tehran, University of Tehran Publication, at p 119; Erfani Mahmood, "Abuse of Job and Power in the Law of Iran", *Comparative Law Institution Monthly* (1981), No 7, University of Tehran Publication, Tehran, at pp 148-231; Seghari Mansoor, "Definition of Business Corporation", in *Private Law Developments*, Edited by Katoozian Naser (1993), Tehran

A related question is to see why amongst the existing models of corporate governance, the Iranian law adopted the continental Europe model rather than the Anglo-American model. A distinctive feature of the latter is the lack of a controlling shareholder. In this model, external finance is the main source of corporate capital and corporate shareholdings are widely dispersed among the public so that corporate managers can seize real control of corporations. As the name suggests, the model is mainly American and British. On the other hand, companies in the former model depend on internal financing and there are often one or a few shareholders who have shareholdings enough to control the corporation. This is the norm for the rest of the world.¹¹⁰

Both models have advantages as well as disadvantages. As the latter relies more on market constraints rather than shareholder control, disclosure of information plays a decisive role in controlling mismanagement, but short-termism becomes the policy of shareholders and agency costs are increased. Instead, in the former, the effectiveness and efficiency of corporations depends on shareholder control which is to mean long-term shareholder performance in control of corporations and less agency costs but they suffer from lower disclosure standard and minority oppression.¹¹¹ Most contemporary legal comparatists admit that none of the models are ideal and the choice between one

University Publications, at p 199; Eskinia Rabiaa, "Trade Law: Business Corporations" (2000), Vol. 2, Samt Publication, Tehran, at p 78.

110 Shleifer, Andrei and Vishny, Robert W., "A Survey of Corporate Governance", *The Journal of Finance* (June 1997), Vol. LII, No. 2, at p 754; MacNeil Iain, "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies" (2002), *Journal of Corporate Law Studies*, vol. 2, part 2, 289, at pp 291-297, Hart Publishing; MacNeil Iain, "An Introduction to The Law on Financial Investment" (2005), Hart Publishing Co., Oxford, at pp 252-255; Cheffins Brian R., 'Current Trends in Corporate Governance: Going from London to Milan via Toronto', *Duke Journal of Comparative & International Law* (1999), Vol. 10, No. 5, at p 7; Cheffins Brian R, "Corporate Law and Ownership Structure: A Darwinian Link?", University of Cambridge (2002), available at Social Science Research Network (SSRN), Electronic Library at <http://ssrn.com/abstract=317661>, at pp 30-37.

and another model for a host system is one of economic, political and cultural or a mixture of them.¹¹² Economists suggest legal systems adopt a model of corporate governance that efficiency dictates to corporations working within them otherwise corporations which have inefficient corporate governance structure will not survive in the market. Efficiency, therefore, explains why the Anglo-American and the Continent Europe differ in the choice of their corporate governance models.¹¹³ Public regulation on political considerations is seen as determinant in development of corporate governance models too. On this view, Roe, for example, suggests that the Anglo-American model is a product of democratic movements towards social democracy which required prevention of concentration of power in hands of few people or institutions.¹¹⁴ Path dependence theory at a wider view attributes evolution or adoption of a model of corporate governance in a legal system to matters of culture and the social values of a given society, and explains society's resistance to any subsequent change on efficiency considerations.¹¹⁵ Some evidence from empirical

111 MacNeil (2002), (above, note 110) at pp 292-3; Cheffins (2002), (above, note 110) at pp 23-44; Roe (2002), (above, note 31) at pp 1-10.

112 Kamba, W. J., "Comparative Law: A Theoretical Framework" (1974), *International and Comparative Law Quarterly*, vol. 23, 485, at pp 513-518; Orucu, Esin, "Law as Transplant" (2002), *International and Comparative Law Quarterly*, vol. 51, 505, at p 207; Bratton W. and McCahery, "Comparative Corporate Governance and The Theory of the Firm: The Case against Global Cross Reference", (1999), 38 *Columbia Journal of Transnational Law* 213; Cheffins (1999), (above, note 110) at p 11; Cheffins (2002), (above, note 110) at p 23.

113 Easterbrook and Fischel (1991), (above, note 33); Cheffins Brian R., "Law, Economics and the UK'S System of Corporate Governance: Lessons from History" (2001), *Journal of Corporate Law Studies*, vol. 1, part 1, 71; Ogus, Anthony, "Competition Between National Legal Systems: A contribution of Economic Analysis to Comparative Law" (1999), *International and Comparative Law Quarterly*, vol. 48, 405, at p 406.

114 Roe M.J., "A Political Theory of American Corporate Finance", (1991), 91 *Columbia Law Review* 10; see also Shleifer and Vishny (above, note 110) at p 754.

115 Bebchuk L.A. and Roe M.J., "A Theory of Path Dependence in Corporate Ownership and Governance", Columbia Law School Centre for Law and Economic Studies, Working Paper No. 131 available at www.ssrn.com; Licht A. N., "The Mother of All Path Dependencies, Towards a Cross Cultural Theory of Corporate Governance Systems" (2001), 26 *Delaware Journal of Corporate Law* 147.

research has also recently shown that the formation of corporate governance structure can depend on how strongly a legal system protects its financial investors.¹¹⁶

Similar factors can explain why Iranian lawmakers at the time of initial adoption took the continental Europe as its model. From a political perspective, the model was apt to allow the government to seize control of the private sector. Iranian statesmen for different reasons have always wanted to have a weak and controlled private sector.¹¹⁷

They were suspicious about modern companies and considered them as a potential threat to stability of the Iranian society and government. Before the Iranian revolution of 1978, the authoritative structure of the governing regimes gave rise to the exercising of arbitrary interference by governments in private sector and especially private property and ownership.¹¹⁸ After the Islamic revolution of 1978, the private sector was treated worse, as the new government viewed them rather suspiciously. Article 44¹¹⁹ of the new constitution gave state protection to companies only to the extent that they contribute to the growth of the Iranian economy, and Article 22 authorised the government to take statutory measures in order to seize companies that fail to satisfy

116 LLSV (above, note 82).

117 Jalali Naini, Ahmad R., "Capital Accumulation and Economic Growth in Iran: Past Experience and Future Prospects", *Iranian Studies*, Volume 38, number 1, 91, March 2005; Saeidi, Ali A., "Charismatic Political Authority and Populist Economics in Post-Revolutionary Iran", *Third World Quarterly*, Vol 22, No 2, 219-236, at pp 221-2; Ghani Nejad Moosa, "Brief Interview with Professor Moosa Ghani Nejad", 29 Aug 2006 available at <http://www.bbc.co.uk/persian/>.

118 Ashraf Ahmad, "Historical Obstacles to the Growth of Capitalism in Iran: Ghajarieh Period" (1980), Tehran, Zamineh Publication, p 61.

119 "The economy of the Islamic Republic of Iran is to consist of three sectors: state, cooperative, and private ... ownership in each of these three sectors is protected by the laws of the Islamic Republic, in so far as this ownership is in conformity with the other articles of this chapter, does not go beyond the bounds of Islamic law, contributes to the economic growth and progress of the country, and does not harm society..." [Article 44 Constitution of Islamic Republic of Iran (1980/1358) hereafter cited as CIRI].

the public interest objective.¹²⁰ The right to form companies, therefore, is seen not as deriving from freedom of association, but rather is treated as a state-granted concession which can be withdrawn when the public interest requires. As a further consequence of such viewing, the government has narrowed areas of economic activity in which companies could enter. Dividing the economy of Iran into three sectors, governmental, co-operative and private, Article 44 has allocated exclusively to government much of the room for economic activity, even activities that by their legal definition are regarded as private. Government, therefore, monopolises the business in most key sectors of the economy and further it applies control on companies in remaining areas. Besides, from a religious perspective, control of the government over companies could also address the factionalism concern of the Islamic jurists.¹²¹ In addition to these, government control over the private sector could generate income, and its control over the proceeds obtained of oil production and export created financial independence which could save it from any likely inhospitality of the private sector. These factors resulted in the creation of many large corporations which are owned either totally or substantially (over 50 percent shareholding) by the state, and which control up to 80 percent of the economy of Iran.

Economically observed, the continental European model could function more efficiently than the Anglo-American model in the Iranian context. To begin with, the Anglo-American model was not sufficiently popular around the world, or at least it was unknown to the Iranian lawmaker and businessmen on the time of adoption. By the nineteen-thirties it only prevailed in United States and its establishment in Britain

120 "The dignity, life, property, rights, residence, and occupation of the individual are inviolate, except in cases sanctioned by law." [Article 22 CIRI].

was only completed as late as 1979.¹²² Its adoption, therefore, could require extra costs of searching, learning, and practising. In contrast, Iran's vicinity and vast business relationship with continental Europe and the successes of European corporations made the continental model of corporate governance known, attractive and less expensive to adopt. The model was also closer to the traditional partnership concept which was popular in Iran in that it preserved the connection between ownership and control and therefore it was not as expensive to learn and practice as the Anglo-American model. Furthermore, it is now clear that the Anglo-American model's performance is closely dependent on the existence of a market economy able to align companies through competitive constraints.¹²³ In a context like Iran in which business was mainly conducted through either closely-held firms or state-owned associations, and competitive constraints were to a great extent absent, and in which the financial market is yet under developed and share transactions relatively uncommon, adoption of the Anglo-American model could have generated hazardous consequences.

121 See (above, note 89); also see generally Kuran (above, note 94) at pp 12-19.

122 Cheffins (2001), (above, note 113) at pp 81-4; Cheffins (2002), (above, note 110) at pp 3-10.

123 Cheffins (1999), (above, note 110) at pp 11-17; MacNeil (2002), (above, note 110) at pp 291-297; Bebchuk and Roe (above, note 115) at pp 11, 22.

I.3. Conclusion

This Chapter reviewed from the perspective of English and Iranian laws lines of arguments that have been developed in favour of application of the majority rule in companies. As to the English company law, it identified and examined three approaches which have been most influential in developing and justifying the rule of majority in corporations. The first approach (political), regards the majority rule as being a product of adoption from political ideas. It draws analogies between states and corporations and justifies the majority rule in the latter as it is justified in the former. In this approach, majority rule is desirable only because it facilitates control of corporate members over the corporate management. Most company lawyers would accept that democratic theory has been influential in the development of the current model of governance in corporations. Many of the structural and governance issues in corporations including the majority rule originally inspire from the democratic theory. Yet as the Economic theory explains, because of essential differences which exist between corporations and states a political justification could no longer work in the former. It pays little attention to the economic aspect of corporations and puts excessive emphasis on personality of corporate members. The political approach, thus, while supporting the majority rule offers disproportionate safeguards for shareholders which can be inefficient. The second approach (economic), which views endurance of the majority rule in corporations as being a consequence of adaptation, seeks to justify the majority rule using the efficiency argument. As corporations rely on finance which is decisively important for their business and because corporate decisions are taken collectively, they need a rule that can facilitate collective action and encourage shareholder financing and these can only be achieved through the majority rule. Since

a rule cannot be for all, it should inevitably be for the majority shareholders because otherwise would discourage financing in corporations. Majority control is the risk minority shareholders must take to obtain greater value. The approach, however, can facilitate majority abuse as it considers any minority involvement in the making of corporate decisions and control of companies entirely interruptive and troublesome. The political and economic approaches agree in the sense that they both support governance of the majority in corporations. They diverge, nevertheless, in that while in the former majority rule is a device which enables corporate members' participation in control over management, in the latter it facilitates financing rather than being a controlling device.¹²⁴ Finally, the third approach (doctrinal), which accommodates the rule within the corporate laws, seeks to justify the rule of majority, using certain legal reasoning and policy considerations. The doctrinal justification, in turn, if rigidly interpreted is liable to injustice. The BJR is liable to abuse particularly where the same people hold both majority of shares and managerial position.¹²⁵ The proper plaintiff rule is also capable of being diverted to serve the majority shareholders because under majority influence, directors may differentiate between corporate actions and initiate only those that benefit the controlling majority.¹²⁶ Too, the fear of multiplicity of actions argument is unable to assure that only fallacious claims of minority shareholders will

124 See Chapter three below, at III.1.4.

125 It will be explained in Chapter four that Iranian company law does not know any systematic exemption from liability for corporate management as to their negligence. See Chapter four below, at IV.2.

126 Majority rule in Iranian company law is not to explain why company shareholders from a procedural standpoint are debarred from taking corporate claims. That is a consequence of an amalgamation of companies' separate personality and ownership rights and is recognised by procedural rules of taking actions generally. See section 2 Civil Procedure Act 2000 (hereafter is cited CPA) which provide: "No court can hear a claim unless a person or persons having proprietary interest or a person or persons who are their agents (lawyer), successors or legal representatives initiate action and demand judicial trial according to the law". Also see section 84 (10) CPA that states, "In following issues defendant when responds in substance can make a

be rejected.¹²⁷ Lastly, the internal management principle which refers every dispute of shareholders to the meeting of shareholders relies on the assumption that internal rules are capable to offer autonomous solutions for every contingency. This is not correct because contractual solutions in the company context may not be fully autonomous as they are taken, and are changeable, by a majority decision.¹²⁸

Similar approaches although borrowed from the western economies can be found in the Iranian company law too. It has been made clear that the society of Iran for a number of reasons was not ready to generate an indigenous company law and hence it did not need to justify the rule of the majority. Westernisation of the economy and adoption of law on the European model further relaxed such need.

While the two countries share in how to justify the rule of majority, they diverge in their chosen model of corporate governance. English companies tend to have dispersed shareholders. Unless the company is small, no single or few persons can control the company. Iranian companies, on the other hand, most often have one (the state and its dependant organisations, as to large companies) or several controlling shareholders (families, in the case of small companies). Interestingly, such divergence was partially caused by one similar factor, i.e. efficiency. For England, a dispersed shareholding

procedural objection to the claim initiated against him/her ...(10) Plaintiff is not of interest in the claim”.

127 Iranian law also does not recognise any policy that dictates abdication of judicial jurisdiction due to fear of multiplicity of shareholder actions.

128 That, internal disputes must be settled internally is also the applicable rule in Iranian company law. The only difference is perhaps one of the source. While it is a common law rule in England, internal management is a statutory rule in Iranian company law. See section 86 JSCA, “Ordinary general meeting is of discretion to decide on all issues relating to the company’s affairs excluding issues which fall within the authority of Founders and Extra ordinary meetings”.

structure was efficient because a concentrated structure could mean greater risks, on the one hand, for majority shareholders whose investment was liable to the risk of mismanagement and, on the other hand, for minority shareholders who were victims of abuse of power by the majority shareholders. In the case of Iran, on the other hand, the concentrated model could function efficiently as companies depend mostly on internal finance rather than external investment. In addition to the efficiency consideration, political and religious factors were also relevant in the case of Iran because a concentrated model could ensure control of the private sector by the Islamic government. Nonetheless, it must be remembered that recent signals from Iran indicate that the Iranian lawmaker currently seeks to pursue a gradual shift from a heavily government-directed economy towards privatisation and a market economy, which could, in the long term, mean development of a less concentrated pattern of shareholding in Iranian corporations and improvement of the law so as to accommodate some more minority shareholder protection mechanisms in Iranian company law.¹²⁹ This is now noticeable in the Tehran Stock Exchange proclaimed policies which encourage dispersion of shareholding.¹³⁰

129 The government has had a privatisation programme since the First Development Plan (1988-92) that has been carried onto the Second, Third and Fourth Development Plans. Further recently the parliament enacted the Securities Market Bill, proposed by the government in 16 Oct 2005, which mandates a higher standard of disclosure of information and imposes criminal liability on those who trade shares using hidden information. More recently, Ayatollah Khamina'i, the supreme leader, has sought a huge reform in the article 44 of the Iranian Constitution so as to displace much of the government's monopolies in favour of greater private sector participation. See Jalali Naini (above, note 117) at p 92; Ghani Nejad (above, note 117); Iranian Students News Agency (ISNA) at <http://www.isna.ir> (07/02/2006).

130 According to TSE Listing Rules a public company's shares is not accepted for listing, even in the secondary table of the main Hall, if less than 10 shareholders possess 80 percent of the company's issued shares at the listing stage. The authorised maximum shareholding reduces to 75 percent by the end of second year. And if the company wishes its shares is listed and displayed in the principal table of the main Hall, it needs to ensure that not less than 10 shareholders possess 70 percent shareholding. See TSE Listing Rules available in Farsi at the following website: <http://www.irbourse.com/FForms/gavanin/Section4.aspx#B1>.

Chapter II: Scope of majority rule

In Chapter one, I examined three lines of arguments which are commonly used to found application of majority rule in companies. The intention was to show why and how the rule is justified hereby to demonstrate the source of some of minority problems. Justifications aside, another aspect of the majority rule, which needs to be considered, is its field of application. As this research concerns in great part examination of the rule of majority, its mission will not be completed unless it considers the field of application of the majority rule and I therefore dedicate this Chapter to such consideration. The Chapter concerns the question of scope and intends to show in which area in the relationship between majority and minority shareholders majority rule applies. Although principally shareholders are required to submit to resolutions adopted by a simple majority vote, this, however, does not follow that majority rule applies in every circumstance and on every issue. There are limitations in law that sensibly narrows the scope of applicability of the rule.¹ In England, the common law traditionally had collected these limitations under the category of the so called 'necessity' which meant minority shareholders could initiate derivative actions when such actions were the only way to remedy wrongdoings in companies.² The necessity measure, however, overwhelmed the rule in practice, meaning that if a derivative action were open whenever the majority could block a minority then it

1 *Kaye v. Corydon Tramways* (1898), 1 Ch. 348, 377 per Vaughan Williams L. J.; See Wedderburn K. W., "Shareholder's Rights and the Rule in *Foss v. Harbottle*", (1957), *Cambridge Law Journal*, Cambridge, Cambridge University Press, at p 199.

2 "...to allow, under such circumstances, a bill to be filled by some shareholders on behalf of themselves and others, would be to admit a form of pleading which was originally introduced on the ground of necessity alone, to a case in which it is obvious that no such necessity exists...", [*Mozley v. Alston* (1847), 1 Ph. 790 Per Cottenham L. C.].

would be open all the time. Subsequently, James L. J. in the *Macdougall v. Gardiner* case classified situations that fall beyond applicability of majority rule into the fraud upon minority and ultra vires cases.³ A few years later, *Pender v. Lushington* added to this classification personal rights of corporate members.⁴ In 1950, *Edwards v. Halliwell*⁵, which was a case about a special majority requirement, brought the mentioned limitations together classifying them under the following four headings: 1) Where the act complained of is ultra vires or illegal; 2) Where the matter could validly be done only by some special majority; 3) Where the personal rights of the claimant have been invaded; and 4) Where what has been done amounts to a fraud on the minority.

Although, this classification has attracted considerable support in case law⁶ and among many company law writers⁷, it, however, seems to be more practical than academic, as it does not recognise any distinction between situations that fall beyond the ambit of majority rule and situations that are excluded in law from that ambit.⁸ While the first three headings primarily fall outside the scope of the rule, the fraud upon minority heading is about transactions which are prima facie within the power of the majority, but excluded in law for minority protection reasons. In any case which involves one of

3 *Mac Dougall v. Gardiner* (1875), 1Ch D 13 per James L. J.; see also *Burland v. Earl* (1902), AC 83 per Lord Davey.

4 *Pender v. Lushington* (1877) 6 Ch D 70.

5 (1950) 2 All ER 1064 per Jenkins L. J.

6 *Bamford v. Bamford* (1970), Ch 212; *Prudential Assurance Co. Ltd. v. Newman Industries Ltd and others (No. 2)* (1982) Ch 204; *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2.

7 Wedderburn (1957), (above, note 1) at pp 203-4; Farrar John H., "Company Law", (1991), London, Butterworths, at p 445; Pettet Ben, "Company Law", (2000), Harlow, Longman, at pp 230-1; Stedman Graham & Jones Janet, "Shareholders' Agreement", (1998), 3rd Ed., London, Sweet & Maxwell, at p 76-80; Thorne James (ed.), "Butterworth's Company Law Guide", (1995), Butterworths, London, UK at p 186.

8 *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2 per Megarry VC; Thorne (above, note 7); Pettet (above, note 7) at pp 230-1; Farrar (above, note 7) at p 449; Sealy L.S., "Cases and Materials", (2001), Chap 10, at p 489, London, Butterworths.

the first three headings, a shareholder is permitted in law to take action to stop application of the majority rule. In the case of the fraud exception, however, there would have been no such permission for a shareholder, if the law had not expressly granted its protection.

For a better understanding of the scope of majority rule and in the interest of theorization of the existing practice, I prefer to follow a different type of classification which relies on issues that fall beyond applicability of majority rule, classifying such issues by considering their sources. Accordingly, limitations on the governance of majority rule in corporations can be classified into two categories; i. e. those imposed by the law and those arising from the constitution.

Limitations imposed by the law whether enacted by the Parliament or developed by the courts are always put in a mandatory footing, as distinguished from defaults. The latter refers to rules that allow parties to an arrangement to escape from the scope of them. The former relates to rules that limit parties' freedom and that are not subject to change.⁹ By legal limitations, only mandatory rules are aimed, as defaults have no intrusive feature and parties have always the option to waive them.¹⁰

9 MacNeil Iain, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory", *Journal of Corporate Law Studies*, (June 2001), Oxford, UK, Hart Pub, at p 107.

10 Default or presumptive rules apply to company affairs without the affected parties taking any sort of affirmative step. They apply unless those governed by them elect to opt out. Right attached to shares is an example of this. On the contrary, mandatory rules allow no option to affected parties to displace them. While defaults pursue facilitation of bargaining objective, mandatory rules seek to restrict and regulate market behaviour and to inhibit parties from exercising their personal and contractual preference in certain circumstances. [Cheffins Brian R., "Company Law: Theory Structure and Operation", (1997), Oxford, Clarendon Press, at pp

Such limitations contribute in two ways to draw the framework within which the majority rule works. Either, as a matter of public order and regulation, they impose limitations on private contracts and persons, whether natural or legal. Or, they specifically target the majority/minority relationship and provide some protection to minority shareholders with the intention to prevent abuse of power by majority shareholders. The discussion here concerns only to the former. The latter that include the issue of fraud upon minority shareholders and derivative mechanism will be fully discussed later in Chapter five.

Also, limitations imposed by the constitution affect the majority/minority relationship in several ways. They divide corporate power between shareholders and directors through which a great deal of corporate powers is delegated to directors. By doing so, they limit the size of power directly exercisable by the majority. They also determine the object for which the company is formed and should work and they hereby majority shareholders from authorising any ultra vires activity. They may further list certain issues that require a super majority vote, something which is beyond application of the majority rule. In addition to these, they confer on members some personal rights that fall outside the power of majority shareholders.

As legal and constitutional rules play decisive role in the majority/minority relationship, I must review and examine their relevance as to such relationship and I do so in this Chapter. The Chapter is divided into two sections. Section one considers the legal rules and section two concerns with the constitution and specifically examines

four constitutional mechanisms; i. e. internal division of power, ultra vires issues, special majority requirement and personal rights; that coordinate to shape the majority rule's field of application.

II.1. General laws

Shareholders once taking corporate decisions in meetings are required in both English and Iranian systems to observe legal rules since complying with the law is necessary for every person, whether natural or legal. When the lawmaker prohibits people from doing certain acts, it often aims to implement certain observations that are ranked prior to individual freedom. To permit individuals to act illegally contradicts the purpose for which the very Act is enacted and condones an attack on the law. Unlawful activities fall outside the power of companies and as a result cannot be authorised by majority shareholders. Acts are unlawful when they are prohibited in law in the sense of legally impossible for companies to engage such conducts.¹¹ The word unlawful covers any violation to the mandatory rules of company law¹² as well as any act, which is prohibited by the general law.¹³ Where a company is engaged in unlawful issues, a minority shareholder can take action against the company and sue wrongdoers on behalf of the company for the simple reason that illegal acts are totally outside the power of a company and cannot be ratified even with the unanimous decision of shareholders.¹⁴ In such cases, law interferes simply because it is vital to preserve interests of the public. Take the case of England, section 142 Companies Act 1985, for instance, requires public corporations to take steps to appropriately deal with major loss of assets. Similarly, section 143 Companies Act 1985 prohibits companies from purchasing their own shares at a discount. Similar mandatory rules can be found in Iranian law too. For example, majority shareholders cannot take decision on issues

11 Wedderburn (1957), (above, note 1) at p 204.

12 For instance, sections 142 and 143 Companies Act 1985; for case law examples see *Bellerby v. Rowland & Marwood's* (1902), 2, Ch. 14; *Hope v. International Financial Society* (1876), 4 Ch. D. 327.

13 *Powell v. Kempton Park Racecourse Co.* (1897), 2 Q. B., pp 242, 260, 268.

exercise of which constitutes crime.¹⁵ Similarly, a shareholder meeting is not of power to exempt directors from their duty to set the statutory saving for the company, as the duty to set statutory saving is mandatory.¹⁶ Any violation to mandatory rules of company law gives every shareholder right to take action against the company and those who are responsible for such violation, asking for a nullification order and damages, if any.¹⁷

English and Iranian company laws have diverged on the issue of legal rules in the sense that the former recognises a distinction between threatened and past unlawful activities as it does so in respect of *ultra vires* activities¹⁸, while the latter knows no such distinction.¹⁹

14 Pennington Robert R., "Company Law", (1990), 6th ed., London, Butterworths, at p 802.

15 Sections 90, 237-240 and 258 (1) JSCA.

16 Section 140 JSCA.

17 See sections 270 and 273 JSCA.

18 Pettet (above, note 7) at pp 230-1; Thorne (above, note 7) at p 186; Farrar (above, note 7) at p 446.

19 This distinction will be discussed in more details in the following section. [See below, at II.2.2].

II.2. Constitution

The majority/minority relationship is often mainly regulated through constitution. Corporate members through the constitution determine the purpose of company, provide guidelines for corporate incumbents on things to do and things not to do, devise some checks over controllers, and enjoy some rights which subject discretion of corporate authorities. Constitutional rules can, therefore, be described as corporate self-regulation; i. e. regulations that parties to the company contract make to enable their corporate vehicle to be incorporated and work efficiently. The term 'constitution' refers either to the articles of association of corporations, as it does so in the case of Iran²⁰, or in the case of England, to both the articles and the memorandum of associations.²¹ Speaking generally, constitutional rules, which limit the scope of power held by majority shareholders, can be classified into four categories as shown below and I will examine them in the following parts in the light of both Iranian and English company laws:

1. Internal division of powers
2. *Ultra vires* issues
3. Special majority requirement
4. Personal rights.

20 Sections 6, 8, 17, 18, and 20 JSCA.

21 Sections 1(1), 2, 7(1), 8(2), 10, 13, 14 Companies Act 1985.

II.2.1. Internal division of powers

In modern companies, the exercise of corporate power is often divided between shareholders and directors. The common format is to vest the power to run the business of corporations on a day-to-day basis in directors who exercise it through board decisions and to preserve for shareholders monitoring function which is exercised through shareholder meetings. Accordingly, shareholders delegate broadly their powers to directors²² who run the company business and who take business decisions for it.²³ This division of powers between shareholders and directors relies on certain practical and functional logics. Practically, in the absence of such division, it appears almost impossible for dispersed shareholders especially in large companies to engage themselves with the day-to-day management of corporate business. Competition in the market, which underlies business activities, requires quick action, whereas shareholder action is normally slow. Either, shareholders do not have time for a day-to-day management of the corporate business or even if they have time, they must act collectively which is difficult and slow. When, for example, a business opportunity emerges in the market, business rivals never wait until a given company's shareholders gather, discuss, take decision collectively and act. These difficulties are absent when management is vested in directors. Functionally, shareholders are not often very well experienced and informed of corporate business and, even if they are, they have no or little incentive to involve in running of the corporate business. Unlike

22 Art 70, Table (A) Companies Act 1985.

23 "subject to the provisions of the Act (Companies Act 1985), the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company". [Art 70, Table (A) Companies Act 1985]; See also Pettet (above, note 7) at p 226; Parkinson J. E., "Corporate Power and Responsibility", (1993), Oxford, Clarendon Press, at p 237, 9; Hale, Christopher, "What's Right with the Rule in Foss v. Harbottle?" (1997), *Company Financial and Insolvency Law Review*, Oxford, Mansfield Press, 219 at p 224].

shareholders, directors as competent persons who have expertise in business can undertake the management professionally. The practical and functional logics aside, there is also a third logic, which concerns the majority/minority shareholder relationship in companies. Internal division of powers is capable to contribute to rein the majority rule in companies. The mechanism of division extracts some parts of corporate powers from majority shareholders and places them in the hands of directors who may seem better positioned as an independent authority in company to exercise them.²⁴ This might also seem more realistic when one notes that company law has designed viable ways to allow shareholders have directors aligned with the company best interest objective. Nonetheless, once closely examined, it will be soon realised that the division of power could offer no significant protection to minority shareholders. Any extensive delegation of power to directors can be dangerous to either minority shareholders or shareholders generally. Where a controlling shareholder is present, it can facilitate abuse of rights by the controllers. Where such control is absent, it would put directors in a position that they can easily pursue collateral objectives and continue office with impunity.²⁵ If this were the case, and as the case law²⁶ and many commentators²⁷ have emphasised it is often the case, then it would seem very

24 Farrar (above, note 7) at pp 315-6, 385; Ratner David L., "The Government of Business Corporations: Critical Reflections on the Rule of One Share, One Vote", *Cornell Law Review*, (1970), Number 1, Vol. 56, 23 Cornell University, Cornell Law School, at pp 21, 35-8.

25 Farrar John H., "Company Law", (1985), London, Butterworths, at p 7; Parkinson (above, note 24) at p 246.

26 *Atwool v Merryweather* (1867) 5 Eq. 464 n.; *Daniels v. Daniels* (1978) Ch 406; *Prudential Assurance Co Ltd v. Newman Industries Ltd (no 2)* (1981) Ch 257, (1980) 2 All ER 841; *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9; *Richard Brady Franks Ltd v. Price* (1937), 58 CLR p 136; *Howard Smith Ltd v. Ampol Petroleum* (1974), AC p 832; *Hogg v. Gramphorn Ltd.* (1967), 1 Ch 254; *Clemens v. Clemens Bros Ltd* (1976), 2 All ER 268; *Re Smith and Fawcett, Limited* (1942) 1 Ch 304.

27 Wedderburn K. W., "Shareholder's Rights and the Rule in *Foss v. Harbottle*", (1958), *Cambridge Law Journal*, 97, Cambridge, Cambridge University Press, at p 97; Parkinson (above, note 24) at pp 237-246; Pettet (above, note 7) at p 226.

unlikely²⁸ that a wronged company could take action against its wrongdoer directors. The power to take corporate actions rests in directors and in a case where directors themselves are the actual wrongdoers no action will commence.²⁹ The safer arrangement is perhaps to have a system of corporate governance in which shareholders overallly control directors. Such arrangement can offer a two-sided guarantee for minority shareholders. On the one hand, in exercising their powers, directors owe fiduciary and care duties to companies which means they should act carefully and should regard interests of all shareholders not simply the majority. On the other hand, in the exercise of their monitoring role, the majority helps to keep management in the line of shareholder wealth maximisation which benefits minority shareholders too. Yet, the overall control of the majority over directors is also dangerous, as majority shareholders can indirectly influence management so as to push them exercise their power only for the benefit of the majority. Thus, two issues must be addressed. One relates to examination of how corporate power is distributed between corporate organs and the other concerns consideration of directors' duties and the relevance of their role as to the majority/minority shareholder conflict. I consider the first issue below but the second issue will be examined in Chapter four.

In England, company law determines for modern corporations two internal organs, general meetings and boards. Companies Act 1985 provides guidelines in general terms about how power is distributed between the two mentioned organs. It requires

28 Parkinson (above, note 23) at p 237; Farrar (above, note 7) at p 444; Pettet (above, note 7) at p 226; Hale (above, note 23) at p 224.

29 In some exceptional cases, directors may, in fact, bring proceedings to remedy wrongdoing committed by their fellow directors. One main case is where the control of the company passes to other persons such as a liquidator in liquidation or to a new board elected by a successful takeover bidder. [See Pettet (above, note 7) at p 226 and Parkinson (above, note 23) at pp 237-9].

that every company shall in each year hold a general meeting as its annual general meeting.³⁰ In addition to annual general meeting, a company may also from time to time hold other general meetings, which are called extraordinary general meetings. Certain important matters can only be decided by shareholders in extraordinary meetings.³¹ Shareholders through meetings also control activities of directors and in particular they have power to reappoint directors to, or remove them from, the office.³² Companies Act 1985 also requires that every company must have a director or directors who manage company business³³ and whose acts bind the company even where shareholders fall in disagreement with them.³⁴ General guidelines aside, the Act rejects, perhaps intentionally, to list in details the sort of power each organ will have and to tell how precisely the affairs of companies are to be managed. These are left to shareholders who can determine them through articles of associations³⁵, which is, as a constitutional document, suitable for regulating corporate internal relationships and affairs.³⁶ In short of a shareholder drafted articles, shareholders are assumed in law to have accepted³⁷ default articles prescribed by the Table A Companies Act 1985 which provides in its Art 70:

30 Section 366 Companies Act 1985.

31 Some of these matters are: to alter the objects of the company (s 4); to alter the company's articles of association (s 9 (1)); to change the company's name (s 28 (1)); to ratify ultra vires acts of directors (s 35 (3)); to authorise directors to allot shares (s 80); to reduce share capital (s 135 (1)) Companies Act 1985.

32 Section 303 (1) Companies Act 1985.

33 Section 282 Companies Act 1985.

34 "...the power of the directors to bind the company is deemed to be free of any limitation under the memorandum or articles." [section 35 (1) Companies Act 1985].

35 Pennington (above, note 14) at p 765.

36 Sections 7-9 Companies Act 1985; unlike articles, memorandum of associations governs the external transactions of the company. It is the public document from which those dealing with the company can establish significant features of the company, such as whether it is public or private, limited or unlimited and, for a limited company with share capital, the amount of the share capital. [Sections 1-6 Companies Act 1985].

“Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company...”

However, both a shareholder drafted and the Table A model articles, are inevitably incomplete failing to offer detailed prediction of every contingency. Filling up of this gap is the responsibility of the case law, which has given, from time to time, more guidelines in this respect. According to the case law, directors do not act as agents for majority shareholders.³⁸ Neither are they agents for all shareholders.³⁹ This follows that members cannot instruct directors about how they shall exercise their powers. Similarly, it has been accepted that running the business is a managerial function that rests in directors. Shareholders only exercise control through general meetings⁴⁰ and they cannot interfere with the exercise of managerial powers⁴¹ that can extend from mere business issues to financial incidents of the business.⁴² Case law has also made it clear that acts of shareholders particularly in the exercise of their controlling function may affect directors in overall but that is not to be viewed as interference in the exercise of managerial powers.⁴³ Likewise, case law prohibits directors from interfering in the exercise of shareholder powers.⁴⁴

Iranian company law, on the other hand, provides three internal organs for companies, board of directors, inspectors, and shareholder meetings. The board of directors,

37 Section 8(2) Companies Act 1985.

38 *Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunninghame* [1906] 2 Ch 34 p 42-43 per Collins MR.

39 *Gramophone and Typewriter Ltd v. Stanley* [1908] 2 KB 89 p 105-106 per Buckley L.J.

40 *Gramophone and Typewriter Ltd v. Stanley* (1908), 2 K. B. 89 per Moulton L. J.

41 *John Shaw & Sons Ltd. v. Shaw* (1935), 2 K B., 113 per Greer L.J.

42 *Scott v. Scott* (1943) 1 All ER 582, per Lord Clauson.

43 *Isle of Wight v. Tahourdin* (1883) 25 Ch D 320, Per Cotton L.J.

44 *Hogg v. Cramphorn Ltd.* (1967) 1 Ch 254, at pp 268-9 per Buckley J.

members of which are appointed among, and by, shareholders⁴⁵, conducts a company's business and manages its affairs⁴⁶ which include representation of the company in its external relationships.⁴⁷ Before the introduction of the JSCA, directors were treated as agents of, and having agency relationship with, shareholders and they owed their duty to shareholders as principal.⁴⁸ This was inconsistent with separate corporate personality⁴⁹ and was to mean that directors had no power unless what and to the extent that they were given either expressly or impliedly through articles or by shareholder resolutions in appropriate cases. Their acts could create no legal effect what so ever in cases where they exceeded their powers or breached their fiduciary duty. Transactions of this sort even in relation to third parties were always considered voidable and a wrongdoer director was also personally liable for committing tort both to the company and to third parties if his acts would entail damages. However, the position of the company law in relation to the power of directors has changed sharply with the enactment of the JSCA. By the new Act, directors are no longer agents of shareholders. They act for the company, owe their duties to it and excluding certain listed issues that fall within the powers of meetings, they have very extensive power to take every action, which is necessary for managing affairs of the company provided that their decisions and acts are in line with the object of the company.⁵⁰ Directors' extensive power is deemed in relation to third parties even where the rules of articles of association or any appropriate resolution of shareholders in meetings have no

45 Section 107 JSCA.

46 Section 108 JSCA.

47 Section 118 JSCA provides that 'except where making and implementing decision on an issue is within the authority of shareholder meetings, directors of a company possess all necessary powers in order to run company affairs.'

48 Section 56 TA.

49 Sotoodeh Tehrani Hasan, "Trade Law", (1997), Tehran, Dekhoda Publication, vol. 2, at pp 151, 185-186.

indication of that power, or even where they expressly limit the scope of such power and even if they do not consider the interests of the company for which they are transacting.⁵¹

The second internal body that exercises certain corporate powers is inspectors. They investigate the company on behalf of shareholders. Their investigation is overall and includes taking every step which is necessary for the exercise of right of control by shareholders over corporate directors and their appointed management, and this, of course, must be exercised without interfering in the exercise of management's power to run the company business. They are under a statutory duty to the company⁵² to exercise certain functions which cannot be stopped by a majority resolution. These functions are: to comment on directors' annual reports⁵³; to control truth and reliability of information given by directors to meetings⁵⁴; to make sure company treats shareholders equally⁵⁵; to convene annual general meetings in case of directors' failure to convene⁵⁶; to convene extraordinary meetings when they think it is necessary⁵⁷; and to report any fault⁵⁸ and probable crimes⁵⁹ of directors.⁶⁰

50 Section 118 JSCA.

51 Such limitations are only operative in relation between company and its directors. [Section 118 JSCA].

52 See section 154 JSCA.

53 Section 148 JSCA.

54 Sections 148, 150 and 151 JSCA.

55 Section 148 JSCA.

56 Section 91 JSCA.

57 Section 92 JSCA.

58 Section 117 JSCA.

59 Sections 148-151 JSCA.

60 Inspectors, therefore, perform quite different functions in Iranian corporations contrast to functions of auditors in English company law which are stated in sections 384-394 Companies Act 1985. The use of auditors as distinguished from inspectors has also been prescribed by Iranian company law in section 242 JSCA which imposes a statutory duty on directors in public companies to invite official auditors to check and, in case of reliability, certify the company's accounts and business books and balance sheets and other relevant financial documents.

General meetings constitute the third internal body that exercise corporate power. Company law prescribes three types of meetings. Founders meeting is the first corporate meeting which is convened before the company is legally formed.⁶¹ All founders and share subscribers are entitled to attend in this meeting and each share will have one vote.⁶² The function of this meeting is generally to review every preliminary step taken by founders in the company formation stage in order to ensure everything is done as accurately as the company law requires. Having checked all requirements, they will sign the articles and choose the first directors and inspectors and by doing this they complete formation of company and further finish the mission of founders meeting.⁶³ The second corporate meeting is the extraordinary meetings which are convened by directors to address matters of fundamental change such as alteration of articles of association, change in the size of the share capital, and pre-date dissolution of company.⁶⁴ To be formally valid, this meeting requires participation of at least half plus one of those shareholders who have voting rights⁶⁵ and when there is a valid meeting, resolutions are adopted by a two third majority.⁶⁶

61 Section 82 JSCA exempts private companies of the requirement of founders meeting.

62 Section 75 JSCA.

63 To be formally valid, this meeting requires participation of subscribers who own at least half plus one of company shares. If this requirement was not met for the first time, the required amount of capital reduces to one third of such subscribers and in any case they reach decisions by a two third majority resolution. [Section 74 JSCA].

64 Sections 83, 161, 189 and 199 (4) JSCA; Also it has authority to allow directors to issue preference shares (sec. 42) and debentures (sec. 56).

65 If this requirement was not met for the first time, the required number of voting right holders reduces to one third of such shareholders and in any case they reach decisions by a two third majority resolution. [Section 84 JSCA].

66 Section 85 JSCA.

Having aside funders and extraordinary meetings which are either single purposed or exceptional, ordinary general meetings are the third corporate meeting which regularly convened at the instance of board of directors at a constitutionally specified time and on a once-a-year basis and hence is called annual general meeting.⁶⁷ Directors and inspectors can also convene ordinary meetings extraordinarily.⁶⁸ Ordinary meetings have quite wide discretion to take decision on all issues in relation to the affairs of companies except those which fall within the powers of funders and extraordinary meetings.⁶⁹ They have authority in particular to appoint/disappoint directors⁷⁰, to review balance sheets and annual report provided by directors⁷¹, to check list of company assets, financial claims and debts⁷², to verify and authorise distribution of profit shown by directors⁷³ and to ratify certain corporate transactions in which directors have personal interest.⁷⁴ To be formally valid, this meeting requires participation of those shareholders who own at least half plus one of company shares, having voting right. If this requirement was not met for the first time, a second call will initiate and this time participation of whatever voting shares would suffice⁷⁵ and in any case decisions will be adopted by a simple majority of those present.⁷⁶

67 Sections 89 and 138 JSCA.

68 Section 92 JSCA.

69 Section 86 JSCA.

70 Section 88 JSCA; This is subject to the authority of the promoters' meeting in respect of appointing the first directors. [See above note 63].

71 Section 89 JSCA.

72 Section 89 JSCA.

73 Sections 90 and 240 JSCA.

74 Sections 129-131 JSCA.

75 Section 87 JSCA.

76 Section 88 JSCA.

II.2.2. Ultra vires issues

In the case of England, the *ultra vires* doctrine used to require companies to act in compliance with their object clause. A transaction made by a director on behalf of his company which was outside the object clause in memorandum of association was treated void having no effect what so ever and thus a third party was not able to enforce it. Such transaction was also irratifiable even with a unanimous consent of company shareholders.⁷⁷ However, the traditional connection between a company's objects and its capacity was abolished following the Companies Act 1985.⁷⁸ A company has now capacity to engage any legal act even though outside its stated power and the majority is now able to ratify such act and therefore bind the company and its members. Section 35(3) Companies Act 1985 and section 108 Companies Act 1989 have conferred such a capacity to the majority to ratify *ultra vires* acts. Thus *ultra vires* transactions no longer constitute a significant limitation on the rule of majority in English companies. An *ultra vires* act is now within the power of the company capable of being ratified by the majority.⁷⁹ The only statutory check imposed by company law is the requirement of a greater majority, i.e. a majority of three-quarters of the holders of voting rights. Yet, the object clause remains relevant for the purposes of preventing the company from engaging in any future *ultra vires* activities. A company member has right to bring proceeding in order to restrain the company of doing any future act or from the progressing any act which is beyond the company's capacity.⁸⁰ This right does not affect any act that is previously done by the company. It has also no effect on the

77 *Ashbury Railway Carriage and Iron Co Ltd. v. Riche* (1875) LR 7 HL 653.

78 "The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum". Section 35 (1).

79 *North West Transportation Co Ltd. v. Beatty*, (1887), 12 App CAS 589.

fulfilment of obligations arisen from a previous act of the company.⁸¹ Neither it is to restrain the company from doing acts or entering into transactions that are incidental to the stated powers of the company, as these are not considered *ultra vires*.⁸² In addition to this, in respect of acts that fall within the capacity of the company but are outside the powers of its directors⁸³, a member has right to bring proceedings in order to restrain directors from doing of such acts.⁸⁴ However, again the right has no effect on acts, which are previously done, or on fulfilment of obligations which arise from a previous corporate act.⁸⁵ Although *ultra vires* transactions are now presumed valid in favour of persons who deal with company, this presumption does not relieve directors from personal liability before the wronged company. As Companies Act states any special resolution that ratifies such acts shall not affect directors' liability unless a separate special resolution actually relieves them from the liability.⁸⁶

Although the law is clear in respect of when a shareholder can take action in respect of *ultra vires* transactions, arguments have been brought to challenge the law and to give right of personal recovery to shareholders in such cases. The touchstone argument is the one that suggests *ultra vires* acts can constitute not only a wrong to the company but also a wrong to the membership rights of every member. In other words, since such acts are unconstitutional, a shareholder can complain that any departure from the

80 "A member of a company may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity." [Section 35(2) Companies Act 1985].

81 See section 35(2) Companies Act 1985.

82 *A-G v. Great Eastern Rly Co* (1880) 5 App Cas 473 (House of Lords).

83 "In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution." [section 35A (1) Companies Act 1985].

84 Section 35A(4) Companies Act 1985.

85 Section 35A(4) Companies Act 1985.

constitution is a departure from the terms of his contract and as a consequence he should have a choice between taking derivative and personal actions.⁸⁷ However, for a number of reasons, this approach does not seem correct and can bring about undesirable consequences. For one, it allows dual actions (one, by a member in his personal capacity, and the other, by a member in the capacity of the representative of the company) to be taken, both for remedying the same wrong. This increases the existing level of overlap between personal and corporate rights and in its extreme application helps to defunct the majority rule. For another, it seems conflicting with the nature of the relationships between members and directors with companies. As a matter of company/members relationship, an *ultra vires* act is not attributed to the company unless ratified by it. Without a proper ratification the act is considered as being only the act of company directors who are not a party to the company contract.⁸⁸ There are rules that separate acts of companies from those of persons who work for companies. These are usually labeled as the rules of attribution that can be found in case law.⁸⁹ One of those rules is the agency rules that refer to the situations in which a director acts as agent of the company and therefore his actions are attributed to the

86 Sec. 35(3) and sec. 35 A (5) Companies Act 1985.

87 Baxter Colin, "The True Spirit of Foss v. Harbottle", (1987), Northern Ireland Legal Quarterly, Vol. 38, No. 1, Belfast, Stevens & Sons, at p 10; Thorne (above, note 7) at p 188; Farrar (above, note 7) at pp 445-8; Pettet (above, note 7) at pp 230-1; Pennington, Robert R., "Company law", (2001), 8th ed., London, Butterworths, at pp 800-1; Wedderburn (1957) (above, note 1) at p 206.

88 The concept of statutory contract referred to by section 14 Companies Act 1985 only speaks of two contracts, one, between company members inter se and the other, between members and company. Directors are parties to neither of them. They have a separate contract with the company to provide service to it. As a result they are under contractual duty to the company rather than its shareholders.

89 Meridian Global Funds Management Asia Ltd. v. Securities Commission (1995) 2 AC 500 per Lord Hoffman at p 506; Trevor Ivory v. Anderson, (1992), 2 N.Z.L.R. 517; Tesco supermarkets Ltd v. Nattrass, (1977), A.C. 153; Lennard's Caring Co. Ltd. v. Asiatic Petroleum Ltd. (1915), A.C. 705; Alder v. Dickson (1955), 1 Q.B. 158.

company through the normal rules of agency.⁹⁰ These rules exclude *ultra vires* activities from being attributed to the company unless the company ratifies them⁹¹ and once ratified, they can constitute a breach of the articles (though not illegal) by the company for which a personal remedy can be obtained. If the company does not ratify the *ultra vires* act, then, it is not considered the act of the company even though a third party can hold the company bound to that act.⁹² That, a third party can hold a company to assume responsibility for *ultra vires* acts of its directors, is only an exception from the general principle in favour of third parties acting in good faith. Therefore, there cannot be a breach of membership rights as the act is not that of company and as a consequence no personal remedy would be conferred. The director remains responsible for this act⁹³ but any action taken by a shareholder would have to be through the derivative form, assuming that the company failed to act.

The recognition of personal right for shareholders in respect of *ultra vires* issues after ratification can be advantageous as well as disadvantageous. It is advantageous because it can eliminate overlap between corporate and personal rights in *ultra vires* cases. According to it, where a case involves *ultra vires* activity only two alternate contingencies can be imagined. Either, it involves a violation to personal right that is where the act is ratified. Or, it involves a violation to corporate right that is where it is not ratified. It is disadvantageous because any such reading can fall inconsistent with the logic of section 35(3) Companies Act 1985 and section 108 Companies Act 1989 that

90 *Fairline Shipping Corp. v. Adamson* (1974), 2 All E.R. 967; *Williams v. Natural Life Health Foods Ltd.*, (1997), 1 BCLC 131; *Kirby v. National Coal Board* (1958), SC 514; *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*, (1964), A.C. 465.

91 See also section 35 (3) Companies Act 1985.

92 Section 35A (1) Companies Act 1985.

93 Section 35A (5) Companies Act 1985.

allow ratification of *ultra vires* acts by companies. As Lord Davey⁹⁴ and Knox J⁹⁵ put it a minority plaintiff cannot have a larger right to relief than the company itself would have if it were plaintiff. As a result, a minority shareholder cannot complain of acts, which are capable of being confirmed by a special majority unless it is shown that the majority in ratification has committed fraud upon the minority.⁹⁶ When an *ultra vires* act is threatened a shareholder has a personal right to apply to the court to restrain such proposed act. The reason, as Knox J explained lays in the fact that 'neither of the two bases for the rule (in *Foss v. Harbottle*) is applicable, that is to say the matter is not, by definition, a mere question of internal management nor is the transaction capable of ratification by or on behalf of the company'.⁹⁷ However, when the case relates to a past *ultra vires* transaction involving a compensation demand for the loss to the company, only the wronged company can initiate action and any action by minority shareholders must be in a derivative form, which must also be subject to observation of section 35 (2, 3) Companies Act 1985.

In the case of Iran, the *ultra vires* doctrine still persists in company law.⁹⁸ Legal persons can perform only functions that conform the object for which they are formed.⁹⁹ This is

94 *Burland v. Earl* (1902), AC 83.

95 *Smith v. Croft* (No. 2) (1988) Ch 114 at 167, (1987) 3 All ER 909 at 943.

96 *Smith v. Croft* (No. 2) (1988) Ch 114 at 170, (1987) 3 All ER 909 at 945; See also Farrar (above, note 7) at p 446; Thorne (above, note 7) at pp 186, 230-1; Pennington (above, note 87) at pp 800-1; Conway Mark, "Minority Shareholder Protection and the Rule in *Foss v. Harbottle*: Increasingly a *Foss* about Nothing" in *Companies in the 1990s*, edited by Gary Slapper, (1995), London, Cavendish, at pp 3-4.

97 *Smith v. Croft* (No. 2) (1988) Ch 114 at 170, (1987) 3 All ER 909 at 945.

98 "except where making and implementing decision on an issue is within the authority of shareholder meetings, directors of a company possesses all necessary powers in order to run the company affairs providing that their conducts and decisions are within the scope of stated object of that company..." [Section 118 JSCA].

99 As well as object clause restriction, corporate capacity is also restricted by natural limitations, which separates them from individuals. [Section 588 TC]; See generally Motamani Tabatabaai Manoochehr, "Legal Personality", in *Developments of Private Law*, (1992/1372), Edited by

to prevent such persons from irrelevant activities and to allow them to save their resources to be used efficiently. Also in the interest of the society, this facilitates specialization and functional order, as with it not every legal person would be able to perform every function.¹⁰⁰ Obviously companies as clear instances of legal persons and in conformity with the law have certain objects specified in their articles. These objects draw the framework within which companies can take decisions. If the object clause limits the object of a company to, for instance, producing carpet and to take every measure in that respect, the company cannot switch to the production of, and transactions in relation to, ceramic unless it first alters its objects in order to include new objects. Inconsistent transactions are basically void and produce no effect. Equally true, a transaction that a company cannot engage, its internal organs (meetings, and board of directors) cannot engage too¹⁰¹ and a third party who is a contractual party to such transaction will not be able to enforce it against the company.¹⁰² Such transactions give every shareholder right to commence personal actions against the wrongdoer company and its controllers and in the exercise of such right it makes no difference whether the *ultra vires* transaction is threatened or is already completed, though, a possible order of the court may differ.

Katoozian Naser, Tehran, University of Tehran Publication, pp 242-3; Sotoodeh Tehrani Hasan, "Trade Law", (1996), Tehran, Dadgostar Publication, vol. 1 at p 144; Eskini Rabiaa, "Trade Law: Business Corporations", (2000), Vol. 2, Samt Publication, Tehran, at p 149.

100 For example, a registered society for the protection of animal rights is not of capacity to take a claim to the courts for the protection of human rights.

101 Section 8 JSCA requires companies to mention expressly the object of the company as a clause in their articles of association and submit the articles to the public registrar for the purpose of registration. Also see section 118 JSCA (cited above, note 98).

102 Motamani Tabatabaai (above, note 99) at pp 225, 243; Sotoodeh (above, note 99) at p 149.

II.2.3. Special majority

The constitution often requires a greater majority vote for making a collective decision on certain important issues that touch more or less the core basis of a shareholder's agreement with company and its other members. This occurs when controllers try to change terms of original articles through later constitutional amendments. However, not every change is considered opportunistic. When circumstances change, constitutional rules may need to change in order to become updated. Nonetheless, controllers can also change them even though there is no or little change of circumstances. The latter is often the case where the controllers attempt to engage in opportunistic constitutional amendments. Therefore, a balance should be made between the changability of constitution and the consideration that minority rights need to be protected from opportunistic changes to the constitution which can be made by a simple majority resolution. The greater majority requirement can offer some safeguards to individual shareholders against any likely attempts of majority shareholders to change original articles opportunistically. In the absence of it, a majority shareholder could easily circumvent important elements of constitution through changing terms of the original contract. Its functioning is simply to require a controlling majority to obtain minority consent in certain issues. If the majority fails to do so, every dissatisfied shareholder will have the right to commence legal action for an order of the court, which nullifies majority action. Case law confirms the right of a minority shareholder to protect him/herself in such cases. It is clear in case law that majority rule does not prevent an individual member from suing if the transaction in question is one which could validly be done or sanctioned only by a special majority resolution otherwise, a company would be allowed to act in breach of its articles by

passing an ordinary resolution instead of a special one in matters that could only be done or sanctioned by the latter.¹⁰³

The size of a higher majority vote requirement often depends on shareholder consent although a three quarters majority seems to be the most frequently used size. Companies Act 1985 illustrates the range of issues that require special majority vote. For instance, section 4 prescribes a special majority requirement for altering the objects of company and section 9 (1) requires such majority for altering corporate articles. Also, section 28 (1) necessitates a special majority for changing company name and sections 35 (3), 80 and 135 (1) prescribe such majority respectively for ratifying *ultra vires* acts of directors, authorising directors to allot shares and reducing corporate share capital.

Special majority exception in this context includes not only a greater level of votes but also all formalities and processes associated with it as prescribed by the constitution and company law.¹⁰⁴ In *James v. Buena Ventura Nitrate Grounds Syndicate Ltd*¹⁰⁵, for example, corporate articles prescribed a specified method for issuing new shares. Although, this method was principally alterable through altering the very articles of association with a special majority resolution, but shareholders adopted a different method by a special resolution without having the articles altered first. Although this resolution was passed by the votes of a greater majority, the court construed it to be an attempt to alter articles of association in an inappropriate way.¹⁰⁶ Similarly, when

103 *Cotter v. National Union of Seamen* (1929), 2 Ch 58 per Romer J.

104 *Allen v. Gold Reefs of West Africa, Limited*, (1900) 1 Ch 656 at 671 per Lindley MR.

105 *James v. Buena Ventura Nitrate Grounds Syndicate Ltd.* (1896), 1 Ch. 456.

106 *Ibid.* See also Farrar (above, note 7) at pp 446-7.

removal of a director required alteration of articles, it would seem inappropriate for shareholders to pass simply a special resolution without having articles altered first.¹⁰⁷

Similar safeguards that subjects application of majority rule to a greater majority requirement can be found in Iranian company law. In particular, issues that fall within the power of extraordinary and founder meetings can be taken as most clear examples.¹⁰⁸ In addition to these, shareholders in ordinary meetings are required to pass with a two-third-majority of votes cast any resolution that seek to change shareholder rights.¹⁰⁹

II.2.4. Personal rights

Personal rights refer to the rights that are personal in the sense that they fall into the personal pocket of every shareholder. A shareholder, needless to act with other shareholders, is theoretically able to enforce such rights. Personal rights in its wide application can constitute a major limitation on the scope of majority rule because they generally allow shareholders to take action in order to enforce company contract against controllers. Nonetheless, the impact of personal rights has become rather trivial as they are not all enforceable by a shareholder and even those that are enforceable might become subject to the majority rule. To explain why this is so, one needs to grasp a clear understanding of the nature of personal rights and the relationship which exists between shareholders and companies under the company contract. This itself depends on making distinction between company contracts and other contracts. Unlike

107 *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9 at p 21 per Scrutton L. J.; see also for a similar case *Bushell v. Faith* (1970), 1 All ER 53.

108 See above, notes 61-66.

traditional contracts, company contracts do not allow parties to enforce outsider rights.¹¹⁰ This means that a company is entitled as against its members to enforce and restrain breaches of its regulations¹¹¹ and that shareholders as against their company can enforce and restrain breaches of such regulations¹¹² and that shareholders can enforce the contracts made inter se as members of the company.¹¹³ However, shareholders can only enforce rights which are obtained in the capacity as members.¹¹⁴ To enjoy such capacity one needs to enter into contract with company and its members in which he undertakes with respect to most rights, which his membership carries, to accept as binding upon him the exercise of his corporate rights by the company.¹¹⁵ A company member, therefore, obtains two types of rights, which arise out of the company contract, those of personal and corporate.¹¹⁶ Corporate rights are those that belong to shareholders as a body corporate¹¹⁷ and its attribution to shareholders is only for the reason that shareholders are given power to apply either direct or indirect control on the exercise of them and for the fact that they (shareholders) enjoy, as residual right holders, the consequences of such exercise either positively (annual profits given to shares and increase in their market value) or negatively (loss suffered by the company that reduces the share price or expected profits). Internal organs,

109 See section 93 JSCA.

110 *Wood v. Odessa Waterworks Co.*, (1889), 42 Ch. D 636; *Rayfield v. Hands and Others*, (1960), Ch. 1; *Hickman v. Kent or Romney Marsh Sheepbreeders' Association*, (1915), 1 Ch. 881; *Re Saul D Harrison & Sons plc* (1995), 1 BCLC 14 at 17.

111 *Borland's Trustees v. Steel Bros. Ltd.*, (1901), 1 Ch 279.

112 *Wood v. Odessa Waterworks Co.*, (1889), 42 Ch. D 636; *Johnson v. Lyttle's Iron Agency*, (1877), 5 Ch. D. 687.

113 *Rayfield v. Hands and Others*, (1960), Ch. 1.

114 *Hickman v. Kent or Romney Marsh Sheepbreeders' Association*, (1915), 1 Ch. 881; *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9 at p 21 per Scrutton L.J.; *Swabey v. Port Darwin Gold Mining Co.* 1 Megone 385 Cited in *Allen v. Gold Reefs of West Africa, Limited*, (1900) 1 Ch 656.

115 Section 14 Companies Act 1985.

116 *Palmer Francis Beaufort*, "Palmer's Company Law", (1976), 22nd ed., Edited by Schmitthoff C.M., London, Stevens, at pp 597-603; Pennington (above, note 87) at p 795.

board of directors and general meetings of shareholders as the case might be, represent the company in the exercise of them.¹¹⁸ Clear examples of such rights are right to enter into transactions, the right to bring proceedings, the right to make resolutions, the right to alter articles and the right to ratify a wrong done to the company.

By contrast, personal rights belong to individual shareholders and fall outside the powers of majority shareholders. As personal rights originate from constitution, they are also often liable to change through procedures prescribed by the constitution. It is hardly possible to enumerate them, but familiar instances include the right to have information, the right to attend at meetings and vote,¹¹⁹ pre-emption rights¹²⁰, the right to transfer shares¹²¹, the right to share in profits, and the right to share in capital in case of dissolution.

Personal rights may derive also from other sources such as statutes¹²² and separate shareholder agreement.¹²³ If company law in a mandatory fashion confers personal rights, majority rule will have no application on them and they will not be liable to change through contract. Similarly, if a member acquires his personal rights from a separate agreement, his rights will become inviolable and will be safe from change through contractual mechanisms and, therefore, such rights sit out of the ambit of the

117 *Greenhalgh v. Arderne Cinemas Ltd* (1950), All ELR vol. 2, 1120, per Evershed MR.

118 Hale (above, note 23) at p 224.

119 *Pender v. Lushington* (1877), 6 Ch. D. 70.

120 *Greenhalgh v. Arderne Cinemas Ltd* (1950), All ELR vol. 2 1120.

121 *Moffat v. Farquhar* (1878), 7 Ch. D 591.

122 For example, a member has a right to restrain the company from doing ultra vires acts [Sec. 35 (2) Companies Act 1985]; He has right not to have his financial obligations to the company increased without his consent [Sec 16(1) Companies Act 1985]; And he has also right to have company operation fairly conducted. [Sec. 459 Companies Act 1985].

123 Pennington (above, note 87) at p 794.

majority rule.¹²⁴ Such rights must be distinguished from personal rights which originate from company contract in the sense that while the former is regarded absolute the latter is seen changeable through majority decision. This means, it is not always possible for a shareholder to enforce his personal rights which is obtained under company contract. Sometimes, he may be able to enforce his personal rights, but most of the times he will be debarred from enforcing his constitutional right because it is possible for an appropriate majority to change them. As Dixon J observed 'prima facie rights altogether dependent upon articles of association are not enduring and indefeasible but are liable to modification or destruction: that is, if and when it is resolved by a three-fourths majority that the articles should be altered'.¹²⁵ The company contract is designed to work over a long period of time and parties to it 'are bound up in the same enterprise, and thus have to do business with each other over a long period of time'¹²⁶. Therefore, they are interested more in keeping this long-term relationship than to put an end to it. However, in the long run, their interests and needs may change with a change of circumstances and this requires rights of shareholders to be relative rather than absolute. This further follows that company contract should provide some reasonable level of flexibility so that it can adjust and modernise itself to changes. Relativity of rights under company contracts means that a shareholder's personal rights cannot be seen in isolation but only in relation to the rights enjoyed by

124 *Swabey v. Port Darwin Gold Mining Co.* 1 Megone 385 Cited in *Allen v. Gold Reefs of West Africa, Limited*, (1900) 1 Ch 656; *Allen case* Ibid. at p 688 per Vaughan Williams and at pp 673-4 per Lindeley MR; *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9 at pp 21-22 per Scrutton LJ.

125 *Peter's American Delicacy Co Ltd v. Heath*, (1939), 61 CLR 457 (High Court of Australia).

126 *Drury R.R.*, "The Relative Nature of A Shareholder's Right to Enforce The Company Contract", (1986), *The Cambridge Law Journal*, 42(2), 219, Cambridge, Cambridge University Press, at p 222.

other members¹²⁷ regarding ratification of violations to the contract¹²⁸, regularising trivial breaches of contracts¹²⁹ and altering company contract by a special majority.¹³⁰

Although, a shareholder has rights in respect of all regulations expressed by the constitution, he can enforce them only after observation of other members' parallel rights.¹³¹ In sum, the principle is constitutional rights are enforceable by a member as far as they are not changed subject to observation of rights enjoyed by other members. It is, however, not very certain in which circumstances other members have such parallel right. Farrar indicated the point very well in saying 'it is primarily with rights arising from articles that we are concerned, for that is the grey area where the conflict between shareholder protection and the majority rule is most acute'.¹³² While a shareholder may wish to pursue the company for ignoring certain terms of the company constitution, the company itself through the mechanism of majority rule may want to ratify such unconstitutionality. Therefore, in deciding whether or not to pursue the company in order to enforce a regulation of constitution, a shareholder needs to see if the alleged breach is the one which can be ratified or regularised by other members who decide through majority rule in shareholder meetings and this unfortunately is

127 Drury Ibid at p 224.

128 Hogg v. Cramphorn Ltd., (1967), 1 Ch 254 at p 271-2; North West Transportation Ltd v. Beatty (1887) 12 App Cas 589 (Privy Council).

129 Burland v. Earle (1902), AC 83, PC, p 93-94; Mac Dougall v. Gardiner (1875), 1 Ch.D.13.

130 Andrews v. Gas Meter Co. (1897) 1 Ch. 361; Pepe v. City and Suburban Permanent Building Society (1893), Ch. 311; Botten v. City and Suburban Permanent Building Society (1895), 2 Ch. 441; Allen v. Gold Reefs of West Africa, Limited, (1900) 1 Ch 656 at 671 per Lindley MR; Peter's American Delicacy Co Ltd v. Heath, (1939), 61 CLR 457 (High Court of Australia).

131 MacIntosh Jeffrey G, "Minority Shareholder Rights in Canada and England: 1860-1987", (1989), Osgoode Hall Law Journal, vol. 27, No. 3, Toronto, Osgoode Hall Law School, at p 604; Pennington (above, note 87) at p 795; Sealy Len, "Shareholders' Remedies in the Common Law World", (1997), *Company, Financial and Insolvency Law Review*, 173, Oxford, Mansfield Press at p 181.

132 Farrar (above, note 7) at p 447.

not very certain under the current company law.¹³³ The common law has developed an irregularity rule which authorises ratification of any breach of trivial terms in constitution.¹³⁴ It was first developed by Melish L. J. in *Mac Dougall v. Gardiner*¹³⁵ and was subsequently followed by Lord Davey in *Burland v. Earle*.¹³⁶ What constitutes a trivial breach cannot be answered in definite. There is not a statutory guideline to separate trivial and non-trivial matters.¹³⁷ The courts tend to interpret triviality in the sense of any unconstitutional act which does not violate shareholders' membership rights¹³⁸, rights that offer property to individual shareholders.¹³⁹ They say where there is not a clear violation to such rights, any breach of constitutional rights will not be personally recoverable.¹⁴⁰ This probably was the main reason why Russell L. J. in

133 Company Law Reform, "Modern Company Law for a Competitive Economy: Completing the Structure", (London, DTI, 2000), paras 5.64 and 5.73.

134 Griffin Stephen, "Company law: Fundamental Principles", (1996), 2nd ed., London, Pitman, at p 300; Drury (above, note 126) at pp 224, 237-244; The irregularity rule has also recently been confirmed by the Company Law Reform Committee. [Modern Company Law for a Competitive Economy: Final Report, (London, DTI, 2001), URN/942 & URN/943, para 7. 34].

135 *Mac Dougall v. Gardiner* (1875), 1 Ch.D.13 per Melish L.J.

136 *Burland v. Earle* (1902), AC 83, PC, p 93-94 per Lord Davey.

137 Sealy L. S., "Problems of Standing, Pleading and Proof in Corporate Litigation", in *Company Law in Change*, Edited by Ben Pettet, (1987), London, Stevens, at p 8; Sealy L. S., "Company Law and Commercial Reality", (1984), London, Sweet & Maxwell, at p 5 and Sealy Len (1997) (above, note 131) at p 181.

138 See instances in case law like: the right of a member to have his vote recorded [*Pender v. Lushington* (1877), 6 Ch. D. 70]; to have a dividend paid in cash if the articles so specify [*Wood v. Odessa Waterworks Co* (1889) 42 Ch D 636]; to enforce a declared dividend as a legal debt [*Mosely v. Koffyfontein Mines Ltd* (1904) 2 Ch 108, CA.]; to have the articles observed if they specify a particular procedure to be followed in particular instance [*Edwards v. Halliwell* (1950) 2 All ER 1064]; See also Pennington (2001), (above, note 87) at p 794; Thorne (above, note 7) at p 188.

139 *Pender v. Lushington* (1877), 6 Ch. D. 70 Jessel MR.

140 For example, a member does not have a right to have a poll taken [*Mac Dougall v. Gardiner* (1875), 1 Ch.D.13]; nor to have accounts prepared in accordance with the requirements of Companies Act [*Devlin v. Slough Estates Ltd* (1983) BCLC 497]; nor to have directors retire in accordance with the articles [*Mozley v. Alston* (1847) 1 Ph 790]; See also Pennington (2001), (above, note 87) at p 794; Thorne (above, note 7) at p 188.

Bamford v. Bamford left an improperly motivated issue of shares by directors for the majority to decide.¹⁴¹

Yet, there are cases in common law which can hardly be reconciled with the prevailing understanding of the triviality measure. For instance, in *Edwards v. Halliwell* the primary purpose of the petitioners (two shareholders) was to invalidate an ordinary resolution that was taken in substitute of a special resolution, something which seemed more to be a matter of procedure rather than property rights, and Jenkins L. J. delivered his judgement in favour of the petitioners arguing that 'it seems to me the rule in *Foss v. Harbottle* has no application at all for the individual members who are suing, not in the right of the union but in their own right to protect from invasion their own individual rights as members...' ¹⁴² In other cases where a denial of a particular constitutional procedure could entail intervention in the exercise of members' voting right, which is considered as a clear example of property right, the courts rejected to view such denial as touching any element of property.¹⁴³ In sum, the measure of irregularity is not very clear.¹⁴⁴ While some constitutional procedures were seen as non-trivial¹⁴⁵, some others were considered as being simply trivial matters that fall within the ambit of the majority rule.¹⁴⁶

141 *Bamford v. Bamford* (1970), Ch 212, (1969), 1 All ER 969; See also *Hogg v. Gramphorn Ltd.* (1967), 1 Ch 254.

142 *Edwards v. Halliwell* (1950) 2 All ER 1064.

143 See *Mac Dougall v. Gardiner* (1875), 1 Ch.D.13.

144 *Sealy Len* (1997) (above, note 131) at p 181; *Davies* (above, note 10) at pp 449-45.

145 *Pender v. Lushington* (1877), 6 Ch D 70; *James v. Buena Ventura Nitrate Grounds Syndicate Ltd.* (1896), 1 Ch. 456; *Edwards v. Halliwell* (1950), 2 All ER 1064 per Jenkins L.J.; *Cotter v. National Union of Seamen* (1929), 2 Ch 58.

146 *Mac Dougall v. Gardiner* (1875), 1 Ch.D.13; *Australian Coal & Shale Employees' Federation v. Smith* (1938) 38 SR (N.S.W.); See also *Griffin* (above, note 134) at p 300.

There has been proposal from academics of English company law who by implication speak of elimination of the irregularity rule. They say it ought to be the rule that every unconstitutional act could give personal right of action to shareholders.¹⁴⁷ An unconstitutional act, according to them, is not simply a corporate wrong but rather is a violation to individual shareholders' personal right because it is a breach of terms of the constitution which is the source of his membership contract with company and other shareholders.¹⁴⁸ Some company law scholars, too, have attempted to circumvent the irregularity rule. The latter took the view that where a case involves unconstitutional acts, shareholders can pursue not the company but its directors for a breach of contractual duty. According to this theory, a contract with its terms found in the corporate constitution exists between members and directors. By accepting his post, a director assumes an express duty to the company and an implied duty in favour of individual shareholders to comply with the rules of the constitution.¹⁴⁹ Likewise, when a shareholder consents to the constitution, he, in fact, consents to controllers to act according to the rules of the constitution and further when he votes in meetings to appoint a director, his vote is impliedly subject to a duty of the prospective director in complying with constitutional rules. Therefore, directors' self-interested¹⁵⁰ as well as

147 Wedderburn (1957), (above, note 1) at p 206; See also Sealy (above, note 8) at pp 483, 493, 498; Rajak Harry, "Source Book of Company Law", (1995), Bristol, Jordans, at pp 533-4; Davies, P.L., "Gower's Principles of Modern Company Law", (1997) 6th ed., London, Sweet & Maxwell, at pp 660-665, 737.

148 Sealy (1987), (above, note 137) at p 8; Sealy (1984), (above, note 137) at p 5; Pennington (above, note 14), at pp 55-56; Following cases in common law may support this view too: *Edwards v. Halliwell* (1950), 2 All ER 1064 per Jenkins L.J.; *James v. Buena Ventura Nitrate Grounds Syndicate Ltd.*, (1896), 1 Ch. 456; *Mac Dougall v. Gardiner*, (1875), 1 Ch.D.13.

149 Sterling M. J., "The Theory and Policy of Shareholder Actions in Tort", 1987, *The Modern Law Review*, Vol. 50, 468, London, England, Stevens & Sons, at 474.

150 *Re a Company* (1987), BCLC 82 at 84; see also Beck Stanley M., "The Shareholders' Derivative Action", (1974), 52, *Canadian Bar Review*, 159, Toronto, Carswell for the Canadian Bar Association, at pp 171-2.

unconstitutional transactions¹⁵¹ could be seen as violation to the rights of both the company and its shareholders.

These proposals are advantageous in that they diminish the controversy in relation to the nature and scope of personal rights and enable minority shareholders to insist on compliance by controllers with their personal rights. Nonetheless, they cause difficulty in that they can widely open the gate for shareholder actions, conferring a veto power to every shareholder against the rule of majority. They further, allow dual actions to proceed, increase the level of overlap between personal and corporate rights and enable every unhappy shareholder to initiate opportunistic and disruptive litigations.¹⁵²

The law relating to the personal rights has recently been reviewed by the Company Law Reform Committee too. The Committee confirmed that the law in this area is uncertain especially because it fails to determine what rights were enjoyed by members personally under the constitution. It proposed that the current uncertainty could be resolved through a new Act that states all constitutional obligations are enforceable by individual members unless the contrary is provided in the constitution or the alleged breach concerns 'trivial or fruitless' matters.¹⁵³ Taking into consideration the 'trivial or fruitless' exception and the 'no reflective loss rule'¹⁵⁴, it also regarded as immaterial

151 *Cotter v. National Union of Seamen* (1929), 2 Ch 58; *Pender v. Lushington* (1877), 6 Ch. D. 70.

152 *Drury* (above, note 126) at p 237; *Sterling* (above, note 149) at pp 482-9.

153 Company Law Reform, "Modern Company Law for a Competitive Economy: Completing the Structure", (London, DTI, 2000), para 5.73.

154 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481.

concerns about increase in the number of shareholder opportunistic actions and the possibility of double recovery which can result from this proposal.¹⁵⁵

This proposal, however, does not seem to be capable of making the situation in respect of members' personal rights very better, as it mainly reflects the current state of the law and further seems to be rejected by the British government because it is not included in the government's newly proposed Companies Bill.¹⁵⁶

As in English company law, shareholder rights can be personal or corporate in Iranian company law.¹⁵⁷ Personal rights refer to the rights that fall into personal pocket of every shareholder. They may derive either from company law or from the company contract. To enforce such rights, a shareholder, needless to act with other shareholders, is able to take personal action against the company. Corporate rights, on the other hand, refer to those that primarily belong to the company itself and its attribution to shareholders is only for the reason that shareholders are given power to apply either direct or indirect control on the exercise of them and for the fact that they (shareholders) enjoy, as residual right holders, the consequences of such exercise either positively (annual profits given to shares and increase in their market value) or negatively (loss suffered by the company that reduces the share price or expected profits). Since these belong to the company, the company itself through its internal organs make relevant decisions and exercise them. These rights might relate to external affairs of the company, which is normally conducted by the board of directors.

155 Company Law Reform, "Modern Company Law for a Competitive Economy: Final Report", (London, DTI, 2001), URN/942 & URN/943, paras 7. 34, 7. 51, and its note 113.

156 The Companies Bill, (218-20 Jul 2006), available from the DTI website at the following address: <http://www.publications.parliament.uk/pa/pabills/200506/companies.htm>.

Examples of such rights are right to own property, right to conduct its own business, right to enter into transactions, right to ratify voidable transactions, right to employ employees and right to take legal actions to the courts or respond to actions taken against it. They may also relate to internal affairs of the company for exercising of which either the board or the meetings (depending on how articles and company law divide powers between meetings and board of directors) will have the corresponding authority. For example, it is within the authority of shareholders' meetings to exercise the right of the company to make resolutions, to change its articles, to empower directors to issue new shares, preference shares and debentures, to increase or decrease the company's capital, to appoint or dismiss directors and to relieve faulty directors from personal liability.¹⁵⁸ Equally, it is within the authority of the board of directors to exercise a company's right to convene meetings¹⁵⁹, to reject a purported transfer of shares in private companies¹⁶⁰, and to ask payment in respect of any unpaid amount of shares against shareholders in the manner and within the period prescribed by the articles.¹⁶¹ When a right is identified as corporate, a shareholder is not allowed to enforce it on his own initiative and he is subject to the authority of the relevant internal organs in the company. It, however, does not mean that a shareholder is disinterested in respect of it. He is personally and indirectly interested, but this personal indirect interest is subject to the interests of other shareholders that are reflected through application of the majority rule in meetings where shareholders are required to act collectively and in accord with the company's constitution and the company law.¹⁶²

157 Eskini (above, note 99) at p 78.

158 See sections 42, 56, 83, 86, 88, 107, 108, 116, 157, 161, 164, 185, 188, 189 JSCA.

159 Sections 89, 95 and 138 JSCA.

160 Section 41 JSCA.

161 See sections 6, 7(6), 8 (7), 9 (8 and 11), 13 (4 and 7), 33 JSCA.

162 Section 86 JSCA.

However in certain exceptional circumstances company law permits shareholders to enforce corporate rights on behalf and for the benefit of the company. Two examples of such statutory permission are: first, the right of shareholders to call shareholders' meeting where directors and inspectors respectively fail to convene meetings¹⁶³; and second, the right of shareholders to take corporate action to the courts in order to ask recovery of any loss suffered by the company due to commission of fault on the part of directors.¹⁶⁴

For a number of reasons, personal rights in the Iranian company law can offer more protection to minority shareholders compared with the case in English company law. For one, certain personal rights can be absolute which means they cannot be ignored by a majority vote of shareholders. This is explained by making distinction between personal rights that are absolute and personal rights that are relative. Most personal rights are relative in the sense that they are changeable within the framework provided by company contract. Yet, they are enforceable so far as they are not changed. Except for rights that are linked with the essence of the company contract and certain statutory rights that are mandatory¹⁶⁵, every rights deriving from shares are subject to change through the mechanism of majority decision and company law prescribes two different procedures¹⁶⁶ for changing rights attached to ordinary and preference shares.

163 Section 95 JSCA.

164 Section 276 JSCA.

165 For example, right to have information (sections 139 and 220 JSCA), right to have the company's nationality unchanged and right not to be obliged to increase one's obligation without his consent (section 94), and right to start corporate action against faulty directors (sections 276 and 277 JSCA). [See generally Ktoozian Naser, "An Introduction to The Law", (1993), Tehran, University of Tehran Publication, at No. 112; Jafari Langroodi Mohamed Jafar, "The Force of Intent in Civil Law", (1975), Doctoral Thesis, Tehran, University of Tehran Publication, No. 648].

166 Sections 42, 83 and 93 JSCA.

Personal rights can be absolute when they are linked with the essence of the company contract which means they are to be observed not only by the company but also by its members and, therefore, it is not even possible for shareholders to contract out of them. Iranian law provides no list of absolute rights, however, it offers the test of 'link with essential requirements of the contract'¹⁶⁷, which can be used to distinguish absolute rights from those of relative. According to this test when personal rights are direct consequence or principal objective of creating company contracts they must be treated as absolute.¹⁶⁸ Clear examples are membership right¹⁶⁹, right to share in profits¹⁷⁰ and right to share in return of the capital when the company is dissolved.¹⁷¹ However, there are also controversial matters, like the right to vote, which seem difficult to be covered by the mentioned test. Some company law scholars in Iran took the view that a statutory listing of personal rights will solve the controversy.¹⁷² This view is correct subject to its plausibility, as in practice the lawmakers often cannot list every fact which can be taken as being under the realm of shareholder rights. In the absence of a statutory list, it will be the responsibility of the courts to provide clear guidelines in order to resolve the matter.

For another, Iranian company law offer no irregularity rule and from this perspective there has not been made any distinction between trivial and non-trivial irregularities. Articles of association with its particular features constitutes the essential contract

167 Section 233 CA.

168 Katoozian Naser "Civil Code in its Modern Order", (1999), 2nd ed., Tehran, Dadgostar Publication, at p 227.

169 This is so until there is a legal cause that justifies eviction of a member from the company. For example, in circumstances prescribed in sections 35 and 45 JSCA a shareholder who fails to perform his duty to the company can be evicted. [See Eskini (above, note 99) at pp 81-82].

170 Sections 90, 239 and 240 JSCA.

171 Sections 223 and 224 JSCA.

between the company and its shareholders and in the case of a violation by the former, the latter will be entitled to take action to the courts in order to restore the situation or to demand damages if any. Constitutional rules even conferring relative rights must be respected so far as they remain unchanged.

172 Eskini (above, note 99) at pp 78, 206.

II.3. Conclusion

This Chapter examined the rule of majority from the perspective of its field of application. It considered two factors; i. e. legal and constitutional rules. The former concerned rules which derive from general law and which limit companies and their majority shareholders' power as a matter of public order and regulation rather than being a matter of minority protection. It was made clear that the law may want to regulate corporate activities, as such activities may affect not only corporate members but also third parties, the economy and the society. The latter concerned rules which derive from the corporate constitution, and which regulate, through private contracting, corporate members' relationship. Some constitutional rules divide corporate power between shareholders and directors thereby extracting certain powers from the ambit of the majority rule, vesting them in directors. This can benefit the relationship generally, as directors are often equipped with the required skills and knowledge and are well prepared to run the corporate affairs and business, in contrast with shareholders. Also, it can benefit minority shareholders specially, as directors are required in law to exercise their power carefully, disinterestedly, independently and impartially. Some constitutional rules which accommodate the object clause into the constitution can prohibit corporations and their controllers from engaging in *ultra vires* activities. This can benefit minority shareholders, as it ensures that a controlling majority will not use corporate resources for activities which are irrelevant and unauthorised. Some constitutional rules subject a majority resolution to a super majority vote. A super majority vote requirement can considerably reduce the likelihood of opportunistic constitutional amendments. Lastly constitutional rules confer on every

corporate member personal rights which can be enforced against the rule of majority in corporations.

These rules are important, as they help to reduce the possibility of abuse of right by controlling shareholders. They do so by drawing the framework within which the rule of majority works. It follows that a majority decision could, as a matter of principle, bind minority shareholders only if it is taken within such framework. For any decision of majority shareholders which otherwise is taken, a minority shareholder will have the right to resist against it and to take action to the courts. Nonetheless, a major criticism is that they have limited capacity to curb abuse of right by controllers. They only concern cases of abuse in which the right is exercised outside its field whereas an abuse of right can also occur where it is exercised within its field. Take, for example, the case of discriminatory as well as self-interested resolutions of majority shareholders on issues which fall both constitutionally and in law within the power of majority shareholders. Also the same is true where the controlling majority exert indirect control (through management) over company affairs. General laws and constitutions rarely address such abusive behaviour. Another criticism is that even with such limited capacity the importance of such rules can further reduce where they fail to provide a clear framework for the majority rule and where they authorise out of field exercise of rights. Take for example the case of personal rights particularly where they derive from the constitution. Such rights are considered relative which means they are changeable by an appropriate majority vote. Further a violation to some of them is considered in the light of the irregularity rule ratifiable by a majority decision, while there is no clear test that could be used to determine precisely violation to which is, or violation to which is not, ratifiable. Likewise, the object clause no longer constitutes a significant limitation on the rule of majority. Ultra vires transactions following the Companies Act

1985 have fallen within the power of corporations and can now be ratified by a three-quarters majority vote. A ratification of an *ultra vires* activity can further cause overlap between corporate and personal rights because such issues once ratified can constitute a violation by the company to the constitution and hereby to the personal rights of each shareholder.

The latter criticism seems irrelevant as to the Iranian company law. Under the current Iranian laws, all constitutional rules are considered as conferring personal rights to shareholders and there is no irregularity rule. Furthermore, the *ultra vires* doctrine that imposes a major limitation on the power of controllers still persists in the Iranian company law.

Chapter III: Nature of majority rule

Earlier Chapters considered the rule of majority from two varying aspects. Chapter one concerned the question of justification and sought to show how and why the majority rule is justified. Chapter two examined two factors that limit the rule of majority's field of application. It sought, on the one hand, to show the source of some of minority shareholders' problems with the majority rule and, on the other hand, to uncover areas and circumstances within which an abusive exercise of right by majority shareholders can occur. This Chapter examines another aspect of the rule of majority; i. e. the one that demonstrates the way in which the rule of majority works. This aspect, which is linked with the shareholder voting, explains how majority shareholders apply control over corporations. The right to vote determines whether a shareholder is in the majority camp and hence holds control of the corporation or else falls in the minority group who is subject of the majority control.¹ The objective is to show how the mechanism of majority rule can generate opportunity for majority shareholders to abuse their rights. In pursuit of such objective, I raise a number of issues. The first issue to be considered is that of different share structures and most importantly division between ordinary and preference shares.² Here, the gist of my consideration is to explain that possessing more shares does not necessarily follow control of companies and hence a shareholder's control can vary depending on the sort of shares they

1 Section 736 Companies Act (1985) implies that if one or few shareholders can control the composition of the board of directors, or hold more than half in nominal value of the equity share capital they can be considered as having majority control. See also sections 4, 9, 14, 16, 125, 127 198, 303, 368, 370, 378 Companies Act 1985.

2 Buxbaum Richard M., "The Internal Division of Powers in Corporate Governance", (1985), California Law Review, No. 6, vol. 73, Berkeley, Calif., University of California, School of

possess. Although as a matter of principle one's control pursues their shareholdings, however, this is only a default principle that can be displaced by contracting.³ The second issue, which will be considered, is that the components of majority and minority may also vary depending on different issues that come up for decision-making in shareholder meetings. While a shareholder may in one matter be in the majority, he can be in the minority group when voting in another matter and this can provide some protection for minority shareholders. The third issue is to see what role shareholder voting can play in corporations; i. e. determining whether it is only a device used for filling contractual gaps or besides it facilitate control of corporations by shareholders too. The fourth issue to be considered is determining whether shareholders have any responsibility once voting to consider interests of their fellow minority shareholders and finally the last issue is whether or not institutional shareholders have been of any assistance to minority shareholders.

The Chapter intends to examine the mentioned issues in the light of English and Iranian company laws and to do so, thus, it divides discussions into two parts. Much of the discussions are covered in the English part as they relate to issues which are considered indigenous to the English company law. In relation to the Iranian part, because the law as a consequence of adoption resembles the English law, it will avoid discussing issues which are similar and covered in the English part. A brief restatement of similarities and a relatively longer discussion on dissimilarities that exist in between the two systems form my focal endeavour in this part.

Jurisprudence at p 1684; Ferran Eilis, "Company Law and Corporate Finance", (1999), Oxford, Oxford University Press, at p 125.

³ Section 370 (1,6) Companies Act 1985; See also Ferran (above, note 2) at pp 125, 320; Birds John Et. Al. (eds.), "Boyle & Birds' Company Law", (1995), 3rd ed., Jordans, Bristol, p 210.

III.1. The case of England

III.1.1. History of voting rights

The history of evolution of voting rights in companies can be traced back to the sixteenth century when the early joint-stock companies in England were granted their corporate charters.⁴ Before, companies were usually small, family-based and were considered as ordinary partnership which worked with the unanimity rule.⁵ They were adequate for domestic sectors of business where the amount of capital needed remained small and environmental changes were few. As companies grew in size and the corporate environment and industry changed⁶, the need for a device, and use, of a new business vehicle that was able to serve globally and could draw its needed capital from remarkably wider sources became urgent. Joint stock companies which enjoyed separate personality, and which offered limited liability and worked on the basis of majority rule emerged in the business sector to address the needs of the time and as a result the existing laws had to change. The reform in laws occurred to accommodate the new vehicle. The law recognised replacement of the unlimited liability of investors

4 The Russia Company was perhaps the earliest example which was granted its charter in 1555 followed by foundation of the English East India Company in 1600. [See Chaudhuri K.N., "The English East India Company", (1965), London, Cass, at pp 3, 26] See also Ratner David L., "The Government of Business Corporations: Critical Reflections on the Rule of One Share, One Vote", *Cornell Law Review*, (1970), Number 1, Vol. 56, Cornell University, Cornell Law School, at p 1; Dunlavy Colleen A. "Corporate Governance in Late 19th Century Europe and the United States, The Case of Shareholder Voting Rights" in *Comparative Corporate Governance- The State of the Art and emerging Research* edited by Hopt K.J., Kanada H, Roe M.J., Wymeersch E. and Prigge S. (eds.), (1998), Oxford University Press, at pp 12-13.

5 Dunlavy Ibid; Carney William J., "Fundamental Corporate Changes, Minority Shareholders, and Business Purposes", (1980), *American Bar Foundation Research Journal*, Chicago, American Bar Foundation, at pp 69, 77-97

6 Mason Edward S., "Introduction", in *The Corporation in Modern Society*, Edited by Edward Sagendorph Mason, (1960), Cambridge, Mass, at p 1; Minett Steve, "Power, Politics, and Participation in the Firm", (1992), Aldershot, Avebury, at pp186-7; Roe Mark J., "Strong

with a new limited liability principle that restricted shareholder liability to the value of their shares.⁷ Reform in the corporate decision-making machinery was the next step which was taken through replacing the unanimity rule with a principle of the so-called majority rule that worked on the basis of 'one share, one vote'.⁸ These replacements occurred gradually and until the time that general laws allowed public to incorporate companies by the method of registration, it took almost three centuries for them to become well established.⁹

As to the majority rule, there was no established rule with respect to how members will vote in the laws relating to the early companies. The rules applicable to voting were differently determined by the source that had granted the charters.¹⁰ However, the prevailing practice was often one vote for every shareholder disregarding the size of his/her investment. Shareholders could not use proxies and they were entitled to one vote each in the absence of explicit arrangements to the contrary in the company's charter or by-laws.¹¹ This was a consequence of political restrictions which were often written into corporate charters. The practice aimed at safeguarding individual

Managers, *Weak Owners: The Political Roots of American Corporate Finance*", (1994), Princeton University Press, at pp 3-4.

⁷ Limited Liability was already known among, and used by, businessmen through inserting clauses in the charters in eighteenth century. This business custom was subsequently confirmed in the 19th century by the first regulatory Limited Liability Act 1855. [See Freedeman Charles E., "Joint-Stock Enterprise in France: From Privileged Company to Modern Corporation", (1979), Chapel Hill, University of North Carolina Press, at p5; Posner Richard A., "Economic Analysis of Law", (1992), Boston, London, Little, Brown, at p 392; Farrar John H., "Company Law", (1985), London, Butterworths, at p 6; Cheffins Brian R., "Minority Shareholders and Corporate Governance", *The Company Lawyer*, (2000), Vol. 21, No 2, London, Oyez Publishing Limited, at p 4].

⁸ Hager Mark M., "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory", *University of Pittsburgh Law Review*, (1989), Vol. 50, Pittsburgh, at pp 633-4.

⁹ Ratner (above, note 4) at pp 7-9.

¹⁰ Ratner (above, note 4) at pp 3-5; Ferran (above, note 2) at pp 249-250.

¹¹ Ratner (above, note 4) at pp 3-5; Dunlavy (above, note 4) at pp 12-13.

shareholders as members of corporation¹² rather than as owners of a portion of the corporate capital and was well supported by the Anglo-American law. As shareholder voting evolved in England, a new practice emerged in the eighteenth century of giving the larger shareholders additional votes. This development towards the rule of 'one share, one vote', as Dunlavy explained, was put to use in the late 18th century in the U.S., Germany and France too. Since then the general direction of change in the nineteenth century in all the four countries was from the more democratic alternative in the political sense, towards plutocratic power relations in which each share carried a vote.¹³ This practice is now widely accepted and normally is put in the form of a default rule in company laws of most countries.¹⁴

III.1.2. Share structures and voting rights

It is said that the division of share capital into different classes of shares first occurred in the 17th century England.¹⁵ Even with such background, it was not common for companies to issue different classes. Early joint-stock companies usually issued only one class of shares. From the middle 19th century onwards and in the light of general laws regarding incorporation by registration, the rise of small investors who merely had financial motive without being interested in control increased the use of different class of shares. However, from the early 20th century there has been a counter-trend

12 Ratner (above, note 4) at p 6.

13 Dunlavy (above, note 4) at pp 12-21; Ratner (above, note 4) at pp 44-46.

14 Lowenstein Louis, "Shareholder Voting Rights: A Response to Sec. Rule 19c-4 and to Professor Gilson", (1989), Columbia Law Review, Vol. 89, No. 5, New York, Columbia University Press, at p 982-3.

15 Farrar John H., "Company Law", (1991), London, Butterworths, at p 221.

towards greater simplicity and as a result shares tended to get one form with the same liabilities and rights attached.¹⁶

III.1.2.1. Ordinary shares and the 'one share, one vote' rule

Although companies, as a matter of contract, may now have two or more classes of shares¹⁷ with different rights attached,¹⁸ they usually issue only one class of shares with the same value, rights or limitations regarding voting right. This type of share is called ordinary¹⁹ and a holder of it has principally one vote for each share.²⁰ As ordinary shares are treated equally, they can encourage corporate financing. In the absence of it, investors may choose not to take their capital to companies where there is too much potential for risks. The equal rights attached to ordinary shares, however, is just a default rule meaning that they are principally given equal rights and limitations except particular rights are given to or limitations are imposed on some of them in the constitution, or through terms of issue at the time of their issuance, or at any later time by a subsequent alteration.²¹ This default rule has two main limitations, that of preference shares and that of conditioned shares. Preference shares are considered as

16 Farrar Ibid, at pp 221-222.

17 See Morse Geoffrey & Others (eds.), "Charlesworth & Morse Company Law", (1999), 16th ed., London, Sweet & Maxwell, at pp 177-8.

18 There may be different justifications to issue different classes of shares such as to retain control of the company, to induce outsider investment and to raise the capital. [See Pennington, Robert R., "Company law", (2001), 8th ed., London, Butterworths, p 239].

19 One unique feature of the ordinary shares is that they offer no fixed return to their holders. [See Ferran (above, note 2) at p 320].

20 Section 370(6) Companies Act 1985 and Art 54 Table A; See also MacNeil Iain, "An Introduction to The Law on Financial Investment", (2005), Hart Publishing Co., Oxford, at p 259; Ferran (above, note 2) at p 320; Birds Et. Al. (above, note 2) at p 210; Leader Sheldon & Dine Janet, "United Kingdom", in *The Legal Basis of Corporate Governance in Publicly Held Corporations*, Kluwer Law International, (1998), 219 at p 233.

21 Ferran (above, note 2) at pp 139, 330; Birds Et. Al. (above, note 2) at p 210.

exception to the default rule of equality of shares.²² Unlike ordinary shares, this type of shares is usually given fixed financial returns.²³ A holder of such shares does not have to be very watchful of company operation.²⁴ However, in exchange for having such financial privilege, preferred shareholders have no right to vote²⁵ except in certain circumstances.²⁶ If a company seeks to issue preference shares, its power to issue must be expressed in its articles of association otherwise any existing shareholder has right to prevent the company by taking action to the courts.²⁷ Conditioned shares, on the other hand, are in fact ordinary shares with certain privileges or limitations.²⁸ They are issued mostly in the form of weighted or enhanced²⁹, restricted³⁰ and non-voting shares.³¹ The first; namely, shares with enhanced voting rights³²; may be issued to attract investment or to induce persons with good business ideas to enter into companies. It is also used to preserve control of the company in the hands of a few persons who may not have sufficient investment in order to obtain or keep control of

22 *Andrews v. Gas Meter Co.* (1897), 1 Ch. 361, CA; *Campbell v. Rofe* (1933), AC 98; *British and American Trustee and Finance Corporation v. Couper* (1894) AC 399, HL, 416 per lord Macanughten; See also Ferran (above, note 2) at pp 319-320.

23 Ferran (above, note 2) at p 320; Farrar (above, note 15) at pp 225-6; *Morse & Others* (above, note 17) at p 178.

24 Preference shares have this feature as well as certain other features in common with debentures. They both normally carry a fixed rate of financial returns and prioritise their holders over ordinary shareholders. Also they both offer restricted voting rights though debentures normally lack voting rights. [See Farrar (above, note 15) at p 226; *Birds Et. Al.* (above, note 2) at p 219].

25 Buxbaum (above, note 3) at p 1684.

26 For example, when decision is made regarding rights attached to preference shares and when financial return in respect of such shares is overdue and outstanding, holders of such shares will have voting right. [See Ferran (above, note 2) at p 245, 330; *Birds Et. Al.* (above, note 3) at p 214; *Morse Et. Al.* (above, note 17) at p 178].

27 Section 35(2,3) Companies Act 1985 and section 108 Companies Act 1989. [See also *North West Transportation Co Ltd. v. Beatty*, (1887), 12 App CAS 589; generally see *Morse & Others* (above, note 17) at p 178.

28 *Birds Et. Al.* (above, note 3) at p 210; Buxbaum (above, note 2) at p 1693-4; *Leader & Dine* (above, note 20) at p 232.

29 Art (2), Table A, Companies Act 1985.

30 *Ibid.*

31 Section 454 Companies Act 1985.

32 Art 2 and 54 Table A, Companies Act 1985.

the company.³³ It is, however, not very popular among companies, as it often serve to displace the normal majority rule which is based on the 'one share, one vote' principle. The second; i. e. shares with restricted voting rights; is normally intended to confine the role of large investors in companies. Using this method, companies issue shares with voting rights of either certain shares, or even all shares, being restricted to a maximum level.³⁴ The method is, however, uncommon among companies. There are instances in case law that show corporate investors tend to resist against such restrictions, by making formal share transfers to their nominees and dummies.³⁵ It can also discourage investment in companies because potential investors may simply decide not to invest in a company that gives inadequate weight to the investment.³⁶ The third; namely, non-voting shares; is uncommon too for the same reason.³⁷ It usually offers interest a few percentages above the market rate aiming to attract outsider investors who may be interested more in financial aspect of investment than in control.³⁸ It affects application of the majority rule and is often considered as a negative factor especially for public companies that seek to find a good position in the stock exchange markets. Although the London Stock Exchange allows listing of non-voting shares, it never recommends such shares and requires that they must be clearly

33 *Bushell v. Faith* (1970), 1 All ER 53, per Thomas J.

34 Articles of association may confine voting rights of shares, for example, to one vote per 10 shares and according to Table (A) Art (2) Companies Act 1985 companies may by ordinary resolution issue restricted or enhanced voting shares.

35 *Moffat v. Farquhar* [(1878), 7 Ch. D 591, per Malins V C; *Pender v. Lushington*, (1877), 6 Ch D 70.

36 Ferran (above, note 2) at p 246; Lee Hazen Thomas, "Silencing the Shareholders' Voice", *North Carolina Law Review*, (2002), Vol. 80, Chapel Hill, North Carolina Law Review Association, at p 1917; Lowenstein (above, note 14) at p 982.

37 Buxbaum (above, note 3) at p 1716.

38 *Pennington* (above, note 18) at p 239; *Morse & Others* (above, note 17) at p 184.

designated as voteless share.³⁹ Non-voting shares also limit the exercise of shareholders' participatory rights in companies⁴⁰, an outcome which is not only dangerous in the relationship between company members and controllers but also is detrimental to the company sector and the economy at large. Voting right is importantly designed for ensuring that controllers are not abusing their powers and it is important, too, for the society that controllers are answerable not simply to themselves. Shareholders with full voting power can help the industry to work efficiently while non-voting shares act quite the opposite.⁴¹ Some company law scholars have recently sought for their legal eradication.⁴²

III.1.2.2. Challenge to the 'one share, one vote' rule

Political thinkers have recently challenged the 'one share, one vote' rule for its capability to encourage inequality among corporate members and for its propensity to subject implementation of any influence in companies to the size of members' financing.⁴³ Seen from political viewpoint, the 'one share, one vote' rule, unlike its egalitarian face, is liable to encourage inequality among corporate members.⁴⁴ The view seeks for replacing the 'one share, one vote' rule, which allegedly is the source of

39 Listing Rules, Chapter 13, Appendix 1, para. 2; See also Ferran (above, note 2) at p 246; Farrar (above, note 15) at p 225; Birds Et. Al. (above, note 3) at p 213; Morse & Others (above, note 17) at p 184].

40 Buxbaum (above, note 3) at p 1684; Lee Hazen (above, note 36) at p 1919-23.

41 Lowenstein (above, note 14) at pp 1004-8.

42 Leader & Dine (above, note 20) at p 233.

43 Ratner (above, note 4) at pp 33-38.

44 Dahl Robert A., "A Preface to Economic Democracy", (1985), Berkeley, University of California, at pp 75-82; Walzer Michael, "Spheres of Justice: a Defence of Pluralism and Equality", (1983), Oxford, Robertson, at pp 293-4; Gewirth Alan, "Community of Rights", (1996), Chicago, London, University of Chicago Press, at pp 262, 266, 285; Ratner (above, note 4) at pp 45-46.

inequality, with the original democratic rule of 'one man, one vote'.⁴⁵ This will not sustain, it argues, any harm to substantial investors since they will still receive more profit for their larger investment.⁴⁶ The 'one share, one vote' rule, it further argues, can cause fractions in companies which could mean disintegration of shareholders and formation of groups with varying interests, something which is not efficient. In the absence of it, companies can work much better to achieve their goals.⁴⁷

The economists and contractarians' response to the challenge is two fold. One takes consideration of the purpose that caused evolution of voting in companies and suggests that the political viewpoint falls largely in contradiction with historical facts. Lowenstein, for example, upholds the 'one share, one vote' rule arguing that 'not only did it survive for three generations, but almost no one tried to fiddle with it'.⁴⁸ The other takes the efficiency argument and maintains that any departure from the 'one share, one vote' rule will result in discrimination between shareholders based on the size of their investment which is further to discourage the flow of the public financing in companies and this is not efficient.⁴⁹

45 Dahl Ibid at pp 75-82; Walzer Ibid at pp 293-4; Gewirth Ibid at pp 262, 266, 285; Ratner (above, note 4) at pp 45-46.

46 Dahl (above, note 44) at pp 75-82; Walzer (above, note 44) at pp 293-4; Gewirth (above, note 44) at pp 262, 266, 285.

47 See Ratner (above, note 4) at pp 35-38.

48 Lowenstein (above, note 14) at pp 983-4; see also Jensen C. Michel and Meckling William H. "Corporate Governance and Economic Democracy: An Attack on Freedom", in Proceedings of Corporate Governance: A Definitive Exploration of Issues Edited by C.J. Huizenga, UCLA Extension, (1983), at pp 1-6 available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/ABSTRACT ID= 321521>.

49 See Posner (above, note 7) at pp 3, 392; Cheffins Brian R, "Company Law: Theory Structure And Operation", (1997), Oxford, Clarendon Press, at pp 7, 41; Schwarts Alan and Scott Robert E., "Contract Theory and The Limits of Contract Law", Yale Law Journal, (2003), vol. 113, New Haven, Conn., Yale Law Journal Co., Yale University, School of Law, at pp 3-6; Farrar (above, note 15) at pp 6-7.

No doubt the 'one share, one vote' is not a perfect rule. Most people would accept that the rule is capable in the strict political sense of encouraging inequality among corporate members. However, they would also accept that this is simply an inevitable incident of the 'one share, one vote' rule which primarily evolved in companies to enable them act effectively and efficiently.⁵⁰ Further, it is not equality among members based on their personality, but rather equality among members based on the size of their investment that matters very much in companies. The solution to remedy its imperfection cannot, therefore, be to replace it with rules that give vote to all shareholders equally or permit application of graduate voting mechanism.⁵¹ Instead, a device should be designed to prevent controlling members from abuse.

III.1.3. Variable nature of majority and minority

Of the implications of the exercise of voting right in meetings is that the nature of majority and minority may vary depending on different issues which come up for decision-making in shareholder meeting. A shareholder may in one case be in the majority camp meanwhile he may fall within the minority camp when voting in another case. If votes were always given honestly in the best interest of the company and companies had only large size, the variable nature could have ensured rights and interests of every shareholder in companies. However, current company law allows shareholders to pursue their personal interests and permits companies to be incorporated with different size. These bring about consequences. When companies are small, nature of majority and minority groups almost always remain the same. Using

⁵⁰ See Ratner (above, note 4) at p 23.

his voting power, a majority shareholder can control the company no matter what issue is going to be decided by shareholders in general meetings. In such context, a dissenting minority may have no choice except to continue in a long-term relationship with the controlling shareholders without hoping that his position may change through the normal democratic way of voice. Likely limitations on share transfers that prevent minority shareholders from selling their shares plus outsiders' reluctance to buy such shares can make the way of exit too costly and prejudicial.

The issue in large companies differs very much. Large companies often raise their needed capital from small investment of a remarkably large number of investors who may have invested, in sum, a quite large amount of money in different companies. But in a given company, the amount of their investment is often very little. Hence, such companies often lack a permanent and stable majority who provide substantial part of the company's financial resource and who can control the company. Instead, the nature of majority and minority will change depending on the varying issues coming up for collective decision-making in shareholders' meetings. Although this variable nature may reduce the possibility of majority abuse to some extent, it never eliminates it. Dispersion of the shareholdings in large companies sometimes only reduces the number of votes required of shareholders in order to seize corporate control. Given the collective action problem and the apathetic attitude of widely dispersed shareholders⁵², a shareholder who possesses, let's say, fifteen percent shareholding in a large

51 A method of voting mostly exercised in 18th and 19th centuries in which every share primarily gave one vote, but there was a maximum limit in the articles of association that limited number of votes attached to shares [See Dunlavy (above, note 4) at pp 20-30].

52 Gower L.C.B., *Gower's Principles of Modern Company Law*", 4th ed., London, (1979), Stevens, at pp 553-4; Posner (above, note 7) at pp 409-411.

corporation is perhaps able to exercise effective control over the variable issues.⁵³ Furthermore, institutional shareholders which possess substantial investment in large companies can now reorganise dispersed shareholdings⁵⁴ and overcome the collective action problem which further means the nature of majority and minority can become stabilised even in large companies.⁵⁵ These observations raise the question of abuse of power not only in private but also in public companies to which company law should offer response.

III.1.4. The role of voting in corporate context

Whether or not the shareholder voting plays any controlling role in the Anglo-American model corporations has been a matter of interesting controversy among company law scholars. The controversy stems from the fact that while in theory shareholders as owners of corporate shares can control such corporations, they have been in practice for a number of reasons unable to do so. This caused development of a theory that denies the idea of shareholder control and views the right to vote as being a mechanism merely suitable for filling contractual gaps. A reduced version of this

53 Cubbin John and Leech Denis, "The Effect of Shareholding Dispersion on the Degree of Control in British Companies: Theory and Measurement", *The Economic Journal*, (1983), Vol. 93, 351-369, London, New York, Macmillan, at p 363.

54 Black Bernard S., "Shareholder Passivity Re-Examined", (Dec-1990), *Michigan Law Review*, Vol. 89, 520 Ann Arbor, Mich., University of Michigan, Department of Law, at p 567.

55 In an empirical research carried out in 1984, it became evident that owing to the increasing volume of the contractual savings mainly in the hands of insurance companies and pension funds since 1945, there has been a sharp increase in the percentage of shares held by institutional shareholders and a sharp decrease in the level of individual holdings in listed companies in the United Kingdom. [See Farrar John H. and Russell Mark, "The Impact of Institutional Investment on Company Law", (1984), *The Company Lawyer*, No. 5, London, Oyez Publishing Limited, at p 107]; The findings of this research was also confirmed by the Hampel Committee's investigation for the review of company law which found institutions during the 1980s and 1990s as holding approximately 80 percent of shares in the listed UK companies. [Hampel Committee, "The Combined Code: A Practical Guide", (October 1999),

theory views shareholder voting as a device primarily designed to allow shareholder control, but it also adds that current corporate context has made this function impossible. The conventional view, on the other hand, regards shareholder control as being the most important attribute of the right to vote and seeks to defeat through a number of ways shareholder inactivism which currently exists in English large corporations. Although this controversy concerns the most the shareholder/management relationship, it can be pertinent as to the majority/minority conflict too, as it is the claim of the first theory that the absence of shareholder control is to mean elimination of majority abuse which forms a great protection to minority shareholders. In sum, there are two main theories:

III.1.4.1. Contractarian theory

Contractarian theory is characterised by its focus on managerial control. A leading example is the theory of separation of ownership and control which was developed by the two American professors, Adolf A. Berle and Gardiner C Means, in the early 20th century, and which views shareholders as beneficiaries for whom managerial powers are held in trust.⁵⁶ The origin of the theory, which is sometimes named as the 'trust theory', goes back into the middle nineteenth century when common law judges started to hear minority allegations against corporate directors using the beneficiary/trustee relationship argument.⁵⁷ In this analysis, although shareholder

London, UK]; see also Ferran (above, note 2) at p 241; similar trend can be found in the US too. [Black (above, note 54) at p 570; Ratner (above, note 4) at p 26].

56 Berle Adolf A. and Means Gardiner C., "The Modern Corporation and Private Property", Revised edition, (1968), New York, Macmillan, at p 245; Berle Adolf A., "Corporate Powers as Powers in Trust", (1931), 44, Harvard Law Review, 1049 Cambridge, Mass, Harvard Law Review Association, at 1073.

57 Smith D. Gordon, "The Shareholder Primacy Norm", (1998), *The Journal of Corporation Law*, Iowa City, University of Iowa, College of Law, at pp 303-306.

voting is primarily a device to be used for controlling managerial misbehaviours, however, the proxy mechanism and the collective action problem make it useless and impossible.⁵⁸ Shareholder control no longer functions in large corporations. Instead, professional managers, as a neutral technocracy, would run the corporation better and would make important corporate decisions benefiting all interested groups and the society not merely shareholders.⁵⁹ Two factors contributed to make this theory very influential. Firstly, in the light of the real entity theory, companies have been recognised as having separate corporate personality, a major development that caused an extensive realization that possessing shares in a company does not follow possession of the company.⁶⁰ Secondly, industrialisation of the economy⁶¹ plus a rapid rise of small investors who were more interested in financial return than control⁶² caused a gradual separation of shareholder ownership right from control and a relocation of the latter in hands of managers.⁶³

In this category sits also the new contractual theory⁶⁴ which was developed in the late 20th century and which argues that shareholder control is impossible because of the collective action problem. Shareholders have lost their controlling power not only

58 Berle & Means (above, note 56) at pp 71-82, 129-131.

59 Berle & Means (above, note 56) at pp 301, 312-312.

60 Hager (above, note 8) at pp 633-4; See also Hill, "Visions and Revisions of the Shareholder", *The American Journal of Comparative Law*, (2000), Vol. 48, Berkeley, Ca., American Association for the Comparative Study of Law, at p 44.

61 Minett (above, note 6) at pp 186-187.

62 Farrar (above, note 15) at pp 221-2.

63 Berle and Means (above, note 56) at p 245.

64 Also known as Chicago School, Contractarians, the Law and Economic Theory; Neo-Classic Theory and Nexus of Contracts Theory. [See generally Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law", (2001), 18th ed., London, Blackstone, at pp 37].

because it is impossible⁶⁵ but also because it is unnecessary and perhaps sometimes problematic⁶⁶, as shareholders do not have necessary managerial skills to control corporations.⁶⁷ The main role for shareholder voting is to fill gaps in company contracts.⁶⁸ The theory differs slightly from the separation of ownership and control theory in that the latter views controlling function necessary but impossible.

One of the important properties of the contractarian theories, it is claimed, is the elimination of any likelihood of majority abuse against minority shareholders. Since shareholders are no longer able to control companies there will be no more minority oppression.⁶⁹ In the absence of shareholder control, professional managers who can strike a fair balance between majority/minority interests will control corporations. Managerial control may make corporations liable to mismanagement but, as the theory argues, this should not cause much concern because mismanagement is incurred by all shareholders equally and further because market forces can effectively control it. In a market economy, market forces especially through market for securities, managerial services and corporate control, prevent management from abuse.⁷⁰ Moreover the

65 Easterbrook Frank H. and Fischel Daniel R., "Voting in Corporate Law", *The Journal of Law and Economics*, (1983), Chicago, University of Chicago Law School, at pp 401-2; see also Posner (above, note 7) at pp 409-411; Farrar (above, note 15) at p 318.

66 "Shareholders' participation in control of the company may expose the firm to an uncompensated risk of making inconsistent or illogical decisions". [Easterbrook and Fischel (above, note 65) at pp 404-5, 408-10]; See also Manne Henry, "Some Theoretical Aspects of Share Voting in the Economics of Legal Relationships", *Columbia Law Review*, New York, Columbia University Press, (1964), Vol. 64, 1427.

67 Manne Ibid.; See also Farrar (above, note 15) at pp 3-7; Posner (above, note 7) at pp 14, 409-411; Easterbrook and Fischel (above, note 65) at p 401.

68 Farrar (above, note 15) at p 318; Easterbrook & Fischel (above, note 65) at pp 401-3; Posner (above, note 7) at pp 409-411.

69 See generally Hill (above, note 60) at pp 57-8 and also Hill Jennifer, "Public Beginnings, Private Ends-Should Corporate Law Privilege the Interests of Shareholders?", in *International Corporate Law*, Edited by Fiona Macmillan, Vol. 1, (2000) Oxford, Hart, at p 22.

70 Schwarts & Scott (above, note 49) at pp 11-16; Stedman Graham & Jones Janet, "Shareholders' Agreement", (1998), 3rd Ed., London, Sweet & Maxwell, at p 1; Keenan Denis &

plenitude of firms makes it possible for investors to diversify their portfolios, obtaining returns at lower total risk.⁷¹ After all, the way of exit is always open to a dissatisfied shareholder who can rationally choose to disinvest.⁷²

The contractarian theories can be criticised on two grounds. Firstly, exiting from the company either through a share sale in the market or through a buy out order granted by the courts may not always be a result of rational reaction of shareholders to managerial abuse, particularly for those who wish to stay in the company and fight to clear corruptions up.⁷³ Further, these theories, which much rely on exit rather than voice, can encourage short-termism among corporate investors, something that is not efficient.⁷⁴ Secondly, the mismanagement problem which is pretended to be trivial in these theories can cause very much more serious problems. Market forces can act imperfectly when market conditions are incompetitive. Where a company dominates a market which is difficult to enter it can survive even performing inefficient. This follows that an uncompetitive market will not quickly convert inefficiency into insolvency and consequently corporate management in such conditions would be able

Bisacre Josephine, "Company Law", (1999), 11th ed., London, Financial Times/Pitman Publishing, at p 255; Easterbrook & Fischel (above, note 65) at 396-7, Ferran (above, note 2) at p 244.

71 Easterbrook & Fischel (above, note 65) at p 401.

72 Easterbrook & Fischel (above, note 65) at p 420; Manne H.G., "Mergers and the Market for Corporate Control", (1965), 73, *The Journal of Political Economy*, 110, Chicago, University of Chicago Press and Manne H.G., "Our Two Corporation Systems", (1967), 53, *Virginia Law Review*, 259, Charlottesville, Va., Virginia Law Review Association; Gilson Ronald J., "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers", (1980-1) 33 *Stanford Law Review*, 819, Stanford, Calif., Stanford University, School of Law; Fischel Daniel R, "Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers", (1978), 57, *Texas Law Review*, 1, Austin, Texas Law Review Association Quoted in Mitchell Charles, "Shareholders' Claims for Reflective Loss", (2004), *The Law Quarterly Review*, Vol. 120, 457 London, Stevens and Sons, at 483-4.

73 Deakin Simon, Ferran Eilis and Nolan Richard, "Shareholders' Rights and Remedies: An Overview", (1997), *Company, Financial and Insolvency Law Review*, 162, Oxford, Mansfield Press, at p 164.

to serve for their own interests.⁷⁵ Market forces also provide most of the times a costly and imperfect way to discipline wayward managers. The reason as Black explained is that they often work through the takeover mechanism which usually involve kicking out old managers while for companies with competent managers who just need closer oversight, this is disproportionate to the problem and adds large disruption and transaction costs.⁷⁶ Further, managerial control cannot guarantee the use of corporate resources only for meeting the shareholder interest objective in corporations and the company law has often limited capacity to curb managerial misbehaviours.⁷⁷ Mismanagement, however, is largely reduced through shareholder control which is exerted by voting in corporate meetings.⁷⁸

III.1.4.2. The conventional theory

The conventional theory which is the common approach among scholars of law and political theorists suggests that significance of the right to vote encompasses two functions of filling contractual gaps as well as control. It is true that shareholders

74 Ferran (above, note 2) at p 241.

75 See Parkinson J. E., "Corporate Power and Responsibility", (1993), Oxford, Clarendon Press; New York, Oxford University Press, at p 114; See also Bebchuk Lucian Arye, "The Case for Empowering Shareholders", (Last revision: Apr-2003), pp 14-16, 50, 63, recently titled as "The Case for Increasing Shareholder Power", (2005), *Harvard Law Review*, Vol. 118, at pp 833-917, Cambridge, Mass., Harvard Law Review Publishing Association.

76 See Black (above, note 54) at p 522.

77 Cheffins Brian R., "Corporate Law and Ownership Structure: A Darwinian Link?", University of Cambridge, (2002), available at Social Science Research Network (SSRN), Electronic Library at <http://ssrn.com/abstract=317661>, at pp 27-37; Bebchuk (above, note 75) at p 63; Roe Mark J., "Corporate Law's Limits", Columbia University, (2002), at p 10 also available at Social Science Research Network Electronic Library <http://papers.ssrn.com/abstract=260582>; Roe Mark J., "The Shareholder Wealth Maximisation Norm and Industrial Organization", (2001), Harvard Law School, p 3, Social Science Research Network (SSRN), Electronic Library at www.ssrn.com (Working Paper No 019 ID 282703); Stout Lynn A., "Bad and Not-So-Bad Arguments for Shareholder Primacy", (2002), *Southern California Law Review*, Vol. 75, 1189, also available in Social Science Research Network (SSRN), Electronic Library at www.ssrn.com, (Research paper No. 25 ID 331464) at p 1199; Bebchuk (2003), (above, note 75) at pp 14-16, 50, 63.

78 Cheffins (above, note 77); Roe (2002), (above, note 77) at pp 10-17.

through the mechanism of voting make rules for unexpected and unpredicted circumstances, but this is only one of the functions of the right to vote. The other function which is perhaps more significant is the one by which shareholders control their companies. A number of arguments have been brought for this theory. Scholars who view corporations politically argue that voting is a way by which citizens (shareholders) exercise control over decisions and conducts of leaders (management) in the corporate community.⁷⁹ Shareholders should be able to control corporate management in order to ensure that managers pursue the shareholder interest objective.⁸⁰ These scholars go along with ideas advanced by the contractarian theory in that they both generally see the majority of shareholders as persons whose interests are pre-eminent in companies.⁸¹ However they fall apart in that political theorists unlike the latter know controlling function for shareholder voting. Those who view corporations from legal perspective argue that shareholder control is in fact a non-separable part of every relationship which involves a person who entrusts his money to the care of another person.⁸² They add that market forces may not adequately prevent managerial misbehaviours and company law is deficient too.⁸³ Therefore,

79 See generally Ferran (above, note 2) at p 246; Hill (2000), (above, note 60) at pp 52-53.

80 Buxbaum (above, note 3) at p 1671; Selznick Philip, "Law, Society, and Industrial Justice", Russell Sage Foundation, (1969), at p 259; Brewster Kigman, "The Corporation and Economic Federalism", in *The Corporation in Modern Society*, edited by Edward Sagendorph Mason (ed.), (1960), 5, Cambridge, Mass at 72; Mason (above, note 7) at p11; Villiers Charlotte, "European Company Law-Towards Democracy?", European Business law Library, (1997), Aldershot, Ashgate, pp 197-205; Pound John, "The Rise of The Political Model of Corporate Governance and Corporate Control", (1993), *New York University Law Review*, vol. 68, 1003 at pp 1007-1013, New York, New York University School of Law; See Latham Earl, "The Body Politic of The Corporation", in *The Corporation in Modern Society*, edited by Edward Sagendorph Mason (ed.), (1960), 5, Cambridge, Mass, pp 218-220; Bottomley Stephen, "From Contractualism to Constitutionalism: A Framework for Corporate Governance", (1997), *Sydney Law Review*, vol. 19, 277, Faculty of Law, University of Sydney, Sydney, at pp 288-298.

81 See Hill, "Visions and Revisions of the Shareholder", (above, note 60) at p 54.

82 Lowenstein (above, note 14) at pp 983-4; Ferran (above, note 2) at p 239.

83 Parkinson (above, note 75) at p 114; Bebchuk (above, note 75) at pp 14-16, 50, 63; Black (above, note 54) at p 522; Ferran (above, note 2) at p 241; Cheffins (above, note 77) at pp 27-37.

there should be a monitoring mechanism inside the company to allow members watch activities of directors⁸⁴ and shareholder voting functions to that effect.⁸⁵ In addition to these, they also say even from the perspective of contractarians the main mechanism by which market forces discipline management is through market for control and takeover mechanism which heavily rely on the idea of shareholder control.⁸⁶ they also add that shareholder control is not impossible because apathy is not a natural automatic reaction of shareholders and might be defeated by the growth in the size of ones' shareholding.⁸⁷ Shareholder control can encourage public financing in corporations because it signals the potential investors that they will be given control based on the size of their investment.⁸⁸

III.1.4.3. Comment

No doubt, it is fundamental to any principal/agent relationship that the former must have power to control activities of the latter. In the absence of such control, agents could engage in self serving activities which impose costs on principal. This is also true about corporations in which management in the absence of shareholder control could easily engage themselves in activities which are either poor or self-serving. However,

84 See Black (above, note 54) at pp 523, 531, 532, 566; Buxbaum (above, note 3) at p 1683; Roe (2001), (above, note 77) at p 10; See also Bebchuk (above, note 75) at p 63; Cheffins (above, note 77) at pp 27-37.

85 Arguments for shareholder control may differ. Some argue that shareholders have controlling right because they are owners. [See Birds Et. Al. (above, note 2) at pp 209, 214, 368; Lee Hazen (above, note 36) at pp 1900, 1910; From Case Law see also Burland v. Earle, (1902), AC 83; North West Transportation Co Ltd. v. Beatty, (1887), 12 App CAS 589; Pender v. Lushington, (1877), 6 Ch. D. 70; Some, on the other hand, argue that a share is only an instrument by which a holder participates in determining what forms general interests of the company. [See Leader & Dine (above, note 20) at p 230]. From Case Law see also Prudential Assurance Co Ltd v. Newman Industries LTD. and others (No. 2) (1981), Ch 257.

86 Buxbaum (above, note 3) at p 1672.

87 Black (above, note 54) at p 585.

88 See Lowenstein (above, note 14) at pp 983, 1008; Lee Hazen (above, note 36) at p 1917-23; Ferran (above, note 2) at p 246.

when a relationship involves not the principal/agent but rather groups of shareholders, one can remain sceptical about the benefits of the shareholder control because it is possible that one group, often the one that have majority of votes, abuses its discretionary power to prioritise systematically its interests over that of the other groups. This possibility which associates with the shareholder control along with the collective action problem have brought the contractarians into the view that shareholder control is generally problematic and should be replaced by managerial control.⁸⁹ Yet, there are good reasons that indicate the advantages of exercising control by majority shareholders even with the possibility of abuse of rights can outweigh those of taking control away from shareholders. If shareholder control is lost, the right to participate in the debate and discussions in meetings will be lost too, which could further mean a complete lack of information for shareholders. This provides opportunity for dishonest and negligent management to extract easily for themselves corporate gains. With the majority control, however, not only management would be monitored, but also minority shareholders through attending at meetings will find opportunity to have access to information needed in order to assess controllers' behaviours. Oppression by the majority which can arise from shareholder control causes little concern compared with the likelihood of mismanagement which associates with managerial control and might, to a great extent, be overcome by the unfairly prejudicial remedy provided by s 459 Companies Act 1985.⁹⁰

89 'mismanagement is less serious than unfairly conduct to shareholders. Mismanagement is not in the managers self interest. It is in fact very much contrary with their self interest, as it will lead eventually to the bankruptcy of the firm and the managers' future employment prospects, as a result of the competition of better managed rivals'. [Posner (above, note 7) at p 410].

90 Black (1990), (above, note 54) at p 552; Roe (2002), (above, note 77) at p 10; Roe (2001), (above, note 77) at p 3; Bebchuk Lucian Arye, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", *Harvard Law Review*, (1989), Vol. 102, Cambridge, Mass., Harvard Law Review Publishing Association, at pp 1830-1; Jensen &

III.1.5. Freedom of voting and imposition of legal duty

Traditionally speaking, a share was seen as a piece of property and the voting right attached to it was also considered as an incident to such property right which allowed shareholders to exercise it free of duty.⁹¹ Once voting, corporate shareholders could expect personal benefits and further could consult with their personal interests.⁹² There was no obligation on a shareholder of company to give his vote with a view to what other persons may consider to be for the interests of the company. As a result, a shareholder who possessed majority of shares was able to make whatever decision he pleased even though those decisions were quite incompatible with minority shareholders' interest or even harmful to it. Thus, voting right was capable to provide controlling members abusive opportunities.⁹³

This fashion gradually changed with increasing concern on the part of the courts and legislators for the protection of minority shareholders and, as a consequence, the exercise of voting right was transformed slowly over time from being a simple matter of right into a rather complicated mixture of right and duty. The first step was taken by Lindley M.R. who developed in *Allen v. Gold Reefs of West Africa Limited* a rule that

Meckling (above, note 48) at pp 1-6; Cheffins (above, note 77) at pp 30-37; Stout (above, note 77) at p 1199.

91 *Burland v. Earle*, (1902), AC 83; *Northwest Transportation Co Ltd. v. Beatty*, (1887), 12 App CAS 589; *Pender v. Lushington*, (1877), 6 Ch. D. 70; See also generally MacIntosh for a review of the courts' view. [MacIntosh Jeffrey G., "Minority Shareholder Rights in Canada and England: 1860-1987", (1989), *Osgoode Hall Law Journal*, vol. 27, No. 3, Toronto, Osgoode Hall Law School, at p 602].

92 *Burland v. Earle*, (1902), AC 83; *North West Transportation Co Ltd. v. Beatty*, (1887), 12 App CAS 589.

93 The ownership approach has attracted supports from current company law scholars too. See Ferran (1999), (above, note 2) at p 247; Birds Et. Al. (above, note 3) at pp 209, 214, 368; Lee Hazen (above, note 36) at pp 1900, 1910; Bebchuk (2003), (above, note 75) at p 15.

subjected the exercise of voting right to consideration of interests of the company as a whole. As he put it:

...the power conferred to the majority shareholders 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 and 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."⁹⁴

Fifty years later, Evershed M.R in *Greenhalgh v. Arderne Cinemas*⁹⁵ interpreted the measure of 'the interests of the company as a whole' introduced by the *Allen* case as being the interests of company shareholders generally. He further offered the famous 'an individual hypothetical member' formula that required taking the case of such member and asking 'whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit'.⁹⁶ However, the new rule had two not very compatible elements of 'bona fide' and 'benefit of the company as a whole'. While the element of 'bona fide' was a subjective measure⁹⁷, the 'benefit of the company as a whole' was seen objectively and this could mean misapplication of the new rule by the courts.⁹⁸ It could also mean while a decision of majority may in fact be for the benefit of shareholders, it may be set aside merely because it is taken by the majority who voted *mala fide*. Also, it could cover only formal discriminations. In other words, a decision that affected every shareholder formally equal but treated them informally unequal could remain untouched. In *Allen* case, for example, though the court was persuaded

94 *Allen v. Gold Reefs of West Africa, Limited* (1900), 1 Ch. 656 per Lindley M.R. at p 671.

95 (1950) 2 All E. R. 1120 per Evershed M.R. at 1126.

96 *Greenhalgh v. Arderne Cinemas LTD*, (1950) 2 All E. R. 1120 per Evershed M.R. at 1126.

97 *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd, and Others*, (1927), 2 KB 9 at pp 20-23 per Scrutton LJ. This decision has been latter supported by *Greenhalgh v. Arderne Cinemas LTD*, (1950) 2 All E. R. 1120; For a contrary judgement see *Dafen Tinplate Co. Ltd. v. Lianelly Steel Co.*, (1920), 2 Ch. 124 which viewed the test in *Allen* case as objective one.

98 *MacIntosh* (above, note 91) at pp 612-4; *MacNeil* 2005 (above, note 20) at p 261.

that the amendment to the articles was aimed at and actually affected only a single shareholder, it dismissed the case on the ground that the amendment treated all shareholders formally equal.⁹⁹ Considering the fact that majority and minority interests can differ largely and that different classes of shareholders may exist in corporations, the test of 'an individual hypothetical member' could not help the courts because it was difficult, if not impossible, to isolate such a member and ask if the change was for that member's benefit.¹⁰⁰

Later developments, to some extent, remedied the above said difficulties. The *Ebrahimi v. Westbourne Galleries Ltd.* case observed equitable considerations in substitute of legal rights of company members and allowed an oppressed minority shareholder to free himself of a closed and unfair company relationship by asking a winding up remedy.¹⁰¹

A shareholder was no longer required to surrender to a majority decision which was taken honestly for the benefit of the company but ignoring at the same time his legitimate expectations. The *Ebrahimi* case, therefore, extended the scope of the duty of majority shareholders from mere consideration of interests of the company to the legitimate expectations of individual shareholders inside the company and to the cases involving informal discrimination. The introduction of section 459 Companies Act 1985 strengthened this trend towards imposing duty on majority shareholders and extended

99 See Lindley MR arguing that 'the altered articles applied to all holders of fully paid shares, and made no distinction between them. The directors cannot be charged with bad faith'. [*Allen v. Gold Reefs of West Africa, Limited* (1900), 1 Ch. 656 per Lindley M.R. at p 675]; See also generally MacIntosh (above, note 91) at pp 608-614.

100 "the very subject matter involves a conflict of interests and advantages. To say the shareholders forming the majority must consider the advantages of the company as a whole in relation to such a question seems inappropriate, in net meaningless, and at all events starts an impossible inquiry". [*Peters American Delicacy Co Ltd v. Heath*, (1939), 61 CLR 457 at 481].

101 *Ebrahimi v. Westbourne Galleries Ltd.* (1973), AC 360; See also *Clemens v. Clemens*, (1976), 2 All ER 268, and Insolvency Act 1986, s 122 (1).

the scope of available remedies from winding up to a range of alternatives listed in section 461 Companies Act 1985. These remedies will fully be discussed later in Chapter five and thus I will avoid bringing any more discussion of them here.

III.1.6. Relevance of institutional shareholders

The central argument I have taken about shareholder/management relationship has been to defend shareholder control which can effectively function to align wayward management. I also explained that control by shareholders even with the possibility of majority abuse is yet advantageous to minority shareholders. However, as shareholders in English large corporations have tended to be small and unorganised, control by shareholders could have served little use.¹⁰² Potentially, the growing size of institutional investment made it possible for the shareholder control to function effectively.¹⁰³ Institutional shareholders could have direct influence on management preventing them from shirking responsibilities and manipulating company assets.¹⁰⁴ Nonetheless, things did not go as expected.¹⁰⁵ Institutional shareholders' response to the controlling capacity they had was odd, unpredictable and disappointing particularly for those who hoped a quick change in the current corporate governance arrangement. As empirical research suggested and many writers indicated, institutional shareholders have tended in practice to influence the management

102 MacNeil (2005), (above, note 20) at p 268.

103 See above, at note 55.

104 Black (above, note 54) at pp 570-575, 585-594; Ferran (above, note 2) at pp 241-244; Birds Et. Al. (above, note 2) at pp 345-246; Mayson Et. Al. (above, note 64) at p 440.

105 For an opposing view see Farrar who took the view that institutions' capability to control companies might change nothing for minority shareholders because institutions may merely provide another example of a power bloc within a company and this is nothing remarkable. [Farrar (above, note 15) at p 599].

through informal dialogue instead of formal exercising of voting rights.¹⁰⁶ Although they often have sufficient votes to control companies, they have rarely used their votes.¹⁰⁷ Instead, they have tended to influence the management through behind scene negotiation¹⁰⁸ and once negotiation is found unworking, they often want to sell their shares and relocate their funds elsewhere which is more profitable and hospitable.¹⁰⁹ Institutional shareholders, it is suggested, only seek to obtain financial return on their financing and as a natural reaction they do not care about control. Most of these institutions are formed with a financial motive only. 'They do not consider themselves as managers in the business world. They view themselves (and it appears they actually are), as financial institutions that invest and manage funds for the benefit of smaller passive investors'.¹¹⁰ They also do not want to 'damage the company's share price that could result from a head to head public confrontation between them and the management'.¹¹¹ The prime duty of institutional shareholders is to pursue the benefits of their own beneficiaries who simply want the highest returns and that may require them to avoid risk. Therefore, neither institutional shareholders nor their investors and beneficiaries care about ups and falls of their investee company. In addition to these,

106 Ferran (above, note 2) at pp 241-245, 248; Birds Et. Al. (above, note 2) at pp 345-346; Farrar (above, note 15) at p 594; Black (above, note 54) at pp 591-594; Ratner (above, note 4) at p 26.

107 As Boyle and Birds pointed out "...it is much more common for a prestigious institution to raise a matter 'behind the scenes' by approaching the chairman of the board or other senior executive directly." [Birds Et. Al. (above, note 2) at pp 347,388].

108 This behaviour is analogous to the democratic strategy that influence on the government may be exerted more by discussion and lobbying than by general election. [Pound (above, note 81) at 1003; Mayson Et. Al. (above, note 64) at p 440].

109 Cubbin and Leech (above, note 53) at p 363.

110 Birds Et. Al. (above, note 2) at pp 345-7; See also Mayson Et. Al. (above, note 64) at p 440; Easterbrook & Fischel (above, note 65) at pp 425-426; Miles Lilian and Proctor Giles, "Unresponsive Shareholders in Public Companies: Dial "M" for Motivate?", *The Company Lawyer*, (2000), Vol. 21, No. 5, London, Oyez Publishing Limited, at p 143.

111 Ferran (above, note 2) at p 245.

they have no duty to exert any active involvement in control of their investee companies.¹¹²

As institutional shareholders have been passive, some political and economic theorists have taken the view that the prevailing passivity of institutions that makes either the very exercise of shareholder control obsolete or the proper functioning of it faulty cannot be cured. They both emphasise on the elimination of institutions' right to vote. Nonetheless, while political thinkers want this in the interest of the proper functioning of the shareholder control mechanism¹¹³, economists' intention is to allow the specialist management seize control of companies.¹¹⁴ These proposals have attracted little support in the current English company law and among legal scholars.¹¹⁵ Considering the significant benefits which associate with the shareholder control and looking at the potential ability of institutions to exercise control, they have taken the view that institutional passivity can be cured with policies taken by regulators that encourage activism among institutions. These policies can take one of the following two forms:

112 Mayson Et. Al. (above, note 64) at p 440; Smith T.A., "Institutions and Entrepreneurs in American Corporate Finance", (1997), 85 *Calif. L Rev.* 1, Berkeley, Calif., University of California, School of Jurisprudence; Birds Et. Al. (above, note 2) at pp 345-6; Ratner (above, note 4) at p 26.

113 For example, Ratner argues that institutional shareholders' passivity has caused a gap in the market for managerial services because with passive functioning of institutions managers would be able to be re-elected with the opposition of dispersed individual shareholders. [Ratner *Ibid*].

114 Easterbrook & Fischel (above, note 65) at pp 403, 426; For a detailed discussion about different sorts of proposals for limiting or abolishing voting rights of institutional shareholders see Farrar (above, note 15) at pp 603-4.

115 Company Law Reform, "Modern Company Law for a Competitive Economy: Final Report", (London, DTI, 2001), URN/942 & URN/943, paras 1.52, 1.56-1.57, 3.51; Nolan RC, "Indirect Investors: A Greater Say in The Company?", (2003), 3 *Journal of Corporate Law Studies*, 73, at pp 73-7.

III.1.6.1. Imposition of legal duty

Some company law scholars proposed that the law should increase responsibilities of institutional shareholders and in particular make them use their voting power on an informed basis. Proponents of this view believe that institutional participation will add value to companies because it may positively influence the management by suggesting efficiency enhancing proposals.¹¹⁶ Also, institutional participation can encourage accountability among managers helping achievement of efficiency in companies which further improves market competitiveness for managerial services.¹¹⁷

While the very issue of the increased responsibility is a commonplace matter, in determining what source supply such responsibility views differ among the proponents of this view. To some, it is a matter of the relationship between institutional shareholders, other interested groups, and investee companies. By buying shares, institutional shareholders assume duty to show active participation in control of their investee company because their conduct may have impact on other interest groups.¹¹⁸ To some others, it is a matter of the relationship between institutional shareholders and their beneficiaries as indirect investors.¹¹⁹ According to this argument, voting rights of institutional shareholders originally belong to their

116 See Bebchuk (above, note 75) at pp 47-63.

117 See generally Ferran (above, note 2) at pp 248-9.

118 "...Given that the arrival or departure of an institution as shareholder may substantially affect share prices, It is not surprising that it has been argued that the institutions have a duty not to sell their holdings if dissatisfaction with management arise, but to stay on and work to remedy any wrongs. A controlling shareholder has responsibility to the other shareholders, employees and even consumers..." [Farrar (above, note 15) at pp 599-600]; See also Black (above, note 54) at p 572; Moody P.E., "A More Active Role for Institutional Investors", (1979), *The Barker*, February 1979, at p 49.

119 Nolan (above, note 115) at p 73; MacNeil 2005 (above, note 20) at pp 259-260.

beneficiaries to whom institutional shareholders have duty to exercise actively rather than to stay passive or simply exit from the company.¹²⁰

Company law currently knows no duty of the sort suggested by the two above-mentioned propositions. On the one hand, it is now a settled issue that shareholder voting is a free mechanism¹²¹ that allows shareholders to choose between voting and failing to vote absolutely free of duty.¹²² Shares and their attached voting rights are seen as property of shareholders. There is no obligation on corporate shareholders to vote with a view to what other persons may consider to be in the interests of the company.¹²³ Although, the *Allen* case¹²⁴ imposes some duty on majority shareholders, it never compels the majority to participate and vote. Nor, it requires the majority to disregard of their personal interests.¹²⁵ Furthermore, Imposition of any legal duty on institutional shareholders 'would constitute an unwarranted fetter on the institution's freedom to manoeuvre'¹²⁶ and, as Ferran observed, it is very likely that as a result of such duty imposition, institutional shareholders adopt a 'box-ticking' behaviour because a discharge of any such duty requires institutions to be informed when they are voting and this might be very difficult and costly to ask them search for information.¹²⁷ On the other hand, although institutional shareholders have duty to act

120 Curzan Myron P. & Pelesh Mark L., "Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues", (1980), *Harvard Law Review*, 670, Cambridge, Mass., Harvard Law Review Publishing Association, at p 694; MacNeil 2005 (above, note 20) at pp 259-261.

121 *Burland v. Earle*, (1902), A.C. 83; *North West Transportation Co Ltd. v. Beatty*, (1887), 12 App. CAS. 589.

122 See *Burland v. Earle*, (1902), AC 83; *Northwest Transportation Co Ltd. v. Beatty*, (1887), 12 App CAS. 589; *Pender v. Lushington*, (1877), 6 Ch. D. 70.

123 *Pender v. Lushington*, (1877), 6 Ch. D. 70.

124 *Allen v. Gold Reefs of West Africa, Limited* (1900), 1 Ch. 656 per Lindley M.R. at p 671.

125 See above, at IV.1.5.

126 Farrar (above, note 15) at p 599.

127 Ferran (above, note 2) at pp 248-9.

for the benefit of their beneficiaries, but this is a duty to be exercised in a general sense without prescribing the ways in which this duty might be discharged and yet institutional shareholders remain the final judge of their preferred way of conduct in their investee companies. Also, 'the person entitled to vote is the registered owner of a share and company law prohibits the interests of any other persons being recorded in a company's register of shareholders'.¹²⁸ Company law, therefore, clearly rejects the idea that institutions act as intermediary and hence their right to vote should be passed to their beneficiaries as indirect investors.¹²⁹

The debate over whether or not to impose a statutory duty on institutional shareholders is also manifested in recent attempts of the British government to reform company law. In 1999, the Department of Trade and Industry (DTI) which was authorised to review company law took the view that it is probably better to impose a statutory duty on institutional shareholders and proposed that 'it may take legislative steps to oblige the institutions to make use of their votes'.¹³⁰ The view was later put by the government in the form of a clause in the proposed Companies Bill which conferred a reserve power to the Treasury or the Secretary of State to mandate disclosure of voting by institutional investors.¹³¹ Subsequently, however, the mentioned clause was eliminated from the Bill and now the Companies Act 2006 includes only a much more relaxed duty which generally requires persons who hold

128 MacNeil (2005), (above, note 20) at p 260; see also Nolan (above, note 115) at pp 73-80.

129 Section 360, Companies Act 1985 and Regulation 5 Table A in the Companies (Tables A-F), (SI 1985/805).

130 DTI, Consultation Paper, "Company General Meetings and Shareholders Communication", (1999) at 13.23.

131 The Companies Bill (108-16 May 2006) Volume II, Clause 876, available from the DTI website at the following address: <http://www.publications.parliament.uk/pa/pabills/200506/companies.htm>.

shares on behalf of others to inform companies of the way they have exercised their voting rights.¹³²

III.1.6.2. Self-regulation

Successive review committees of the Combined Code on corporate governance and their supporters argue that institutional passivity is best remedied through adoption of some non-statutory regulations and self-regulatory rules of conduct rather than by imposing some legal duty. From this perspective, Combined Code and regulations of the like are products of shortcomings of the existing market-directed and company law developed control mechanisms on managerial misbehaviours. By drafting some non-statutory but standardized regulations in respect of corporate governance issues, the drafters focused attention to raise the corporate governance culture in the hope that companies, shareholders and directors will gradually adopt the proposed models at will.¹³³

The Combined Code in particular targets public listed companies exclusively and is generally divided into two sections. The first section relates to companies as it seeks to propose companies certain solutions to publicly expressed concerns about the role of directors, their remuneration, reappointment and accountability and the issue of audit. In particular, it requires company boards to ensure that their companies listen to shareholders' views and concerns.¹³⁴ The second section relates to the institutional shareholders and very gently recommends them to 'enter into a dialogue with

132 Companies Act 2006, sections 152-153.

133 The Combined Code, (2003), preamble, Para 5.

134 The Combined Code, (2003), Section 1, Para D 1.

companies based on the mutual understanding of objectives'.¹³⁵ In this section, the policy of the Combined Code is to encourage activism among the institutional shareholders, aiming importantly to improve managerial behaviour through persuading institutional shareholders to use their voting power responsibly.¹³⁶ The Code has deliberately chosen institutional shareholders as it is sufficiently clear from its background that the majority of 80 percent of shareholders in listed companies including overseas companies are institutional in nature and hence any discussion of the role of shareholders must focus on the institutions¹³⁷ (pension funds, insurance companies, and investment trusts and other collective investment vehicles as defined by the Institutional Shareholders Committee¹³⁸).

While regulations of the first section are sanctioned by the Listing Rules¹³⁹, no statutory rule mandates regulations of the second section. Listing rules only govern the conduct of companies that wish their shares to be listed in the London Stock Exchange (LSE). They are not concerned with the way shareholders of such companies conduct in their

135 The Combined Code, (2003), Section 2, Para E 1.

136 The Combined Code, (2003), Section 2, Para E 3; the same was also stated in the Hampel Committee's report: "they (institutional shareholders) have a responsibility to make considered use of their votes that they should be ready to enter into a dialogue with companies based on the mutual understanding of objectives and they should give due weight to all relevant factors". [Hampel Committee, "The Combined Code: A Practical Guide", (October 1999)].

137 Dignam Alan, "A Principled Approach to Self-Regulation? The report of The Hampel Committee on Corporate Governance", (1998), *The Company Lawyer*, 19 (5) 140, London, Oyez Publishing Limited, at pp 147-148; see also above, at note 55.

138 The Responsibilities of Institutional Shareholders and Agents - Statements of Principles, available at the following website: www.investmentuk.org.uk/press.

139 Although adoption of the proposed solutions of the Code is entirely voluntary, compliance of regulations of this part is given some level of command through the mechanism of the so-called 'comply or explain' in the Listing Rules. [see The Combined Code, (2003), preamble Para 4 and 5; Draper Michael G, Partner, Brown Turner Kenneth, "Corporate Governance", *Law Society's Gazette*, (1992), vol. 89, No 26, p 25] As this research is primarily concerned to the second section, any further discussion in relation to the first part of the Code goes beyond the patience of the research and has to be traced elsewhere.

portfolio company.¹⁴⁰ Such conduct principally and as far as it does not go beyond the limits of the company law is considered to be forming part of shareholders' right of property and freedom. However, it is always possible for shareholders to regulate the way they conduct. This is the case for institutional shareholders as their conduct is governed on a self-regulatory basis by the regulations designed by the Institutional Shareholders Committee, which is comprised of representatives from Association of British Insurers, Association of Investment Trust Companies, National Association of Pension Funds and Investment Management Association. In pursuance to the Combined Code, it sets out principles of best practice for institutional shareholders in relation to their responsibilities in respect of investee companies and generally requires such institutions to adopt the policy of activism and provide a clear and publicly accessible statement on such policy and on how they will discharge their responsibilities.¹⁴¹

140 MacNeil, Iain, "Competition and Convergence in Corporate Regulation: The Case of Overseas Listed Companies", available at The Social Science Research Network website in the following address: www.ssrn.com, Corporate Law & Governance Working Paper Series, autumn 2001 (SSRN ID 278508 code 010812600.pdf).

141 The Responsibilities of Institutional Shareholders and Agents, (above, note 138).

III.2. The case of Iran

This part is about, from the Iranian company law viewpoint, examination of how the rule of majority works in joint stock companies. The examination, as we have earlier seen, concerns the mechanism of shareholder voting and my intention is to show how opportunistically it can be used by the majority against minority shareholders. One important point to consider is that Iranian company law on this matter is considerably similar to the English company law. It was submitted in Chapter one that the idea of modern company which enjoys separate personality and works with the majority rule was imported from the European model to the Iranian trade law. Iranian context was not ready to allow evolution of the majority rule based on voting mechanism and hence no effort on the part of academics was made in order to theorise and institutionalize such idea in business vehicles. In the early twentieth century, however, the Iranian government rapidly decided to westernise the economy and law by referring to the European countries' economies and laws and such westernisation included business vehicles and company law too. As a result, company law was adopted on the model of European countries' laws. Adoption allowed Iranian company law to assimilate, in great part, many of the ideas and mechanisms which existed in the English company law and, thus, many of the issues about voting mechanism that I have discussed earlier in the English part can be raised and answered similarly. These aside, there are also some divergence between the two company laws on this matter. To avoid unnecessary repetition of discussion, my intention in this part is to enunciate similarities and dissimilarities of the two systems.

There are inevitable similarities between Iranian and English company laws about shares and voting mechanism. For one, corporate shares can be classified into two categories of ordinary and preference shares¹⁴², as can be divided so in English company law. For another, Iranian companies, like their English counterparts enjoy the rule of majority¹⁴³ that works on the basis of 'one share, one vote'.¹⁴⁴ Further, both the majority rule and the rule of 'one share, one vote' are like the English model default rules and have contractual nature.¹⁴⁵ Similarly, nature of majority and minority can in theory and in law compose of varying elements depending on different issues which come up for collective decision-making in shareholder meetings. In addition to these, Iranian and English company laws have approached similarly on the shareholder voting and its limits. It is now a settled issue in Iranian law, as it is in its English counterpart, that voting is right and not duty and hence shareholders have discretion to exercise it freely.¹⁴⁶ At the same time, they commonly put similar limitation on controlling shareholders when they take corporate decisions. As the exercise of majority right in English company law is subject to observation of the equal treatment

142 Section 24 JSCA and its note 2.

143 Sections 86, 87, 88 and 103 JSCA.

144 Sotoodeh Tehrani Hasan, "Trade Law", (1997), Tehran, Dekhoda Publication, vol. 2, at pp 121, 124; Hoseingoli Katebi, "Trade Law" (1994), 6th ed., Vol. 2, Tehran, Ganjedanesh Publication, at p 79; Azami Zangeneh Abdolmajid, "Commercial Law" (1974), 4th ed., Tehran, University of Tehran Publication, at p 119; Erfani Mahmood, "Abuse of Job and Power in the Law of Iran", *Comparative Law Institution Monthly* (1981), No 7, University of Tehran Publication, Tehran, at pp 148-231; Seghari Mansoor, "Definition of Business Corporation", in *Private Law Developments*, Edited by Katoozian Naser (1993), Tehran University Publications, at p 199; Eskini Rabiaa, "Trade Law: Business Corporations" (2000), Vol. 2, Samt Publication, Tehran, at p 78.

145 "Shareholders' meetings are formed by gathering of shareholders. Rules relevant to quorum and required votes for taking collective decisions are determined in the company's articles of association unless where the Act prescribes a particular method" [Section 72 JSCA]; Ebadi Mohammad Ali, "Trade Law", (1972), Chehr Publication Co., Tehran, at pp 96-99; Sotoodeh (above, note 144) at p 119; Eskini (above, note 144) at p 83.

146 Sotoodeh (above, note 144) at pp 117-118.

rule established in the *Allen* case¹⁴⁷, Iranian company law offers an equality principle which compels controllers to treat shareholders equally. The principle which works in default of a contrary shareholder agreement is understood by implication from the meaning of a number of sections in the JSCA.¹⁴⁸ Lastly, in both systems voting functions the same; to fill contractual gaps and to control companies.

Similarities aside, Iranian company law has diverged from the English model in certain areas. To begin with, while decisively important for financing English companies, private institutions in the English sense; i. e. institutional shareholders; do not exist in Iran, as most financial institutions including banks and insurance companies are state controlled. Few private institutions, which have succeeded to obtain licence from the state in order to offer financial services, play little role in Iranian corporations. They often either do not want to invest in large corporations or even if they want they will face prohibition. Financing large corporations, which are often dominated by the state and its dependant organisations, can politically and economically be too risky. Large scale projects and main industries too most of the times fall within the state monopoly.¹⁴⁹ As a result, institutional shareholders are almost absent in the Iranian corporate sector. Unlike institutions, individual investors seem interested to invest

147 See this Chapter (above, para III.1.5).

148 See sections 32, 33, 42, 75, 93, 99, 148, 166, 168, 189, and 264 (1) JSCA.

149 Large corporations which are under state control suffer from unsuccessful management while enjoying rent from their monopolies. Private sector, on the other hand, is liable to risks caused by political instability which emerged after the Iranian revolution of 1979, in particular the risks of nationalisation and confiscation. [See Jalali Naini, Ahmad R., "Capital Accumulation and Economic Growth in Iran: Past Experience and Future Prospects", *Iranian Studies*, Volume 38, number 1, 91, March (2005); Saeidi, Ali A., "Charismatic Political Authority and Populist Economics in Post-Revolutionary Iran", *Third World Quarterly*, (2001), Vol 22, No 2, 219-236, at pp 221-2].

money in large corporations which are controlled by the government, as such companies are liable to less political and economic risks.¹⁵⁰

Corporations in Iran and England have also diverged on the issue of variability/stability of the nature of majority rule. While large companies in England may have majority rule made up of varying elements, Iranian companies whether large or small are normally controlled by one or few dominant shareholders who can stabilise the majority nature in every issue that comes up for appropriate majority resolution in shareholder meetings. This divergence is a consequence of differing governance structures which exist in Iranian and English companies.¹⁵¹

Another divergence is that the issue of shareholder control has never been controversial in the Iranian company law. As Iranian corporations enjoy a concentrated shareholding structure, shareholder control has always been relevant both in theory and in practice. As a consequence, most difficulties which stem from the collective action in the English large companies have been absent in the Iranian corporations.

As a further source of divergence, Iranian company law, unlike its English counterpart, seems to be unfriendly as to non-voting shares or insertion of a clause in the corporate articles which deny voting right for a group of shares. Although company statutes especially the JSCA stipulate no clear prohibition, it is a conventional view among

150 Such corporations were often backed up by the governmental support which could largely minimize economical and political risks to individual financing.

151 See Chapter one (above, para I.2).

Iranian scholars that non-voting shares has no place in Iranian companies.¹⁵² Using the logic of section 75 JSCA, which states in a mandatory fashion that every share must have at least one vote¹⁵³, they maintain that right to vote is fundamental to the essence of company contract and any violation of it makes the very contract void. The reason as they say is that non-voting share is to mean separation of ownership from control, something which makes the contract too risky and which is undesirable in law and prohibited in Islam. They also argue that non-voting share is in nature debentures, as they both do not allow holders to participate in control of companies.¹⁵⁴ They, however, add that while it is not possible to issue non-voting shares, exercise of voting right can be subjected through limitations inserted in articles¹⁵⁵ and it is further possible to a shareholder to transact their right in return for consideration.¹⁵⁶ As I explained earlier in Chapter one, of the main reasons upon which Iranian law adopted the European model rather than the Anglo-American model was the former's capability for being adjusted as to accommodate traditional contracts which focused on concentration of ownership and control.¹⁵⁷

Yet, for a number of good reasons one can remain sceptical as to the force of the conventional view. For one, the invoked provision is only relevant to the founders meeting and cannot be used to establish such conclusion in respect of other meetings.

152 Sotoodeh (above, note 144) at pp 114-119; Erfani Mahmood, "Trade Law", (1999), Jehade Daneshgahi Institute Publication (Majed), Tehran, Vol. 2, at p 68; Ebadi (above note 159) at pp 96-99.

153 "...In founders' meeting, every subscriber and founder has right to attend and every share will have one vote." [Note under Section 75 JSCA].

154 Sotoodeh (above, note 144) at p 118.

155 Ebadi (above note 145) at pp 96-99; Rastiin Mansoor, "Commercial Law", (1975), University of Tehran Publications, Tehran, 3rd ed., at p 118.

156 Eskini (above, note 144) at p 85.

157 See Chapter one, (above, para I. 2).

For another, the language and wording of the relevant statutes in respect of extraordinary and ordinary meetings imply that a company may issue non-voting shares.¹⁵⁸ Further, regulatory rules which exist in Tehran Stock Exchange (TSE) listings suggest that it is possible for companies to issue non-voting shares.¹⁵⁹ Also non-voting shares diverge from debenture, as they enjoy participatory right and for example allow their holders to attend meetings and get access to the information in relation to the affairs of the company. Too, while it is possible to transact voting right, it is not very certain why it is not possible to allow such transaction to take place at the very beginning where an issuing company seeks to issue non-voting shares. In addition to these, a non-voting shareholder will always have power to transfer its shares to likely buyers and more importantly such shareholder is able to enforce corporate rights against faulty directors, as are voting shareholders.¹⁶⁰

158 For example sections 84 and 87 (JSCA) while providing the requirement of quorum for a formally valid meeting of ordinary and extra ordinary indicate that for such meetings participation of those shareholders who have voting rights is necessary. This language connotes two meanings. The direct meaning is the one, which is understood by the literal wording. And the indirect one that suggests participation of those who lack voting right is not necessary for such meetings.

159 One of the requirements for shares of public companies to be allowed for listing in the Tehran Stock Exchange is to bear voting right. If it were legally impossible to issue non-voting shares, providing such requirement would seem absurd. [See TSE Listing Rules available in Farsi at the following website: <http://www.irbourse.com/FForms/gavanin/Section4.aspx#B1>].

160 Section 276 JSCA.

III.3. Conclusion

This Chapter considered the nature of the majority rule. It concerned reviewing the relevance of voting mechanism in the majority/minority shareholder relationship. It sought to demonstrate and examine the mechanism through which the majority rule works whereby to show how the rule can opportunistically be used by the controlling shareholders and how effective company laws or other elements in the two systems have curbed such abusive behaviour. It was made clear that the majority rule, which allows majority shareholders to exert control in corporations, works through the mechanism of voting. As shareholders vote in shareholder meetings, they apply control over corporate affairs too. Nonetheless, not every shareholder holds and exerts the same control. The degree of shareholder control can differ depending on the number of votes a shareholder may have. Thus, voting can affect the nature of the majority rule. As the principle of majority rule in corporations relies on the 'one share, one vote' rule, the result is those who possess more shares will have more control. This is to mean as much as control depends on voting, voting itself depends on share ownership. In the normal course of arrangements every share endows one vote to its holder and this is to mean that principally it is the size of shareholder investment that determines how much control a shareholder might have and exercise although this is a default rule that can be displaced through contract.

Voting can also affect the nature of majority rule where shareholders vote in respect of differing issues. A change of the subject issue which is to be decided in shareholder meeting may give rise to a former majority composed of certain shareholders becomes subsequently substituted by a new majority with different components. In other words, the nature of majority rule is variable. Nevertheless, in reality the nature of the

rule can often vary in companies which rely on external financing and which lack presence of one or few controlling shareholders. In such companies, the variable nature of majority rule can offer some safeguard to small shareholders, as no shareholder possesses corporate shares enough to exert control over different affairs. Where corporations have a majority group, which can be made up of the same elements for every issue raised at shareholder meetings, such safeguard is absent. For such corporations, the nature of the rule remains almost always stable. A corollary is that while corporations of the first category are exposed to less majority/minority conflict, their counterparts in the second category can be liable to that conflict more. Yet, the variable nature of majority rule, which occurs in corporations of the former category, can never eliminate the conflict. Sometimes one or few active but relatively small shareholders can yet control companies not because they have sufficient fifty percent shareholding but rather because in such cases dispersed shareholding plus collective action problem contribute to reduce the degree and amount of shareholding one needs to exert *de facto* control.

The mere fact that one or few shareholders exert control in corporations, using the majority rule is not bad at all. In fact, such control, as we have earlier seen, is desirable and necessary.¹⁶¹ What raises concern is only abuse of control which can occur where those who possess majority of shares and exert *de jure* control, or else where those who control companies *de facto*, use their voting rights opportunistically. In pursuit of private benefits, such persons may sacrifice minority interests when voting in shareholder meetings. Voting is principally regarded in law as right that leaves

161 See this Chapter above at III.1.4.3 and Chapter one above.

shareholders with freedom in the exercise of it. It carries no duty which could instruct shareholders in respect of how to vote and this could mean every shareholder while voting can consult with their personal interests and can further ignore interests of their fellow shareholders. Thus, it is the shareholder control plus absolute freedom in the exercise of it that can generate risk and raise concern for minority protection. To address such concern, both private contracting and company law could be relevant. As to the former, it was made clear that contract parties have always the choice to displace the rule or put on it some limitation that deviates the 'one share, one vote rule'. Nonetheless, as any such limitation can affect majority shareholders sharply, they are in practice uncommon among shareholders. As to the latter, both English and Iranian company laws impose legal duty on controlling shareholders which requires them exercise rights non-discriminatory. Nonetheless, the function of such duty as to preserving minority interests is limited as it currently covers only obvious discriminations and, as a result, many cases which involve informal discrimination can escape prosecution.

As institutional shareholders have been substantial investors in English corporations, I considered in this Chapter the relevance of their financing as to the majority/minority conflict. I wanted to see whether the potential controlling power, which is held by such shareholders, could do anything remarkable as to protecting minority rights. No doubt, they are important as to the shareholder/management conflict. As shareholder control is often lost and mismanagement persists in English large corporations, they could serve to enable shareholder control hereby to curb mismanagement. My investigation, however, showed that they have been passive in practice. This means they actually changed nothing important in the shareholder/management conflict, because they tended not to use their voting rights against management. As to the

majority/minority conflict, too, they have done nothing because they do not want to get involved in control of corporations. Even if they wanted to get some involvement, they could have changed nothing in the interest of minority shareholders, as they could only form another example of a power bloc in corporations.

Chapter IV: Relevance of directors' role

Chapters one to three concerned reviewing the majority rule as being a direct control device. They sought to show how majority shareholders could make a direct use of the rule in order to take self-interested and opportunistic resolutions against minority shareholders. This aside, another aspect of the majority rule which requires consideration is the one that allows majority shareholders to exert indirect control over corporations. Such control is often exerted through corporate directors who are principally appointed and monitored by majority shareholders. While being under such control, directors are required in law to take impartial decisions and regard matters which best benefit the company as a whole rather than only the majority shareholders. They therefore can be a device which empowers majority control or else a device which reduces the likelihood of abuse by majority shareholders. Thus, directors' role is important for the purpose of my discussion as it shows how directors can be either a hinder or a help as to minority protection. This Chapter seeks to demonstrate and examine from such aspect the corporate directors' role as to the majority/minority conflict. It concerns, in particular, consideration of directors' duties both on matters of substance and enforcement. Corporate directors, it is said, can play some role in minimising the possibility of majority abuse. They exercise certain key corporate powers which otherwise would have fallen within the authority of majority shareholders. Unlike shareholders, they assume duties imposed by law which require them to act carefully, impartially and loyally when they exercise such powers.¹

¹ Section 309(2) Companies Act 1985 provides that directors' duty is owed only to the company and not its shareholders or any other interested groups, though the matters to which they are to

Company law also offer internal mechanisms of control which enable shareholders to enforce these legally imposed duties of directors. Thus, they are much more likely, contrast to majority shareholders, to exercise corporate power in a manner which is for the benefit of the company and its shareholders generally. However, there are reasons both in respect of the contents of director duties and about the currently existing enforcement mechanisms that suggest their role is not very remarkable as to resolving majority/minority conflicts and can sometimes be problematic. I say problematic because an amalgamation of malfunctioning which stems from substance and enforcement of directors' duties has enabled directors to commit, in different ways and varying degrees, mismanagement in both English and Iranian companies. To address matters of substance, I must examine law relevant to liability of directors which is most reflected in directors' legally imposed duties of fiduciary and care and which I examine them first. Then, I will address matters of enforcement, which concern internal control mechanisms that currently exist in company laws of England and Iran. Divergence in corporate governance structures and the role of market in aligning wayward directors are also pertinent issues which will be discussed afterwards.

have regard in the performance of their functions include the interests of the companies' employees in general, as well as the interests of its members. [See section 309(1) Companies Act 1985].

IV.1. The case of England

IV.1.1. Matters of substance

The touchstone argument here is that while on the one hand exercise of corporate power by directors can be beneficial to minority shareholders, it can, on the other hand, be disadvantageous especially because directors are liable to mismanagement, something that affects every shareholder. The absence of mismanagement is efficient and desirable because it allows companies to attract more investment and to allocate those investments to their optimum use with minimum possible costs. However, mismanagement can reduce the extent to which companies can work efficiently both *ex ante* and *ex post*. At the initial financing stage, it reduces the extent to which investors are ready to provide finance for the use of corporations. When financing is complete, it reduces the size of corporate funds that otherwise would be available to corporations to put into business and to make profit. Mismanagement has recently been an issue of public concern in the England. In the early 1990s, millions of pounds of investors' money were lost in unsuccessful public companies that went insolvent unexpectedly.² In most cases that were investigated, mismanagement (managerial indirect stealing and poor performance) was identified as a prime cause of these failures.³ Several review committees emerged in the 1990s and early 2000s in the England to address the

² See generally Smerdon, Richard, "A Practical Guide to Corporate Governance", (1998), Sweet & Maxwell, London, at pp 37, 52; Cheffins Brian R., "Current Trends in Corporate Governance: Going from London to Milan via Toronto", *Duke Journal of Comparative & International Law*, (1999), Vol. 10, No. 5, at pp 16-17.

³ Cheffins, *Ibid.*

issue of mismanagement in public listed companies.⁴ Yet they did not succeed in solving the problem and thus mismanagement continues to survive in corporations.

Mismanagement is a matter of principal/agent relationship. Managers, as agents, are employed by companies to direct the business of the principal. Companies and their investors need managements' specialised skills to produce returns on their investment. Managers, on the other hand, need investors' funds since they either do not have enough money of their own or want to cash out their investment and exit. This principal/agent relationship is normally put in the form of a service contract whose rules as well as the rules of company constitutions determine the purpose and extent of power conferred to management. But contracts cannot be completely certain, addressing every existing and future contingency *ex ante*. Many important governance and business issues may thus occur all the way through the life of companies that require *ex post* decision-making. Company investors may often find it impractical or unprofessional to take such decisions and may want to vest discretion to make such decisions in management. Thus, they often prefer to draft their contract with some degree of uncertainty in the hope that future events will go right with loyal and careful management and that the law will be able to address likely future deviations of management. This hope, however, is sometimes disappointed. Once in power, management may want either to pursue self-interested projects or may simply pay inadequate attention to the affairs and business of their companies.

⁴ See the successive reports of The Cadbury and Hampel committees in 1990s (Cadbury Committee, "Internal control and financial reporting: draft guidance for directors of listed companies developed in response to the recommendations of the Cadbury Committee", 1994, Institute of Chartered Accountants in England and Wales, London; Hampel Committee, "The Combined Code: A Practical Guide", October-1999, London, UK) and the latest report of Mr

Mismanagement often occurs when managers run the affairs and business of their company poorly or self-interestedly. It can be defined as a decision taken or misconduct implemented by directors that involves negligence. Broadly defined mismanagement can cover any negligent behaviour. In a narrow sense and seen from the perspective of possible recovery, however, it only covers negligent behaviours of directors that constitute breach of duty. A negligent act is not necessarily a source of liability. That is to say, not any negligence is pursuable in law. While serious mismanagement confers on the affected company the right to hold the negligent director liable, mere mismanagement though involving negligence has no such effect. Two divisions, therefore, can be identified: one, between fine management and mismanagement generally, and the other, between serious and mere mismanagement. The first division is commonly used in civil and common-law jurisdictions when dealing with matters of liability of corporate directors for negligence. However, the second seems to be unique to the common law.

The division between serious mismanagement, on the one hand, and mere mismanagement, on the other hand, has been repeatedly recognised by the English courts.⁵ A company director is held liable for the former, while he is seen free from liability for the latter.⁶ In response to a bad business decision, either there is a breach of

Derek Higgs and Mr Robert Smith ("The Combined Code on Corporate Governance" published on January 2003).

⁵ Thomas Gibling v. John Franklin McMullen (1868), LR 2 P C 317; Re City Equitable Fire and Insurance Co. Ltd (1925) Ch 407; Lagunas Nitrate Company v. Lagunas Syndicate (1899) 2 Ch 392; The Overend & Gurney Company v. Thomas Jones Gibb and John Darby Gibb (1872) LR 5 HL 480.

⁶ See generally Trebilcock, M. J., "Liability of Company Directors for Negligence", *Modern Law Review*, (1969), 32, 499, London, Stevens & Sons; Finch, Vanessa, "Company Directors: Who

duty giving the company the right to pursue its negligent director for the recovery of loss suffered,⁷ or there is a mere mismanagement for which the law offers no response and, as a result, for which the courts abdicate their jurisdiction in favour of the companies' own internal forum.⁸

Serious mismanagement, therefore, involves either a breach of duty of care or a breach of fiduciary duty and I examine each in the following discussions.

IV.1.1.A. Duty of care

The duty of care of corporate directors is a mechanism devised by company law to address the issue of liability of corporate directors for honest mismanagement. It is in fact an example of the duty of care imposed through the tort law under the general heading of negligence.⁹ This duty builds on moral and policy considerations. These considerations suggest that 'if a person undertakes a role whose performance involves

Cares About Skill and Care?", (1992), 55:2, *Modern Law Review*, 179, at p 187-9; Griffin, Stephen, "Negligent Mismanagement as Unfairly Prejudicial Conduct", (1992), *The Law Quarterly Review*, Vol. 108, 389, London, Stevens and Sons, at pp 390-392; Arsalidou, Demetra, "Objectivity vs Flexibility in Civil Law Jurisdictions and The Possible Introduction of The Business Judgement Rule in English Law", (2003), *Company Lawyer*, 24 (8), 228, London, Oyez Publishing Limited, at p 230; Wedderburn, "Minority Shareholders and Directors' Duties", (1978), 41 *Modern Law Review* 569; Hagland Gary, "Company Law – Turnbull in FSA Perspective", 2001, Informa Publishing Group Ltd., CM 13. 8 368.

7 *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407; *Lagunas Nitrate Company v. Lagunas Syndicate* (1899) 2 Ch 392; *Bamford v. Bamford*, (1970), L R Ch P 212; *Re Cardiff Savings Bank* (1892) 2 Ch 100; *Norman & Anor v. Theodore Goddard & Others* (1992), BCC, p 14 per Hoffman J; *Atwool v. Merryweather* (1867), LR 5 Eq 464n; *Menier v. Hooper's Telegraph Works* (1874), 9 Ch App 350; *Dafn Tinsplate Co. Ltd. v. Llanelly Steel Co.* (1920) 2 Ch. 124; *Edwards v. Halliwell* (1950), 2 All ER 1064; *Daniels v. Daniels*, (1978), Ch 406; *Prudential Assurance Co Ltd. v. Newman Industries Ltd. (No. 2)*, (1981), Ch 257; *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2.

8 *Pavlides v. Jensen*, (1956), Ch 565; *Turquand v. Marshall*, (1868-69), (L R), 4 Ch App 376 at p 386.

9 Worthington, Sarah, "Reforming Directors' Duties", 64:3, *Modern Law Review*, 439 (2001), Blackwell Publishers, Oxford, at p 449.

the risk of injury to others, he is under a duty to perform functions of that role carefully'.¹⁰

In company law, contents of the duty of care may differ from that imposed under the general law on other persons. While tort law may require persons to take as much care as can be reasonably expected of them, company law allows directors to take risks. The roots of this difference go back to traditional case law where judges often emphasised that different classes of persons may assume substantively different duties of care. As Romer J, for example, emphasized, people may assume different degree of duty of care depending on their class.¹¹ It follows that there is not one and the same duty for all people. A traditional example is the case for directors and trustees. While a trustee is required to avoid risks,¹² directors are encouraged to take risks, as taking commercial risks in corporations is seen not only desirable but also necessary.¹³ Yet, it is not very certain where the line is to be drawn between the degree of care required for a director and that required for a trustee, given that there are also some authorities that require the same degree of duty from both directors and trustees.¹⁴

10 Eisenberg, Melvin Aron, "The Duty of Care and The Business Judgement Rule in American Corporate Law", (1997), *Company Financial and Insolvency Law Review*, 185 Oxford, Mansfield Press, at p 186.

11 *Lagunas Nitrate Company v. Lagunas Syndicate* (1899), 2 Ch 392 at 394 per Romer J.

12 In *Sheffield and South Yorkshire Permanent Building Society v Aizlewood* (1890) 44 Ch D 412, for example, it was held that directors are not trustees in the ordinary sense of the word but are "commercial men managing a business for the benefit of themselves and the other members"; See also *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407.

13 It is desirable because that is very likely to enhance corporate gains. It is also necessary because business circumstances are not entirely certain and as a result managing affairs of a business corporation often involves dealing with great commercial risks.

14 *Charitable Corporation v. Sutton*, (1742), 2 Atk. 400 at p 405-406 per Lord Hardwicke.

The question of how successful company law has been in addressing the issue of honest mismanagement is to be considered in the light of its favoured standard of duty of care. To explain, it is possible, for example, to have a negligent director exempted from liability if in a given case the judge takes as a standard someone with the same competence as that of the defendant. A similar director in like circumstances may assume liability for the same sort of negligence if the judge takes as a standard a hypothetical reasonable person with a minimum level of competence. Sometimes the judges might simply want to consider themselves as the model of practice for the assessment of a defendant director's performance and that may clearly produce different results.¹⁵

IV.1.1.A.1. Subjective standard

The subjective standard emerged more than a century ago when certain judges decided not to hold negligent directors responsible for what was beyond the directors' own capabilities.¹⁶ The argument was simple. As supporters claimed, it is the purpose of law to require directors to do their best when they manage affairs of companies. If this is true, then the law should be drafted in a fashion that requires exemption of a director from liability when his behaviour matches his own potentials. Imposition of liability on directors beyond their own potential is both unfair and useless. 'If the defendant was incapable of doing more than she did, then the threat of liability cannot

¹⁵ This third possibility was soon rejected by the case law for obvious reasons. It would require the courts to take the management of companies which obviously falls in serious contradiction to the traditional attitude of the courts and the logic behind it that suggests the courts should not take the management of companies. [The Overend & Gurney Company v. Thomas Jones Gibb and John Darby Gibb (1872) LR 5 HL 480 per Lord Hatherley; Turquand v. Marshall (1968-69), L.R. Ch. App. Vol. 4, p 386.

¹⁶ Lagunas Nitrate Company v. Lagunas Syndicate (1899) 2 Ch. 392, 435.

change that'.¹⁷ Moreover, a subjective measure could seem to appropriate mostly with the picture of corporate directors' positions under the traditional company law that regards it as a non-professional post.¹⁸ The roots of such an attitude lie in the treatment of directors by the early courts as trustees.¹⁹ Like trustees, directors were expected to show no more than that reasonably expected of non-professionals and ordinary persons.²⁰ An early example in British case law can be found in the case of *Lagunas Nitrate Co. v. Lagunas Syndicate*.²¹ This attitude was followed by later decisions that constitute the basis of modern law on directors' duty of care.²²

The subjective measure was graded very poorly by many commentators²³ and was later reconsidered by the case law. Critics highlighted several shortfalls. It was thought to be too liberal in the sense that it makes it too easy for negligent directors to escape liability. The measure further was very likely to increase uncertainty associated with rules relating to liability of directors. It could create no bottom line below which a

17 It would be unfair because it would simply ignore individuals' potentials and entail blaming directors for behaviours which they were unable to avoid. [See Riley C.A., "The Company Director's Duty of care and Skill: The Case for an Onerous But Subjective Standard", (Sep-1999), *The Modern Law Review*, vol. 62, 697, London, England, Stevens & Sons, at p 711].

18 As the Law Commission pointed out 'directors do not require particular skills to discharge their duties. A company might appoint a person as a director for some attribute he possesses, knowing that he lacks skill in business matters'. The Law Commission (LAW COM No 261) and The Scottish Law Commission (SCOT LAW COM No 173), "Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties", September 1999, Part 5, at p 48].

19 See Lord Hardwicke in *Charitable Corporation v. Sutton* who opined that '(directors) may be guilty of acts of commission or omission, of malfeasance or non-feasance...By accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely honorary; and therefore, they are within the case of common trustees'. [(1742) 2 Atk. 400 at p 405-406 per Lord Hardwicke].

20 Finch (above, note 6) at p 200.

21 *Lagunas Nitrate Company v. Lagunas Syndicate* (1899) 2 Ch. 392, 435 per Lindley M.R.

22 *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407.

23 Trebilcock (above, note 6) at pp 97-112; Hemraj, Mohammed B., "The Business Judgement Rule in Corporate Law", (2004), *International Company and Commercial Law Review*, 15 (6), 192,

particular behaviour could definitely be identified as negligent. With it, one could no longer use a single rule of liability. Instead, there would be thousands of individual rules of liability relative to the number of existing and future directors, 'arguably no standard at all'.²⁴ It also would probably encourage professionals to leave the field to be occupied by amateurs.²⁵ Moreover, 'a subjective standard would be out of line with the duties generally imposed on persons who agree to provide services and would also be out of step with many other jurisdictions such as Australia, Canada, Germany and the USA that require directors to act as reasonable, competent businessmen'.²⁶

Yet, one may defend a subjective measure taking the argument that it is very likely to increase the number of persons who are ready to accept directorial office and take the risk of making business decisions in companies. But this is to be rejected too since the mentioned increase could hardly count as value where mainly incompetent individuals would be encouraged.

IV.1.1.A.2. Objective standard

The objective standard was in fact a product of inadequacies associated with the subjective measure.²⁷ According to this standard, directors' performance should be assessed using the likely performance of an ordinary man. This was first recognised by

London, UK, Sweet & Maxwell, at pp 195-6, 207; Bourne, Nicholas, "Directors' Duty of Care and Skill", (June-1999), *Business Law Review*, London, Butterworths, 154-155.

24 Mackenzie, Allan L., "A Company Director's Obligations of Care and Skill", (1982), *Journal of Business Law*, 460, at p 461.

25 This is because, supposedly, the idea advanced by such a measure is to treat professionals more tightly since they are more competent and have more qualifications and experiences. By contrast, a director who is less competent is also less likely to face liability. [Mackenzie Ibid at p 469].

26 The Law Commission (above, note 18) at p 48.

Foster J in the case of *Dorchester Finance Co. v Stebbing*.²⁸ Foster J was ignorant of the nature of the duties undertaken by directors in a given case and limited the application of the objective measure to the duty of care as distinguished from the duty of skill. Later decisions rejected the attempted distinction and took consideration of the very duties undertaken by an alleged negligent director. A clear illustrative case in this respect is the *Norman & Anor v. Theodore Goddard & Others* in which Hoffman J opined that a judge should take consideration of the type and nature of duties undertaken by him/her and compare their performance with that expected of a reasonable person.²⁹

However, the proposed objective measure was criticised from two dimensions. One concerned the charge that while management of modern corporations is a profession with more vigorous obligations attached, the objective standard simply treats them as amateurs.³⁰ 'Many areas of business do require specialized skills and knowledge beyond those possessed by the layman'.³¹ Public expectation now requires corporate directors not only to meet a minimum degree of relevant knowledge, skills and experience, but also to possess a greater degree of competence and to act professionally.³² This charge, although correct in its premise, fails to regard the fact that not every director performs the same function. In fact, a single objective standard that

27 For arguments against an objective test and in favour of having a subjective one, see Riley (above, note 17) at pp 709-720.

28 *Dorchester Finance Co. v Stebbing* (1989), BCLC, 498.

29 *Norman & Anor v. Theodore Goddard & Others* (1992), BCC, p 14 per Hoffman J. Subsequently followed by Hart J. in *Re Landhurst Leasing plc, Secretary of State for Trade and Industry v. Ball and Others* (1999) 1 BCLC 286, 344; See also The Law Commission, (above, note 18), at p 48.

30 The Company Law Review Steering Group, "Modern Company Law: Final Report", (2001), Vol. I, pp 31, 33.

31 The Law Commission, (above, note 18), at p 48.

32 See generally Parkinson, J. E., "Corporate Power and Responsibility", 1993, Oxford, Clarendon Press; New York, Oxford University Press, at pp 101-6, 248; Deakin, Simon and

is common to every corporate director may be impractical and may raise unfair consequences.³³

The other criticism argues that an objective measure does not allow the courts to assess managerial performance in the light of their actual competence. 'It would ignore the special qualifications that a director has, even if they were the reason why the company appointed him'.³⁴ This was problematic especially in cases where managerial competence exceeded the minimum required by the objective measure, in the sense that highly competent and professional but negligent directors could escape liability simply because they could meet the minimum requirement prescribed by the objective measure.³⁵

Instead of a single objective standard, some suggested a number of different standards, each applying to directors of the same area of expertise.³⁶ 'Thus, within the area of professed or inferred competence of each director, an objective standard of care would

Ferran, Ellis and Nolan, Richard, "Shareholders' Rights and Remedies: An Overview", (1997), *Company Financial and Insolvency Law Review*, 163, Oxford, Mansfield Press, at pp 165-166.

33 It is too hard, if not impossible, to design a comprehensive measure that could cover all directors and require them to meet the same minimum standard of behaviour. Even if that could practically be overcome, it would seem unfair to expect every director to have equal knowledge and experience of every aspect of the company's operations. [See generally Mackenzie (above, note 24) at p 468; Sealy, Len, "Reforming the Law on Directors' Duties", (1991), *The Company Lawyer*, vol. 12, No. 9, 177; Trebilcock (above, note 6) at pp 509-10; Davies P.L., Gower and Davies' Principles of Modern Company Law, Chapter 16, at p 435, London, Sweet & Maxwell, (2003), 7th ed., at p 435; Worthington (above, note 9) at p 449; The Law Commission, (above, note 18), at p 48].

34 The Law Commission, (above, note 18), at p 50.

35 In cases where managerial competence falls below the minimum required by the objective measure, the problem is less serious because the British lawmaker deliberately sought to level up managerial accountability in companies. [See The Law Commission, (above, note 18), at p 50].

36 See Trebilcock, (above, note 6), at 511; Mackenzie, (above, note 24), at p 470.

be applied'.³⁷ But this, too, might fail, as there might sometimes not be a match between a professed or inferred area and the actual role that a particular director plays in a given company. 'The mere fact that an individual possesses knowledge, experience or qualifications would not be relevant where these are not reasonably to be expected in their directorial role'.³⁸ A better formula is, perhaps, the one that regards reasonable skill and care to be expected of directors who perform within the same functional class.³⁹

IV.1.1.A.3. Objective/subjective standard

The downsides associated with both a single objective standard and a single subjective standard led the Parliament to formulate a new measure of assessment of directorial performance in 1986. The formula sets out the standard on an objective/subjective combination basis. It is reflected in the section 214 Insolvency Act 1986⁴⁰ that is primarily concerned with liability of negligent directors for wrongful trading in insolvency proceedings but can be extended to their liability in other negligent cases through analogy.⁴¹

The new formula enabled the courts to discover the level of reasonable care and skill expected of a given director using the functions assigned to them as guideline. This

³⁷ Trebilcock, (above, note 6), at 511.

³⁸ Finch (above, note 6) at p 203; As Finch put it, a director must show the skill and care that can be expected of a reasonable director doing 'their kind of role in their kind of company' [Finch, *Ibid*]; See also Davies (above, note 5) at p 435; Boyle (1992) (above, note 13) at p 7.

³⁹ Finch, (above, note 6), at p 203; Davies (above, note 33) at p 435; Boyle, Anthony, "The Common Law Duty of Care and Enforcement under S. 459", (1996), *Company Lawyer*, 17 (3), 83, at p 7.

⁴⁰ Section 214 (4) Insolvency Act 1986.

⁴¹ Finch (above, note 6) at p 201; Davies (above, note 33) at pp 432-3; Boyle (1996) (above, note 39); The Law Commission, (above, note 18), at pp 48-9.

guideline can help the standard to more closely approach the factual situation of each defendant director. However, the wording of the section suggested that a negligent director, whose skill and experience sits below the minimum required by the objective measure, can escape liability because, to establish liability for negligent directors, it was equally a requirement that the courts should consider their knowledge and skill.⁴²

In the light of case law, observations made by critics and recommendations delivered by the Law Commission,⁴³ the government is now seeking to address the above-mentioned shortfall.⁴⁴

Yet one may object to the proposed formulation, taking the view that such formulation would put directors in a dilemma. How could directors, he asks, be motivated to serve their companies, while they are always liable to attribution of liability for behaviours they have had no control over them?⁴⁵ However, the objection must be rejected for a number of good reasons. For one, the law wants to encourage competent persons who are most likely to take reasonable commercial risks rather than every ambitious and incompetent, but opportunist, person who may either want to shirk duties or gamble with shareholders money in corporations.⁴⁶ For another, personal competence of a given director is not something completely beyond his/her control. A director is often

42 Bourne (above, note 23) at pp 154-155.

43 The Law Commission, (above, note 18), at p 49.

44 Part B section 5, Company Law Reform, White Paper, March 2005, CM6456 available at the Department of Trade and Industry's website in the following address: <http://www.dti.gov.uk/cld/4.pdf>.

45 Riley, (above, note 17), at pp 709-12.

46 This mixture formulation is a deliberative choice made by the English company law that was concerned about the dramatic rise in the number of mismanagement cases and hence sought to discourage incompetent persons and to level up 'with greater awareness, the responsibilities of directors'. [The Law Commission, (above, note 18), at p 49]. Besides, the existence of a market in directors & officers liability insurance can eliminate or at least reduce the threat of being personally responsible for taking negligent corporate decisions. [The Law Commission, *Ibid.*].

aware of his capabilities at the very beginning of his selection, and can choose not to nominate himself for the post if he finds himself unfit for it. When he irresponsibly insists on taking the post by asserting that he has the expertise the company is seeking and takes, or assists the board to take, some bad business decision, the argument that the alleged behaviour was beyond his control does seem rather unsatisfactory.⁴⁷

IV.1.1.B. Fiduciary duty

IV.1.1.B.1. Background

Directors, as agents, are employed by companies to direct their business. Once in power, they may want either to pursue self-interested projects or may simply pay inadequate attention to the affairs and business of their companies. They normally assume directorial posts for reasons of personal benefit rather than for some philanthropic purposes. Thus, in cases of conflict of interests, they might prioritise their own benefits over those of their companies. By imposition of fiduciary duty, company law wants directors to act with good faith and in the honest belief that they are acting in the best interest of their companies rather than their owns.⁴⁸ It is necessary, however, as Davies pointed out, to bear in mind that 'a person who is fiduciary and who acts negligently does not, without more, commit a breach of

47 Davies, (above, note 33), at pp 433-4; Lord Hope of Craighead, "The Duties of a Director", *Company Lawyer*, (2000), 21(2), 49-50.

48 For fiduciary duty see *Re Smith & Fawcett* (1942), Ch 302, at 304 per Lord Green MR; see also *Aberdeen Railway Co v. Blaikie Bros.* (1854), 1 Macq. H.L. 461 at 471 per Lord Granworth; *Regal (Hastings) Ltd. v. Gulliver* (1942), All ER 378; *Cook v. Deeks* (1916), 1 AC 554; *Percival v. Wright* (1902), Ch 421; *Hogg v. Cramphorn* (1967), Ch 254; *Isle of Wight v. Tahourdin*, (1883), 25, Ch D, 320; *Haward Smith Ltd. v. Ampol Ltd.* (1974), AC 821; *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.*, (1983), Ch 258; *Lonrho Ltd. v. Shell Petroleum Co. Ltd.*, (1980), 1 WLR 627 at p 634, (1980) QB 358; *West Mercia Safety Wear Ltd. v. Dodd*, (1988), BCLC 250; Also see Companies Act 1985 ss 309, 317, 346, 727.

fiduciary duty'.⁴⁹ For that to occur, the alleged act must have not only the attribute of negligence, but also that of bad faith and disloyalty. However, directors' duty is only to act according to what they, themselves, regard as being the best interest of company. It follows that their duty is assessed subjectively. In other words, they will not be held responsible for a mal-identification of the best interest of the company if they honestly believed it to enhance company interests.

As well as preventing directors from self-interested behaviours, fiduciary duty requires directors to avoid pursuing interests of any specific interested group but shareholders within the corporate constituency. Company law is traditionally described as 'shareholder-centred' or based on a norm of shareholder primacy.⁵⁰ This means that companies are incorporated and work to further only shareholders' wealth. The most direct manifestation of the norm is the law relating to fiduciary duty.⁵¹ Directors as people who make most decisions in companies have a fiduciary duty to make decisions that are in the best interests of their company⁵² and for a business company this means only the financial interests of the company shareholders.⁵³ In practice, the norm was tended to be construed by the case law rather narrowly only to cover the interests of

49 Davies, (above, note 33), at p 435.

50 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law" (2001), 18th ed., London, Blackstone, at p 13; Roe, Mark J., "The Shareholder Wealth Maximization Norm and Industrial Organisation", 'Harvard Law School', (2001), available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/abstractid=282703>, at p 3; Smith D. Gordon, "The Shareholder Primacy Norm", (1998), *The Journal of Corporation Law*, Iowa City, University of Iowa, College of Law, at pp 297-303; See also Hill Jennifer, "Visions and Revisions of the Shareholder", *The American Journal of Comparative Law*, (2000), Vol. 48, Berkeley, Ca., American Association for the Comparative Study of Law, at p 43; Hill Jennifer, "Public Beginnings, Private Ends-Should Corporate Law Privilege the Interests of Shareholders?", *International Corporate Law*, Edited by Fiona Macmillan, Vol. 1, (2000) Oxford, Hart, at p 20.

51 Smith (above, note 50) at p 278; Ferran Eilis, "Company Law and Corporate Finance", (1999), Oxford, Oxford University Press, at p 134.

52 Companies Act 1985 Sec. 309(2).

the majority shareholders as against minority shareholders as well as other non-shareholder participants in corporate commonwealth.⁵⁴ This traditional tendency was also recognised by many of the company law scholars.⁵⁵

Traditional tendency aside, modern English company law also tends towards appreciation of the shareholder primacy norm. For example, company law reviewers in their report ruled out any task for company law which requires redistribution and reallocation of corporate benefits between different participants in the economy on grounds of fairness, social justice or any similar criteria.⁵⁶ This shareholder centred focus can also be traced in statutory provisions regarding directors' duties in Companies Act 1985. For example, section 309(1) requires directors of companies to regard employee as well as shareholder interests.⁵⁷ Although, a company director has a duty to consider interests of employees, nonetheless, the mentioned duty does not give employees legal right to enforce it against directors. Employees' interest is seen as a matter of general concern⁵⁸ and as Goddard explained it signals that in company law the stakeholder debate is viewed as being an aspect of directorial decision-making rather than something that can provide certain protection or voice for non-shareholder

53 Ferran (above, note 51) at pp 125-6.

54 Leader, Sheldon, "Private Property and Corporate Governance: Part I: Defining the Interests" in Kluwer Law International, Edited by Fiona Macmillan, (1995), 94, Patfield, London at p 94-96; Smith (above, note 50) at p 279.

55 Gower L.C.B., "Gower's Principles of Modern Company Law", 4th ed., London, (1979), Stevens, at pp 553-4; See also Manne Henry, "Some Theoretical Aspects of Share Voting in the Economics of Legal Relationships", Columbia Law Review, New York, Columbia University Press, 1964, Vol. 64, 1427; Farrar John H., "Company Law", 1985, London, Butterworths, at p 266.

56 Modern Company Law for a Competitive Economy: The Strategic Framework, (London, DTI, 1998), para 2.5; See also Mayson Et Al. (above, note 50) at p 12.

57 Section 309(1) Companies Act 1985.

58 Mayson Et Al. (above, note 50) at p 13.

constituencies.⁵⁹ Unlike employees, shareholders whose interest must be regarded by corporate directors receive full protection in law. They have legal right to enforce directors' duty.⁶⁰ In addition to this, only shareholders have right to dismiss directors from the office⁶¹ and further only they can take petition to the court for a relief under s 459 if the conduct of the company affairs is unfairly prejudicial to their interests.⁶² In one exceptional occasion where the company is insolvent, however, law allows directors to disregard shareholder interest in favour of creditors. In such case directors must prioritise interests of company creditors over those of shareholders.⁶³

However, companies can affect not only a number of shareholder and non-shareholder groups⁶⁴ but also nearly every aspect of people's life.⁶⁵ They produce food and supply energy, fuel, light, shelter and many other products on which the lives of most citizens

59 Goddard Robert, "Modernising Company Law": The Government's White Paper", *Modern Law Review*, (2003) 66 (3), London, Stevens & Sons, at p 415.

60 Section 309(2) Companies Act 1985.

61 Section 303, CA 1985.

62 Section 459, CA 1985; See also generally Mayson Et Al. (above, note 50) at p 13; Roe (above, note 50) at p3.

63 Section 214 Insolvency Act 1986. This duty towards creditors' interests has recently been extended by common law from actual insolvency cases to cases where director could reasonably knew or should have known that the company will face insolvency. See *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.*, (1983), Ch 258; *Lonrho Ltd. v. Shell Petroleum Co. Ltd.*, (1980), 1 WLR 627 at p 634; *West Mercia Safety Wear Ltd. v. Dodd*, (1988), BCLC 250; *Yukong Ltd. v. Rendsburg Investments Corporation*, (No.2), 1998, 1 WLR 249; See generally Mayson Et Al. (above, note 50) at pp 514-516, 744; Ferran (above, note 51) at pp 481-4.

64 Lee Hazen Thomas, "Silencing the Shareholders' Voice", *North Carolina Law Review*, (2002), Vol. 80, Chapel Hill, North Carolina Law Review Association, at p 1899; Ratner David L., "The Government of Business Corporations: Critical Reflections on the Rule of One Share, One Vote", *Cornell Law Review*, (1970), Number 1, Vol. 56, Cornell University, Cornell Law School, at p 1.

65 "Our style of life is largely determined by the activities and style of business; and the style of business is largely determined by the activities and style of our companies". [Confederation of British Industry, "The Responsibilities of the British Public Company: Final Report of the Company Affairs Committee of the Confederation of British Industry", London, Confederation of British Industry, 1973, at p 8].

depend.⁶⁶ They can also affect the government through influencing important issues like production, investment and employment that are matters of public concern and that are subject of governmental policies.⁶⁷ The public, the government and many interest groups that are affected by, or have interest in, corporations could be disappointed and perhaps injured if corporations only focussed on maximizing majority shareholder wealth. Hence, overtime the traditional view of the shareholder primacy norm has gradually evolved into a subsequent recognition by the courts that the concept of shareholder interest includes those of majority as well as minority shareholders. Upon such evolution, the courts required directors to act in the interest of all shareholders not just the majority.⁶⁸ This was, in fact, a product of gradual rethinking about corporate existence and objective. On the one hand, evolution of the real entity theory, which recognised separate personality and interest for corporations, helped the courts to see companies as entities that are separated from their component shareholders.⁶⁹ On the other hand, expansion of the idea of democracy in companies, which extended the concept of constituency, plus a raise of doubts that undermined traditional justifications for legitimacy of private power⁷⁰ contributed to question about accuracy of the traditional theory. The main question, from this perspective, for many scholars in company law arena became whose interest must be paramount in

66 Mason Edward S., "Introduction", in *The Corporation in Modern Society*, Edited by Edward Sagendorph Mason, 1960, Cambridge, Mass, at p 1.

67 Parkinson (above, note 32) at pp 8-9, 19.

68 Smith (above, note 50) at p 279; Hale Christopher, "What's Right With the Rule in *Foss v Harbottle?*", (1997), *Company Financial and Insolvency Law Review*, 219, Oxford, Mansfield Press.

69 Hager Mark M., "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory", *University of Pittsburgh Law Review*, (1989), Vol. 50, Pittsburgh, at p 633-4; Ferran (above, note 51) at p 134.

70 Parkinson (above, note 32) at pp 1, 9; Norwits T.S., "The Metaphysics of Time: a Radical Corporate Vision", *Greens Business Law Bulletin*, 1991, 46, 377, Edinburgh, W. Green & Son Ltd., at p 387.

companies? Generally speaking, law, economic, and political scholars on this question have been grouped into two main camps, the shareholder primacy camp and the stakeholder camp.

IV.1.1.B.2. Shareholder primacy theories

To justify shareholder primacy norm, scholars in this camp often support a contractarian view in which shareholders are seen as either owners of or beneficiaries in or residual claimants in companies. Hence, three different contract-based theories can be characterized a major common feature of them is the shareholder wealth maximization norm. According to these theories restricting company management to the single objective of maximizing shareholder wealth is the most efficient means of using companies to increase the wealth of society as a whole.⁷¹

The first, the 'shareholder-owner' theory, which was the prevailing theory in 19th century⁷² and which was based on the concept of agency, assumed a principal/agent relationship between shareholders as owner and directors as agents.⁷³ according to it, directors were required to perform the will of shareholders and to further their interests and shareholders had a formal right to control the directors.⁷⁴ A recent example for this is the Noble Prize-winning economist, Milton Friedman, who argued

71 Easterbrook Frank H. and Fischel Daniel R., "The Economic Structure of Corporate Law", (1991), Cambridge, Mass. London, Harvard University Press, at p 38.

72 Hill, "Visions and Revisions of the Shareholder", (above, note 50) at p 42.

73 Lee Hazen (above, note 64) at p 1900.

74 See Hill "Visions and Revisions of the Shareholder", (above, note 50) at p 42; Hill, "Public Beginnings, Private Ends", (above, note 50) at p 21.

that because shareholders of corporations are “the owners of the business” the only “social responsibility of business is to increase its profits”.⁷⁵

The second, the ‘shareholder-beneficiary’ theory which was introduced in the early 20th century and which relied on the concept of trust, assumed that shareholders are not owner but beneficiaries for whom managerial powers are held in trust.⁷⁶ Recognition of corporations as separated bodies⁷⁷, on the one hand, and a gradual separation of shareholders’ right of ownership from their controlling power⁷⁸ and a relocation of the latter in hands of managers⁷⁹ which occurred due to the industrialisation of the economy,⁸⁰ on the other hand, contributed to make the traditional view of ownership-based shareholder primacy defunct. Nonetheless, shareholder primacy norm itself has never been abolished. In fact it has been redecorated by the theory in a new form of a beneficiary-based analysis.⁸¹ In this analysis, although shareholders had already abandoned their controlling power in favour of directors, they remained the only financial beneficiaries of the company’s activities.

75 See Milton Friedman, “The Social Responsibility of Business Is to Increase Its Profits”, *New York Times Magazine*, Sept. 13, 1970, at 32-33, 122-126, quoted in Stout Lynn A., “Bad and Not-So-Bad Arguments for Shareholder Primacy”, (2002), *Southern California Law Review*, Vol. 75, 1189, at p 1190-1.

76 Berle Adolf A., “Corporate Powers as Powers in Trust”, (1931), 44, *Harvard Law Review*, 1049, Cambridge, Mass, Harvard Law Review Association, at 1073.

77 Hager (above, note 69) at pp 633-4; Hill “Visions and Revisions of the Shareholder”, (above, note 50) at p 44.

78 Berle Adolf A. and Means Gardiner C., “The Modern Corporation and Private Property”, (Revised edition, 1968), New York, Macmillan, at p 245.

79 This was allgedly a consequence of collective action problem and the use of proxy machinery by managers. [Berle & Means *Ibid*, at pp 71-82, 129-131].

80 Minett Steve, “Power, Politics, and Participation in the Firm”, (1992), Aldershot, Avebury, at pp 186-187.

81 Hill, “Visions and Revisions of the Shareholder”, (above, note 50) at p 44.

The third, the new contractual theory, which was developed in the late 20th century, sees a company as a larger container for a nexus of contracts among the resource providers (employees, directors, engineers, shareholders, suppliers, etc.) in the company.⁸² A famous example of this theory is the argument presented by Easterbrook and Fischel who claim while shareholders may not be the owners of the corporation, they are at least its sole residual claimants. In contrast to other interest groups in the company, shareholders rely on an implicit contract that entitles them to whatever remains after the firm has met its explicit obligations and paid its fixed claims. Hence, a company has to be directed in a manner, which maximizes shareholders' interests, but it is not for they are the owners or beneficiaries. It is for they are the residual claimants. As shareholders are the sole residual risk and profit bearers, firms should be run with an eye towards maximizing their wealth.⁸³ Although directors' duty is to shareholders, the latter almost ceases his controlling power because it is seen as not only impossible but also unnecessary and perhaps sometimes problematic.

Shareholder primacy theories have substantive deficiencies. To begin with, shareholders do not, in fact, own the corporation. Rather, they only own a type of corporate security which is called stock. Therefore, it is misleading to use the language of ownership to explain the relationship between a company and its shareholders. Likewise, shareholders are not simply beneficiaries in a trust analysis. They own shares in the company which gives them rights and power to have the corporation directed in

82 Easterbrook Frank H. and Fischel Daniel R., "Voting in Corporate Law", *The Journal of Law and Economics*, (1983), Chicago, University of Chicago Law School, at p 401; Farrar (above, note 55) at pp 3-6; Posner Richard A., "Economic Analysis of Law", (1992), Boston, London, Little, Brown, at pp 14, 409-411; Cheffins Brian R, "Company Law: Theory Structure And Operation", (1997), Oxford, Clarendon Press, at p 41.

their interests. Shareholders further do not appear to be the only residual claimants in the company. In reality, they are only one of several groups that can be described as residual claimants.⁸⁴ Also from corporate finance perspective, share capital no longer play a unique role in contemporary large corporations given that many companies now prefer to afford their needed capital through intra group loans and debt sources. Besides, concepts of debt and equity have become increasingly ambiguous considering that preference shares, while classified as equity, are often functionally equivalent to debt.⁸⁵

In addition to these, shareholder primacy theories seem deficient on the basis that they ignore the decisive role that other participants can play in the success of companies. If corporations are viewed as teamwork vehicles, then it must be accepted that corporate directors should give regards to interests of all participants.⁸⁶

IV.1.1.B.3. Stakeholder theories

Stakeholder theories can be seen as a product of viewing corporations from a political perspective⁸⁷ According to them, a corporation like any entity composed of individuals

83 Easterbrook & Fischel (above, note 82) at p 403; Farrar John H., "Company Law", (1991), London, Butterworths, at pp 224-5.

84 "When the firm is doing well, for example, employees receive raises and enjoy greater job security, managers get use of a company jet, and bondholders enjoy increased protection from corporate insolvency. Conversely these groups suffer along with shareholders when times are bad, as employees face reductions in force, managers are told to fly coach, and debt holders face increased risk". [Stout (above, note 75) at pp 1190-1195].

85 Hill, "Visions and Revisions of the Shareholder", (above, note 50) at pp 22-23.

86 See Blair Margaret M. and Stout Lynn A., "A Team Production Theory of Corporate Law", (1999), Virginia Law Review, 85, 247, Charlottesville, Va., Virginia Law Review Association, at p 247; Stout (above, note 75) at p 1195.

87 Buxbaum Richard M., "The Internal Division of Powers in Corporate Governance", (1985), California Law Review, No. 6, vol. 73, Berkeley, Calif., University of California, School of Jurisprudence at p 1671; Selznick Philip, "Law, Society, and Industrial Justice", Russell Sage Foundation, (1969), at p 259.

should be governed by a democratic majority rule.⁸⁸ They, however, vary depending either upon whom they count to be citizens in corporate constituency or in whose interest corporate power is to serve.⁸⁹ Both variables suggest a two-sided categorisation. On the one side, there are theories that emphasise on the application of the idea of democracy in order to: activate shareholder participatory right; impose some checks on the power of controllers, increase the level of accountability of managers; and strike balance in decision-making. They all argue against expansion of the corporate constituency and do not recognise any duty for companies to give regard to the interests of the community at large.⁹⁰ They differ not very much from contractual theories as they see only a single constituency of shareholders whose interests are pre-eminent.⁹¹ On the other side, there are theories that want to extend groups whose interest must be observed by the company management. Only these latter theories can be named as stakeholder theories because only they consider interests of other affected groups and they do so in two ways. They either assume a duty for companies to consider interests of the community at large⁹² or extend the concept of citizenship within the corporate constituency.⁹³

88 See generally Buxbaum *Ibid*; Mason (above, note 66) at p 1-5; Pound John, "The Rise of The Political Model of Corporate Governance and Corporate Control", (1993), *New York University Law Review*, vol. 68, 1003 at pp 1007-1013, New York, New York University School of Law; Latham Earl, "The Body Politic of The Corporation", in *The Corporation in Modern Society* edited by Edward Sagendorph Mason (ed.), (1960), 5, Cambridge, Mass, pp 218-220; Bottomley Stephen, "From Contractualism to Constitutionalism: A Framework for Corporate Governance", (1997), *Sydney Law Review*, vol. 19, 277, Faculty of Law, University of Sydney, Sydney, at pp 288-291; Brewster Kigman, "The Corporation and Economic Federalism", in *The Corporation in Modern Society* edited by Edward Sagendorph Mason (ed.), (1960), 5, Cambridge, Mass at 72; Villiers Charlotte, "European Company Law-Towards Democracy?", *European Business law Library*, (1997), Aldershot, Ashgate, pp 197-205; Hill, "Visions and Revisions of the Shareholder", (above, note 50) at pp 51-57.

89 Hill *Ibid*. at p 54; Mason (above, note 66).

90 Buxbaum (above, note 87); Pound (above, note 88); Bottomley (above, note 88) at p 277.

91 Hill, "Visions and Revisions of the Shareholder", (above, note 50) at p 54.

92 Norwits (above, note 70) at p 387; Dodd Merrick E., "For Whom Are Corporate Managers Trustees", (1932), 45, *Harvard Law Review*, 1145 Cambridge, Mass, *Harvard Law Review*

The stakeholder theory can itself be categorised into two sub-branches depending on the extent to which they expand constituency. One that is known as the Industrial Democracy only seeks to include employee interests. This is not for employees have some sort of ownership right, but for they are subjects of authority and that in democracy collective decisions should be based on and conducted in accordance with the interests of those who are affected, in particular, those who are the subject of the authority.⁹⁴ Employee involvement was also defended using the ownership argument. In this view, corporate constituency includes persons who have contributed inputs in the company coffer and such input may be either human or finance capital. As both shareholders and employees bear the risk of investment in companies, they should be given equal weight.⁹⁵

The other makes further extension and takes into account interests of wider constituency including consumers, suppliers, creditors, directors, environmental groups, local communities, and the society at large. It views corporations as entities that have social responsibility to regard interests of other stakeholders. As citizens

Association, at pp 1148, 1149; Mason (above, note 66) at pp 4 -5; Selznick (above, note 87) at p 259; Parkinson (above, note 32) at pp 1, 9.

93 See Villiers (above, note 88) at pp 197-205; Brewster (above, note 88) at p 72; Hill, "Visions and Revisions of the Shareholder" (above, note 50) at p 54.

94 Villiers (above, note 88) at pp 197-223; Stone Kathrine Van Wezel, "Labour Markets, Employment Contracts, and Corporate Change", in McCahery Joseph, Picciotto Sol and Scott Colin (ed.), Clarendon Press, Oxford, (1993), p 61 at 92-93; Dahl Robert A., "A Preface to Economic Democracy", (1985), Berkeley, University of California, at pp 75-82; Walzer Michael, "Spheres of Justice: A Defence of Pluralism and Equality", 1983, Oxford, Robertson, at pp 293-4; Gewirth Alan, "Community of Rights", (1996), Chicago, London, University of Chicago Press, at p 262, 266, 285; Ratner (above, note 64) at pp 260-285; Pateman Carol, "Participation and Democratic Theory", (1970), London, Cambridge U.P, at pp 42-45; Macpherson C.B., "The Life and Time of Liberal Democracy", (1977), Oxford, Oxford University Press, at pp 93-100.

95 Blair Margaret M., "Ownership and Control: Rethinking Corporate Governance for the Twenty First Century", Washington Brooking Institute, (1995), at p 239.

enjoy rights against abuse of power by public bodies, they also have such rights against abuse of power by private institutions.⁹⁶

Stakeholder theories have also been defended using the so-called 'team production argument. According to this argument, stakeholder involvement will promote efficiency by encouraging all interested groups to participate actively in the corporate field. Shareholders alone cannot make a firm work. Corporate production is dependant on inputs from a number of different groups. Suppliers, creditors, employees, managers, and even local community often must make contributions in order for an enterprise to succeed. Therefore, from an efficiency perspective, the ideal rule of corporate governance is to require corporate directors to regard the interests of all groups participating in the process of production which is in the long run beneficial to shareholders too.⁹⁷

Stakeholder theories suffer from major difficulties too. For one, they are not very compatible with the apolitical sphere of companies whose main objective is suggested to be maximising shareholder wealth rather than distribution of fairness and social justice. While citizens in societies 'have diverse values and objectives which have to be

96 Sheikh Saleem and Chatterjee S. K., "Perspective on Corporate Governance", in 'Corporate Governance and Corporate Control' edited by Sheikh Saleem and Rees William (ed.), Cavendish Publishing Ltd., London, (1995), pp 36-37, 55-56; Sheikh Saleem and Rees William, "Corporate Governance and Corporate Control-Self-Regulation or Statutory Codification?", in 'Corporate Governance and Corporate Control' edited by Sheikh Saleem and Rees William (ed.), Cavendish Publishing Ltd., London, (1995), pp 365-366; Tromans Stephen, "Directors' Responsibilities and Shareholders' Wishes-2", (Jan 1998), 148(1), 21, New Law Journal Practitioner, London, Butterworths, at pp 21-22.

97 See Blair & Stout (above, note 86) at 247; Stout (above, note 75) at p 1195; See also Bowels and Gintis, "A Political and Economic Case for the Democratic Enterprise" in The Idea of Democracy edited by David Copp, Jean Hampton and John E. Roemer (eds.), (1993), 375, Cambridge, Cambridge University Press, at pp 390-392; Villiers (above, note 88) at p 203.

balanced against one another, an association is a group in which all members pursue one or more of the same objectives, the objectives which state the association's reason for existence'.⁹⁸ Restricting company managements to the single objective of maximizing shareholder wealth can serve as the most efficient means of using companies to increase the welfare and wealth of people in societies.⁹⁹ For another, stakeholder theories can impose on companies too much agency costs. Through recognising an excessive role of balancer for directors and by eliminating the monitoring role of shareholders¹⁰⁰, they allow corporate directors to pursue their personal interests under the shelter of the corporate or stakeholder interest. Thus, even though stakeholder theories offer some benefits, the risks associated with them often outweigh those of its benefits even for a minority shareholder.¹⁰¹

IV.1.1.B.4. Recent developments

The government recently took the view that both the shareholder and stakeholder theories are important and influential to corporate success and they should be in some way reconciled.¹⁰² One way to do such reconciliation, it states, is to see corporate interests objectively rather than from the angle of its shareholders and that requires

98 Leader Sheldon, "Participation and Property Rights", (1999), 21, *Journal of Business Ethics*, Kluwer Academic Publishers, at p 102-7; See also Hager (above, note 69) at pp 650-653.

99 Easterbrook and Fischel (above, note 71) at p 38; Jensen C. Michel and Meckling William H. "Corporate Governance and 'Economic Democracy': An Attack on Freedom", in *Proceedings of Corporate Governance: A Definitive Exploration of the Issues* edited by Huizenga C.J., UCLA Extension, (1983), at pp 8-9 available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/ABSTRACT ID= 321521>; Mayson Et. Al. (2001), (above, note 50) at pp 13-14.

100 Roe, Mark J., "Corporate Law's Limits", Columbia University, (2002), at pp 10-17 available at Social Science Research Network Electronic Library at <http://papers.ssrn.com/abstract=260582>.

101 Stout (above, note 75), at p 1199; Roe (above, note 50) at p 3; Ferran (above, note 51) at p 125.

102 *Modernising Company Law: White Paper*, (London, DTI, 2002), Cm 5553, Volume 1, para 3.3; See also *Companies Bill, Schedule 2 (2) in Modernising Company Law: White Paper*, (London, DTI, 2002), Cm 5553, Volume II at p 112.

companies to operate with a wider view to the collective interests of shareholders which may include fostering the relationships with employees, customers and suppliers, maintaining corporate business reputation and observing impacts on the community and working environment.¹⁰³ This, nevertheless, is not to mean that companies should consider a wider constituency or make moral or political judgement about how just or fair allocation of benefits might be. It is rather to confirm that directors should manage corporate resources with a view to maximize shareholder wealth and welfare which may require consideration of interests of minority shareholders as well as those of many non-shareholder groups.¹⁰⁴ This approach can offer a double advantage. On the one hand, by preserving the shareholder primacy norm it reduces the agency cost, which can otherwise arise. On the other hand, by looking objectively at the very company interests, it allows interests of minority shareholders and other non-member groups to be heard within the scope of directors' fiduciary duty in companies.

IV.1.1.C. Impunity for mere mismanagement

Principally, negligent directors are granted exemption when their alleged negligence falls within the category of mere mismanagement. The term 'mere mismanagement' refers to situations in which a company director acts negligently and the company suffers loss due to it, but the amount of negligence associated with his action does not reach the level of liability, i.e. breach of duty of care and fiduciary. Authorities suggest

103 Modern Company Law for a Competitive Economy: Final Report, (London, DTI, 2001), URN/942 & URN/943, para 3.8 and Modern Company Law for a Competitive Economy: Developing the Framework (London, DTI, 2000), paras 2.19-2-20 and 3.18-3.28; see also Leader (above, note 98) at pp 102-7; Goddard (above, note 59) at p 402.

104 Modern Company Law for a Competitive Economy, "The Strategic Framework", (London, DTI, 1999), at 2.4; Goddard (above, note 59) at pp 405, 415.

two lines of arguments for not making directors liable for committing of mere negligence. The first line lays emphasis on the consideration that there is no merit for the courts to review quality of management in companies. The second line rests on the assumption that it is not possible to guard directors from falling into errors of judgements. A mixture of these two has caused the courts to feel reluctant to deal with cases involving committing of mismanagement by directors unless the alleged negligence is serious enough to constitute breach of duty.¹⁰⁵

IV.1.1.C.1. Poor quality management

British courts have repeatedly declared that it is not for the courts to take the management of business in corporations and they will not review the quality of management in companies.¹⁰⁶ They have taken the view that it would be wrong “to substitute [their] opinion for that of the management, or indeed to question the correctness of the management’s decision ... if bona fide arrived at”.¹⁰⁷ They have emphasised that ‘mere imprudence or want of judgment would not in itself make a director liable’.¹⁰⁸ Instead, they put the blame on the shareholders of such companies and argue that because directors are not required to qualify for the office, it will not be fair to hold them responsible for what they did without having particular expertise.¹⁰⁹ They do not need to possess special qualifications to be appointed and given

105 *Howard Smith Ltd. v. Ampol Petroleum Ltd.* [1974] AC 821, 832 (PC); *Re Smith & Fawcett Ltd* [1942] Ch.304; *Re Tottenham Hotspur plc.* [1994], BCLC 655, 660; *Runciman v. Walter Runciman plc.* [1992] BCLC 1084; and *Devlin v. Slough Estates Ltd. and Others* [1983] BCLC 497, 504 per Dillon J.; See also generally Cheffins (above, note 82) at p 644.

106 See generally Mackenzie (above, note 24) at pp 460-3; Trebilcock (above, note 6) at pp 502-4.

107 *Howard Smith Ltd v. Ampol Petroleum Ltd.* [1974] AC 821, 832 (PC).

108 *Lagunas Nitrate Company v. Lagunas Syndicate* (1899), 2 Ch 392 at 394 per Romer J.; see also *Marzetti’s Case* 1880 28 W R 541, 543 per Brett L.J.

responsibility as director of business corporations. This is a matter of shareholder concern only. The only thing that the law requires of a corporate director is to have 'the general knowledge, skill and experience that may reasonably be expected of him.'¹¹⁰

A director, further, is allowed not to fully allocate his time to managing affairs of the company unless otherwise is expressly stated in the company constitution or, in the case of an executive director, in his contract for service.¹¹¹ A corollary of not being required to have special expertise and being allowed to show low personal involvement is that directors are seen as people who can delegate matters to one of the company's employees. Likewise, a director can extensively trust to the information, advice and performance provided by the delegates and other company officials. While so trusting, a director can leave the company in order to accept other roles elsewhere, even a directorship in a competing company,¹¹² and he will not be responsible for the mistakes that other officials commit.¹¹³ To make things worse, the law imposes little limitation on directors as to their ability to delegate responsibilities. Case law has

109 *Turquand v. Marshall* (1968-69), L.R. Ch. App. Vol. 4, p 386 per Hatherley LC; *Re Elgindata Ltd.* (1991), BCLC 959 at 994; *Re Forest of Dean Coal Mining Co.* (1878) 10 Ch D 450, 451-455 per Jessel MR.

110 Section 214 (4a) Insolvency Act 1986; In *Re Denham & Co*, plaintiffs took action against a negligent director on the ground that he had failed to detect manipulation of the company's accounts by the chairman of directors and Chitty J relieved the alleged director from liability because 'he (director) was a country gentleman and not a skilled accountant'. [*Re Denham & Co* (1884), 25 Ch D 752 at 767] See also *Re Brazilian Rubber Plantations & Estates Ltd.*, (1911) 1 Ch 425 at 437.

111 *Re Forest of Dean Coal Mining Co.* (1878) 10 Ch D 450, 452 per Jessel MR.; *Re Brazilian Rubber Plantations & Estates Ltd.*, (1911) 1 Ch 425; *Re Denham & Co* (1884), 25 Ch D 752 at 767; *Re Marquise of Bute* (1892) 2 Ch 100; *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407 at p 423; However, recent authorities tend to construe this statement as relevant only in respect of non-executive directors. [See for example *Re Cardiff Savings Bank* (1892) 2 Ch 100 at pp 105-7].

112 *Bell v. Lever Bros.* (1932) A C 161.

113 *Dovey v. Cory* 1901 AC 477, 486; *Bishopsgate Investment Management Ltd v. Maxwell* (No 2) (1993) BCLC 1282; *Re Denham, & Co* (1884), 25 Ch D 752; *Re City Equitable Fire and*

drawn the bottom line at the level of total abrogation of responsibility. It follows that while delegation and reliance on others are widely seen as acceptable, the only limitation is that overall responsibility of a director is not delegable.¹¹⁴ The Law Commission in its recent review of directors' duties confirmed this too.¹¹⁵

However, this line of argument fails to consider that there is no such link to connect the issue of liability for negligence and the issue of shareholders' choice. On the one hand, a choice of poor quality directors by shareholders could mean that an appointed director will commit mistakes. On the other, their choice of good quality directors could mean that directors will never commit mistakes. Further, the question of whether a nominee director is in truth competent enough to take the office is not often clear at the very outset and is seen to be one of asymmetric information. As Riley pointed out, 'a company likely knows much less about a prospective director's competence than does that director himself. This makes it difficult for the company to discriminate between good and bad directors'.¹¹⁶ Also the fact that, in law, possession of general knowledge, skill and experience is required of directors ought not to mean that unskilled directors can take decisions on issues that require special knowledge and expertise. A director who accepts the office undertakes implicitly also to take informed decisions even where his contract permits him not to attend regularly or where he lacks the required expertise.¹¹⁷

Insurance Co. Ltd (1925) Ch 407 at p 423; Norman & Anor v. Theodore Goddard & Others, (1992), BCC, p 14.

114 Unreported, applied by Jonathan Parker J. in *Re Barings plc. (No 5)* [1999] 1 BCLC 433, at p 487; See also *Re Westmid Packing Services Ltd v. Griffiths* [1998] 2 All ER 124, per Lord Woolf MR.

115 The Law Commission (above, note 18) at p 55.

116 See Riley (above, note 17) at pp 712-3; Davies (above, note 33) at pp 433-4.

117 Lord Hope of Craighead (above, note 47).

IV.1.1.C.2. Errors of judgements

The second line of argument seeks to free directors from liability for any committing of errors of judgement. According to it, directors will not be held responsible for errors of judgement when they make business decisions in good faith. The argument relies on the policy consideration that since directors often must necessarily make judgements in uncertain business circumstances and on the basis of incomplete information, it will not be fair to blame them for their errors of judgement and for taking decisions that subsequently turn out to be bad. Although decision-making in such circumstances is risky, taking risky decisions is seen as desirable because they are likely to produce greater value for companies and it is upon such considerations that shareholders choose to invest in companies.¹¹⁸ English courts have also made it clear that they will not hold directors liable simply because directors' activities have resulted in loss to the company.¹¹⁹ Directors are not 'guarantors of a company's success' and hence they 'are not liable for mere errors of judgements'.¹²⁰ Thus, the gist of the errors of judgements shelter, which is sometimes described as being a 'necessary recognition of human fallibility',¹²¹ is to provide a safe harbour for directors of companies when they make honest business judgements, hereby further to stimulate directorial initiative and risk-taking in companies.¹²²

118 Eisenberg (above, note 10) at p 195; Arsalidou (above, note 6) at p 232.

119 Davies (above, note 33) at p 436; Hagland (above, note 6); Stapledon G P, "Mismanagement and The Unfair Prejudice Provision", *Company Lawyer*, (1993), 14 (5), 94-97.

120 *Re City Equitable Fire and Insurance Co. Ltd* (1925) Ch 407 at 408 per Romer J.

121 Arsht, Samuel S., "The Business Judgement Rule Revisited", (1979), *Hofstra Law Review*, Vol. 8, 93, Hempstead, N.Y., Hofstra University School of Law, at p 99.

122 Eisenberg (above, note 10) at p 191; Tunc, Andre, "The Judge and The Businessman", (1986), *Law Quarterly Review*, 102 (Oct), 549-554, London, Stevens and Sons; Arsht (above, note 121) at p 99; Branson, Douglas M., "The Rule That Is Not a Rule-The Business Judgement Rule", (2002),

The rules relevant to the errors of judgement are found in case law.¹²³ The courts have frequently taken the view that it is not for the judges to take the place of directors and make business judgements in companies. A court determines questions of law, not matters of business judgement.¹²⁴ As Lord Greene MR in *Re Smith & Fawcett Ltd.* observed, 'they (directors) must exercise their discretion bona fide in what they consider – not what a court may consider – to be in the interests of the company...'¹²⁵ Similarly in *Richard Brady Franks Ltd v. Price*, Latham LJ in relation to a person challenging an action of directors said that '(The plaintiff) must show that they (the directors) did not honestly act for what they regarded as the benefit of the company...it is not for a court to determine whether or not the action of directors was wise'.¹²⁶

This non-interventionist attitude of the courts has led the judges to become excessively unhelpful in respect of mismanagement cases.¹²⁷ How bad, stupid and harmful a director's business judgement has been does not matter before the courts where the judgement complained of constitutes no breach of duty, though involving negligence.¹²⁸

Valparaiso University Law Review, vol. 36, 631, Valparaiso, Ind., Valparaiso University School of Law, at pp 632, 636; Parkinson (above, note 32) at p 109.

123 Hemraj (above, note 23) at p 192; Tunc (above, note 122) at pp 549-554.

124 *Carlen v. Drury*, (1812), 1 Ves. & B 154 p 158 per Lord Eldon.

125 *Re Smith & Fawcett Ltd.* (1942) 1 All ER 542 at 543-4.

126 *Richard Brady Franks Ltd v. Price* (1937), 58 CLR p 136; See also *Howard Smith Ltd v. Ampol Petroleum* (1974), AC 832.

127 Sealy, L. S., "Problems of Standing, Pleading and Proof in Corporate Litigation", in *Company Law in Change*, Edited by Ben Pettet, (1987), London, Stevens, at p 4.

128 Worthington (above, note 9) at p 450.

Other common law jurisdictions also offer protection in cases of errors of judgment to their corporate directors. In the United States and Australia, for example, there is either a common law rule or a statutory provision serving as a presumption that in making a bad business decision, directors assume no responsibility unless the plaintiff shows that they acted either with mala fide in what was not in the best interest of the company or they acted on an uninformed basis without seeking further enquiry.¹²⁹ When 'conditions of the business judgement rule are satisfied then the quality of a director's or officer's decision will be reviewed, not to determine whether the decision was reasonable, but only under a much more limited standard...(which) is that the decision must be rational, or must have a rational basis, or the like'¹³⁰ and the measure of irrationality is often taken to mean gross negligence.¹³¹ As a result, a director is entitled to make unreasonable or even stupid decisions as long as his judgement is not wholly irrational.¹³²

Using the American and Australian experience,¹³³ some English company law scholars have suggested that it seems good for English company law to develop a statutory

129 To reduce the likelihood that directors escape liability unjustifiably, they make a clear distinction between the process of decision taking and the substance of managerial decisions, suggesting that directors will be given protection only on the latter ground. [See generally references cited below, note 133]

130 Eisenberg (above, note 10) at pp 188-9; American Law Institute's Principles of Corporate Governance, para 4.01 (c) (3).

131 See, for example, in *Shamrock Holdings v. Polaroid Corp.*, judge Berger held that for an uninformed decision of the board to go outside the protection of the business judgement rule, it requires lack of information to be so extreme as to reflect gross negligence on the part of directors. [Del. Ch. Civil Actions Nos. 10,075 and 10,079, January 6, 1989].

132 Tunc (above, note 122); Duesenberg Richard W, "Duty of Care, Duty of Loyalty and the Business Judgement Rule in American Courts", (1997), *Company Financial and Insolvency Law Review*, Oxford, Mansfield Press, 201-202; Hemraj Mohammad B, "Company Directors: The Defence of Business Judgement Rule", (2003), *Company Lawyer*, 24 (7), 218-219, London, Oyez Publishing Limited; Hemraj (2004), (above, note 23) at p 196.

133 For further study of American and Australian corporate laws on business judgement rule see generally Eisenberg (above, note 10) at p 185; Stout Lynn A., "In Prise of Procedure: An

business judgement rule similar to that existing in the US and Australia.¹³⁴ The Law Commission rejected this proposition, taking the view that English company law enjoys an already existing implied business judgement rule to be found in the courts reluctance to review management decisions which were made bona fide for the best interest of the company, and that this explains why there is no need to codify it, as this rule 'is best left to be developed by the courts'.¹³⁵ Further, there might also be a danger that such a presumptive rule might unduly disable the courts from imposition of liability on negligent directors where, considering every circumstance, they should have been found liable.¹³⁶

IV.1.2. Matters of enforcement: internal control

Speaking generally, company law offers two mechanisms to help shareholders bring back in line wayward directors. One is the enforcement by majority mechanism which empowers majority shareholders to apply indirect control over activities of directors. The other is the enforcement by minority mechanism that allows in certain exceptional cases minority shareholders to outflank the rule of majority and to bring allegations against wrongdoer directors.

Economic and Behavioural Defense of Smith v. Van Gorkom and the Business Judgement Rule", (2001) at pp 2, 11 [Research Paper No 01-21 available on the Social Science Research Network Electronic Paper Collection at <http://papers.ssrn.com/abstract=290938>]; Arshat (above, note 121) at p 93; Hemraj (2003), (above, note 132) at p 218; Hemraj (2004), (above, note 23) at p 192; Tunc (above, note 122) at pp 549-554; Kearney, Mark A., "The Evolving Standard of Scrutiny Applied to Directors' Decisions", (1995), *Butterworths Journal of International Banking & Financial Law*, 10 (1), 30, London, Butterworths.

134 See Parkinson (above, note 32) at pp 110-113; Deakin, Ferran and Nolan (above, note 32) at pp 165-166; Finch (above, note 6) at p 189.

135 Law Commission (above, note 18) p 53; The Government has also confirmed this view and therefore no statutory business judgment rule has been drafted in the proposed white paper. [Company Law Reform, White Paper, March 2005, CM6456 available at the Department of Trade and Industry's website in the following address: <http://www.dti.gov.uk/cld/4.pdf>].

136 Davies (above, note 33) at p 437; Arsalidou (above, note 6) at pp 232-3.

IV.1.2.1. Enforcement by majority shareholders

As a general principle enforcement of directors' duties rests on majority shareholders. They enforce directors' duties mainly through pursuing negligent directors and through rejecting ratification of their breach of duties. Under the current case law, breach of directors' duties except in few situations where the wrongdoing amounts to fraud is seen as ratifiable.¹³⁷ This means a wronged company through majority decision in shareholder meeting can choose not to pursue wrongdoer directors in breach of duty cases. This enforcement machinery, which relies on shareholder democracy, works on the assumption that shareholders have the ability to exercise their powers in general meetings. If they find directors guilty of breach of duties, they will have ability to resolve to prosecute negligent directors for the recovery of every loss suffered by the company. They also have power to appoint directors to or remove them from office and can limit or reshape directors' powers into a narrowly prescribed scope. In reality, however, this mechanism of internal control has evidenced to be unreliable. In small companies, often the same people play both controlling and directorial roles. They usually share the running of the business as well as controlling its affairs and this makes it quite unlikely that they pursue themselves. Even if some of them (normally a minority shareholder) want to pursue, the existence of a concentrated shareholding pattern, which gives the wrongdoer director/majority almost absolute right to help himself through ratification would ensure that except in very clear cases of fraud no action would commence against wrongdoer directors.¹³⁸ In the case of large companies, as they tend to have publicly dispersed shareholders there is little incentive for

shareholders to attend in meetings and vote. Each individual shareholder's vote is unlikely to carry sufficient weight and collective action is difficult when shareholders are dispersed.¹³⁹ The collective action problem would give wrongdoer directors protection against any probable attack by shareholders.¹⁴⁰ Even if there were no collective action problem directors would still often be able to retain control of large corporations because they have control over information and agenda of meetings and the proxy mechanism and because they are clever and prudent enough to propose motions that will be accepted by the shareholders.¹⁴¹ The growing size of institutional investment in English large companies made it possible for institutional shareholders to control enough shares in order to overcome the collective action problem and to exercise effective control on management. Nonetheless, such shareholders have evidenced in practice to be rather passive having no or little interest to fight with management.¹⁴² In such context, therefore, enforcement by majority will often be ineffective unless dispersed shareholders are well informed, closely knit and well organised.¹⁴³ That is why some opined that 'what is necessary in the interests of shareholders is not participatory shareholder democracy, but machinery for discouraging management from deflecting too much of the firms' net income from the shareholders to itself'.¹⁴⁴

137 *Bamford & Others v. Bamford & Others* (1970), L. R. Ch., 212; *Hogg v. Cramphorn Ltd. & Others*, (1967), L R Ch, 254.

138 Farrar (1991), (above, note 83) at p 442; Parkinson (above note 32) at p 248.

139 Birds John Et. Al. (eds.), "Boyle & Birds' Company Law", (1995), 3rd ed., Jordans, Bristol, at p 347.

140 Parkinson (above, note 32) at pp 240, 248; Farrar (1991), (above note 83) at p 442.

141 Cubbin John and Leech Denis, "The Effect of Shareholding Dispersion on the Degree of Control in British Companies: Theory and Measurement", *The Economic Journal*, (1983), Vol. 93, 351-369, London, New York, Macmillan, at p 363; Farrar (1985) (above, note 55) at p 266; Parkinson (above, note 32) at pp 160,165, 237.

142 See below, Chapter three at III.1.6.

143 Gower (above, note 55) at p 554.

144 Posner (above, note 82) at p 41.

IV.1.2.2. Enforcement by minority shareholders

As a matter of exception minority shareholders can enforce directors' duties in few cases. English company law has devised the machinery of derivative action which empowers minority shareholders to enforce directors' duties in appropriate circumstances where 'fraud on minority shareholder' is involved. Such machinery which falls beyond the majority power can, to some degree, protect minority rights and discourage mismanagement. The derivative machinery will be examined in details in Chapter five and I do not intend to repeat that examination. For the purpose of my discussion here it seems sufficient only to clarify briefly reasons which can convince a minority shareholder not to use the machinery in practice. To begin with, although collective action problem is absent, a minority shareholder may have no incentive to commence the action considering his trivial investment. Further, the costs of taking action can outweigh the probable benefits which may ensue from a successful derivative action for a minority shareholder.¹⁴⁵ In addition to these, lack of information and prospect of sharing the benefits achieved by a minority shareholder's efforts with non-active shareholders can ensure that no derivative action will be taken to the courts.¹⁴⁶ After all, even if a minority shareholder decides to pursue negligent directors, technical obstacles which the rule in *Foss v. Harbottle* creates in his path plus legal uncertainty which associates with the definition of fraud discourage him.

145 Reisberg Arad, "Derivative Actions and The Funding Problem: The Way Forward", Forthcoming Journal of Business Law, (2006), Working Paper Presented at the Society of Legal Scholars Annual Conference (Strathclyde/Sep 2005), at pp 1-4.

146 Parkinson (above, note 32) at pp 241-3; Farrar (1991), (above, note 83) at p 442; Pettet Ben, "Company Law", (2000), Harlow, Longman, at pp 235, 240.

IV.1.3. External control: market constraints

As English corporations¹⁴⁷ tend to lack presence of a controlling shareholder¹⁴⁸, they rely more on market constraints than shareholder control in controlling mismanagement. Market constraints can discourage mismanagement in various ways. One is the way of market for capital. As controllers do not have enough money of their own or want to cash out their investment and exit, they, therefore, have to search for external financing to cover their financial shortfall. They may not, however, be successful, unless they accept finance from expensive sources because agency costs signal to finance providers that financing in such corporation will be very risky. Another way is the market for products. Expensive finance will mean a rise in production costs and is normally reflected in the price of goods and services that a company produces. As a result, the company may lose the market for its products, as costumers will buy elsewhere at a less expensive rate, and if things continue this way, the company is very likely to face insolvency. A further way is market for corporate control, which is also called 'take over' mechanism. Inefficient management is quite likely to result in loss to the company that may further result in shareholders to opt for selling their shares with the effect of reducing the market value of company's shares on the one hand and a lack of desire on the part of finance providers to buy such shares on the other hand. Yet, a possible scenario is the case of one or more large finance providers who might want to buy the company's shares hereby to obtain its control

147 See Chapter I (above, at I.2.)

148 See generally Shleifer, Andrei and Vishny, Robert W., "A Survey of Corporate Governance", *The Journal of Finance*, (June 1997), Vol. LII, No. 2, at p 754; MacNeil Iain, "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies", (2002), *Journal of Corporate Law Studies*, vol. 2, part 2, 289, at pp 291-297, Hart Publishing; Cheffins (above, note 2) at p 7; Cheffins Brian R., "Corporate Law and Ownership Structure: A Darwinian Link?", University of Cambridge, (2002), Cambridge, UK, available at

and to replace the management with a new team of managers who run the company more efficiently. Lastly, market for managerial services will serve to discourage mismanagement because if managers act dishonestly or negligently, they will be replaced by those who can perform more efficiently, as companies will reject to employ bad managers or if in office will remove bad incumbent managers.

Yet, market constraints do not eliminate mismanagement for a number of reasons, though they reduce it. For one, the control of market forces relies on a presupposition that there exists perfect competition in the market. If that is taken away, they do not function properly. Individuals may not always have full knowledge of all relevant facts. In fact, some may enjoy informational advantages over others due to many reasons including possession of control of substantial means of production, wealth, key posts and private relation with politicians. This may mean corporate manager can work inefficiently while misrepresenting affairs of their corporations. This further means they can attract external finance, as finance providers may not be able to realise the truth about the company's real financial and business position, and they can continue office as shareholders may simply be unable to control them due to their lack of information or organisation. For another, market for products effectively discourages mismanagement where production capital is floating because supposedly managers must obtain their needed production capital at a competitive rate from the market every minute and thus there will remain nothing for them to appropriate personally. But, where production capital is sunk, it might not affect so and managers

would be able to extract private benefits from the corporate funds, as they would no longer need to search for production capital.

IV.2. The case of Iran

Unlike its English counterpart, Iranian law, as other civil law jurisdictions¹⁴⁹, does not recognise the division between serious and mere mismanagement and hence the Iranian courts hear allegations which involve mere mismanagement. The company law makes directors liable for committing any fault in the management of the company. The concept of fault is very wide, covering any mistake or error either in respect of procedures necessary for making business decisions or in relation to the very decisions and, principally, every fault, which causes damage, is a source of liability. It covers both intentional and non-intentional violation to the rules of law, articles of association, and appropriate resolutions of meetings.¹⁵⁰ It is further inclusive of honest/careless behaviours and any dishonest disregard of the company interests, which can expose directors to civil liability and even sometimes, when conditions subsist, to criminal liability.

Although Iranian company law (Joint Stock Companies Act and Trade Act) includes no statute law which either expressly or by implication imposes a duty on directors to regard the best interest of the company, assumption of such duty by directors can be by analogy inferred from general principles of agency law which are most manifested in section 667 of the Iranian Civil Code. According to the section 667 'a representative

149 For French company law position on the issue of mismanagement see Tunc (above, note 122) at pp 554-5; Arsalidou (above, note 6) at p 228; For the same position in Iranian company law see section 51 Trade Code 1931 (hereafter is cited TC), sections 614, 615, 631, 663, 667, 951 and 953 Civil Code 1925 (hereafter is cited CC) and in particular section 276 Joint-Stock Companies Act 1967 (hereafter is cited JSCA) which hold directors liable for breach of statutes and articles and for committing any fault which entails damages to the company.
150 Sections 142 and 276 JSCA.

must consider the best interests of the principal and in the exercise of his/her powers must not exceed of what has been expressly delegated by contract or deemed to have been conferred by implication of the custom'. Nonetheless, it is necessary to bear in mind that not any disregard of company interest makes directors personally liable. To hold a director liable for failing to regard company interests, the wronged company should principally show that such director's failure has entailed to fault. The principle aside, company law lists certain examples of such disregard by directors which are by expression considered fault. Sections 129, 130, 131 JSCA, for instance, refer to circumstances in which a wrongdoer director is personally interested in corporate transactions or sets up his/her personal business through which he/she competes with the business of the corporation.

Principally, Iranian law regards corporate directors as agents whose activities are deemed for the account of their principal corporations and hence such activities create no effect either positively (rights) or negatively (duties) for directors personally. However, in the exercise of powers which the company entrusts to him a director might assume personal liability when he commits fault. For that to occur, a director must do something which can reasonably attribute causation of damages incurred by the company to his conducts and that thing is fault.¹⁵¹ As defined by the CA, fault exists where a person commits an act or acts to which he, either by contract¹⁵² or by

151 Sections 666 and 331 CC.

152 Section 220 CC provides that: "A contract binds the parties to perform duties not only in respect of what mentioned by the parties expressly in the contract but also in respect of what derives from the custom and the statutes as a result of that contract." This has been further emphasised by sections 225, 344 and 356 CC.

standards of custom¹⁵³, is forbidden to do and also where such person forbears to act where he is either by contract or by standards of custom, under a duty to act in order to protect, manage or take care in relation to someone else's rights and property.¹⁵⁴ The test for measuring such person's conduct is to compare his conduct with that of a hypothetical reasonable person who does the same sort of functions and which is viewed by the courts in the light of the same external circumstances in which he acted.¹⁵⁵ A director's discretion to make business decisions forms only one factor among factors the courts will take into account when deciding whether a director has acted negligently or not.¹⁵⁶ Another important factor is to view the nature of directors' duty in relation to managing affairs of the company. A director's contract normally consists of duties both to ensure certain results and to try to achieve certain goals. Directors' duty to obey rules of articles, resolutions of meetings and rules of law in managing company affairs forms clear examples as to the former. In such matters, they are required to ensure that they will comply with legal as well as constitutional rules all the times and it would not be accepted from them as an excuse to say that we tried not to violate these rules but we could not avoid. Directors' duty to manage the business of the company successfully constitutes a clear example for the latter. Directors owe duty to the company to manage the company business with reasonable diligence and they discharge such duty if they make their honest effort which meets

153 In tort context, where there is no contractual relationship between the wrongdoer and the wronged person, a person is held responsible if he damages rights and property of another person either directly or through indirect causation. [Sections 301-337 CC].

154 Sections 951,952 and 953 CC.

155 See Katoozian Naser, "Liability in Torts and Civil Liability", (1997), Tehran, University of Tehran Publication, at No. 105; Katoozian Naser "Civil Code in its Modern Law Order", (1999), 2nd ed., Tehran, Dadgostar Publication, at p 575.

156 For German company law position see Hopt Klaus J., "Shareholder Rights and Remedies: A View From Germany and The Continent", (1998), Company Financial and Insolvency Law Review, 261, Oxford, Mansfield Press, at 265-266; Arsalidou (above, note 6) at p 228.

standards of custom.¹⁵⁷ Accordingly, once managing the corporate business a director does not guarantee good results. Instead, his duty is to apply reasonable effort to secure good results for the company and, therefore, he will not be held liable if he took a honest decision and complied with the necessary care which can be expected from a reasonable director in the same circumstances.¹⁵⁸

Under the current Iranian law, enforcement of directors' duties falls principally within the power of shareholders who act through meetings. If directors commit fault, it is up to shareholders to decide through majority resolution to prosecute the wrongdoer director or to ratify the wrongdoing and relieve him/her from liability. This power of meeting can be inferred by implication from the meaning of a number of sections in the JSCA which suggest that shareholders in the ordinary meeting control directors' activities.¹⁵⁹ Shareholders' discretion to decide between prosecution and ratification in respect of a negligent director is considered absolute and, unlike English shareholders' ratification power, this discretion has not been subjected to any exception.¹⁶⁰ Considering the share ownership pattern which prevails among Iranian corporations, this controlling power is capable of preventing directors effectively from mismanagement, as most companies, whether large or small, have one or few shareholders who are able to control the corporation.¹⁶¹

157 Katoozian (1997), (above, note 155) at Nos. 43, 164 and 165; Jafaritarbar Hasan "Civil Liability of Physicians", (2004), available at <http://www.dadgostary-tehran.ir/main.asp>.

158 Katoozian (1999), (above, note 155) at pp 441-2; Katoozian Naser "Specific Contracts", vol. 4, 1994, Tehran, Behnashr Publication, at p 103; Katoozian Naser, "General Principles of Contracts", Vol.1, (1995), Tehran, Dadgostar Publication, at p 327.

159 Sections 86, 89, 106 (2), 116, 138, 148, 149, 151, 152, 232 JSCA.

160 Under the English company law transactions that constitute fraud upon the minority cannot be ratified by a majority resolution.

Yet, the reality suggest otherwise. In small companies, this controlling power can be unsafe for the purpose of minority rights. Normally in such companies both the wrongdoer directors and the controlling shareholders are the same and as a result it seems very unlikely that the majority shareholders commence any action against wrongdoer directors. As to large companies, the controlling power, which rests in the dominant shareholder who is often the government, is not utilised effectively and therefore mismanagement persists for a number of reasons. For one, managerial team which is appointed by the government is not often very familiar with matters of business. As employees of the government, they have little incentive and required skills to run the business in such corporations. For another, because of its bureaucratic nature, the government is often unable to exercise effective control in such corporations.

As a matter of exception, Iranian company law empowers minority shareholders in certain circumstances in which managements' activities constitute fault to initiate corporate action against wrongdoer directors.¹⁶² Shareholders who own at least one fifth of the corporate shares are given statutory right to pursue wrongdoer directors who cause damage to the company. I will study this power in details later in Chapter five where derivative action will be examined. For the purpose of my discussion here it is useful only to know that the power does not form a very remarkable protection for minority shareholders as company law allows majority shareholders to block minority actions through ratification of management's faults.¹⁶³

161 See Chapter one (above, at I.2).

162 Section 276 JSCA.

Internal controls aside, mismanagement can further persist in Iranian corporations because of the weak and deficient functioning of the market constraints. As corporations rely more on internal finance, the existence of an unresponsive market for capital will not constitute a threat to inefficient corporations. Market for products too has little impact on such corporations, as they often enjoy monopolies. Finally, the government which is often a dominant shareholder in Iranian large corporations is very unlikely to refer to the market for managerial services. In such corporations, managerial team is often composed of persons who are employees of the government and who are disciplined, in case of failure, through administrative regulations and sometimes when conditions exist through law relevant to civil and criminal liability rather than market. In a context like Iran in which business is mainly conducted through either closely held firms or state-owned associations, and competitive constraints are to a great extent absent, and financial market is yet under developed, and share transactions are relatively uncommon, management will have more free room to commit mismanagement.

163 See Chapter five (below, at V.2.2.4)

IV.3. Conclusion

In this Chapter I considered the role of corporate directors in the majority/minority relationship. In this consideration, I challenged the claim that states directors play a remarkable role in reducing the majority/minority conflict. Accordingly, the merit of the claim, it is suggested, should be subjected to directors' accountability before companies and shareholders. Strong but unaccountable directors can commit mismanagement which is perhaps more problematic compared with dangers associated with the majority rule for minority shareholders. It was also explained that such accountability would not be reached unless three conditions are met. First, company law should ensure that its designed mechanisms of directors' duties are sufficiently inclusive in respect of directors' negligence so that mismanagement is discouraged. Second, company law should also ensure that suitable and practicable mechanisms of internal control which enable principally majority shareholders and, in appropriate circumstances, minority shareholders to enforce directors' duties exist in corporations. Third, the law and policy makers should design relevant regulations that enable the market to serve through its competitive constraints in order to curb mismanagement effectively.

English company law has not met the first condition yet. As regards the duty of care, there are good reasons to believe that the rules of liability and those of exemption from liability for corporate directors are not sufficiently certain and are improperly balanced. For one, the law fails to provide guidelines to determine what sort of conduct

associated with negligence should count as reasonable or unreasonable.¹⁶⁴ Decided cases that only reflect the intuition of particular judges also have a limited capacity to make this clear. In fact, from established cases of breach of duties to clear cases of mere negligence there is a very large grey area of disagreement among the courts in understanding, and upon such understanding in the discovery, of managerial negligence in companies¹⁶⁵; this makes the division hard to exercise and largely susceptible to misunderstanding, disagreement and misapplication.¹⁶⁶ Where the law offers a not very clear guideline to allow people to make an appropriate distinction, uncertainty may serve to further the position of negligent directors, as they are often able to make commercial excuses to justify their actions in doubtful areas, and even when they have no such ability and as a consequence shareholders may want to choose to take action, the uncertainty of the law, the threat of reputational damage to the company and the prospect of the costs of pursuing the wrongdoer director will disappoint them in doing so. For another, the question of whether the law has struck a good balance can be answered in the negative, when one takes into consideration the tendency of current company law to favour managers excessively. The law permits any negligence short of breach of duty, no matter how foolish and damaging, to occur. The law also allows incompetent persons to take management of corporations. In addition, the law assesses negligent directors' activities with a general standard of behaviour that requires simple compliance with the standard of performance of ordinary persons

164 Worthington (above, note 9) at p 449.

165 Law formulates the measure of duty of care in a generalised fashion in the hope that the courts would apply it coherently. However, since the courts' judgements are always fact-specific, it is always possible that they may fall into disagreement when dealing with similar facts and they can further differentiate even between cases that share most of their facts. A further difficulty is that it is hardly possible, if not impossible, to classify corporate directors into one and the same class with uniform code of practice.

rather than professionals. Of course, this arrangement would tend to greatly encourage many persons, no matter how inexperienced, to accept office and take business risks and attracts complete support from existing English directors.¹⁶⁷ But, such arrangement would also seem no longer desirable for companies and their shareholders, as it fails to deter directors from mismanagement and allows them to shirk their responsibilities or to negligently cause companies to suffer considerable loss.¹⁶⁸

As regards the fiduciary duty, the mechanism is not very reliable as the duty enjoys a subjective standard which requires directors only to act according to what they, themselves, regard it to be the best interest of companies. Furthermore, recent attempts that have been made in order to accommodate non-shareholder groups' interest within the scope of fiduciary duty of corporate directors have the potential that negligent directors under the label of corporate interests pursue self-interested objectives more.

In contrast, Iranian company law imposes stricter as well as higher levels of liability on corporate directors. It does not know any division between different sorts of negligence and as the concept of fault is inclusive of any negligent behaviour, it offers no systematic exemption from liability to corporate directors for mere mismanagement. Also, it does not know any division between duties of care and fiduciary of corporate directors and the concept of fault, which is assessed objectively, can include both.

166 Griffin, Stephen, "Negligent Mismanagement as Unfairly Prejudicial Conduct", (1992), *The Law Quarterly Review*, Vol. 108, 389, London, Stevens and Sons, at pp 390-392.

167 Directors have evidenced that they are happy with the scheme of the current law on directors' liability. This is implicitly understood from the reasoning of the Law Commission in refusing to recommend a statutory business judgement rule. [The Law Commission (above, note 18) at p 53].

Further, directors' duty only accommodates interests of company shareholders as against non-shareholder groups and, therefore, there is no or little possibility that directors could pursue interests other than those of the company.

As regards the second condition, both the English and Iranian company law allow the use of the two internal control mechanisms (i.e. enforcement by majority shareholders and enforcement by minority shareholders) in respect of directors' duties. Yet, as a consequence of the varying models of corporate governance which exist in the two systems each has been strong only in one of the two existing mechanisms. In the case of England, as company shares tend to be publicly dispersed in large companies, enforcement by majority shareholders serves little function. Here, company law should probably adopt policies which encourage shareholder organisation and activism.¹⁶⁹ Instead, enforcement by minority shareholder mechanism functions more effectively as majority shareholders have no power to stop it. Nonetheless, certain practical obstacles plus some level of information asymmetry and heavy costs of legal proceeding associate with this mechanism which require the English lawmaker to review law in this respect. For Iran, the converse is true. Companies rely more on enforcement by majority than by minority shareholders because company shares tend to be concentrated and further because majority shareholders have always had power to stop minority action when the case involves fault of directors. Yet enforcement by majority has been either problematic in the case of small companies or weak in the case of large companies because in the former case often the controlling majority and the

168 Arsalidou, Demetra, "The Impact of Modern Influences on The Traditional Duties of Care, Skill and Diligence of Directors", (2001), *Kluwer Law International*, The Hague/London/Boston, at p 173; Arsalidou (2003) (above, note 6) at p 232.

wrongdoer directors have been the same people and in the case of large companies control by government has evidenced to be deficient.

Lastly, while external control over directors' activities in English corporations is strong, it serves very weak in the case of Iranian corporations. As the economy in the former rely hugely on market, relevant regulations which encourage competitiveness in the market and require higher level of disclose of information are enacted to enable market constraints in order to curb mismanagement effectively. By contrast, Iranian economy which is greatly directed by the government and in part by the market often enjoys regulations which discourage competitiveness in the market and which call for sub standard disclosure of information requirement. Internal financing makes the threat of market for capital trivial and further it, in conjunction with concessions and monopolies which are enjoyed by the state-owned corporations, helps to reduce the threat of market for products. Also, appointment of management in large corporations which constantly occur outside the market negates the threat of market for managerial services.

169 Nolan R.C., "Indirect Investors: A Greater Say in The Company?", (2003), 3 Journal of Corporate Law Studies, 73, at pp 73-7.

Chapter V: Legal constraints on majority rule

Previous Chapters were dedicated to examining from several aspects the rule of majority and its consequences in the majority/minority relationship in companies. It has become clear in this examination that while the rule is generally and both in theory and practice appreciated by, and advantageous to, corporations and their shareholders, in some circumstances it can generate unjust harm to interests of minority shareholders. Such harm can stem not from a mere commercial failure to which every shareholder by his contract surrenders but rather from what is called abuse of rights that often comprises of certain sinister and vicious attempts of controllers who either intentionally or recklessly fail to regard minority interests. The contract, which mainly regulates this relationship, is unable to avoid such harm. Contractual safeguards simply lack the capability to curb controllers' abuse. General laws which regulate corporate activities have also limited capacity to curb such abuse because abuse of right often occurs within the ambit of contract and general law. Further, the shareholder voting with which the majority rule works can be exercised abusively. It bears with it no duty that could dictate majority shareholders once voting to regard minority interests and the constraint imposed by the company law that requires shareholders to avoid discrimination can only cover clear cases of discrimination. Lastly, directors under different circumstances can facilitate either mismanagement or majority abuse and disciplines of the market also seem either irrelevant or trivial as to addressing the question of majority abuse. An interesting question which is to be addressed and which is the subject of my consideration in this Chapter is whether the law has been responsive about the issue of abuse of right by majority shareholders and if so how has it been successful? The Chapter, therefore, concerns reviewing the rules

and mechanisms which are devised by the lawmaker with the intention to protect rights and interests of minority shareholders. The Chapter is divided into two parts. Part one considers the issue in the English company law and part two relates to the Iranian company law. As the legal constraints in English company law comprise of common law and statutory constraints, a subdivision is made in part one. Common law constraints constitute the first subdivision which specifically targets the mechanism of derivative action. As the other common law constraint; i.e. 'bona fide for the benefit of the company as a whole,' was fully discussed earlier in Chapter three, I avoid repeating that discussion here. Statutory constraints which form the second subdivision concern the two statutory remedies of 'winding up' and 'unfairly prejudicial conduct'. In part two, I review several mechanisms which exist in the current Iranian laws and which offer some protection to minority shareholders against abuse of right by the majority shareholders. These include the 'no abuse of right' principle, right to convene shareholder meeting, cumulative voting, disinterested ratification, and the shareholder action.

As the purpose of this Chapter is to explain intervention of the law in the majority/minority relationship in order to curb the possibility of majority abuse of right, two preliminary issues must be addressed before I could commence the discussion. The first issue, to be considered, is to see whether or not corporate members need the help of the company law at all? To answer this question approaches differ. The economic school and new contractarians have taken the view that company contract is merely premised on freedom of contract for its creation and continuity, as

are other private contracts.¹ By using the contract system, company law in every market economy should aim to reach efficiency and it will not be achieved unless parties are allowed to use their freedom to choose any arrangement they wish.² Companies are totally private organisations that need no support of company law³ which may only provide some voluntary standard form contracts in order to help parties avoid costly process of renegotiations and rewriting.⁴ Early manifestation of this approach can be traced back in the words of Adam Smith, the 18th century Scottish economist, who viewed 'the object of the public works and institutions [as being] to facilitate commerce in general'⁵. More recently, it was reflected in the Company Law Review Steering Group's report where it explained the purpose in setting out proposals for company law reform as being facilitation of the commerce.⁶

In this model, minority shareholder's interests are adequately preserved through the system of market self-regulation, especially the markets for securities, managerial

1 Easterbrook Frank H. and Fischel Daniel R., "Voting in Corporate Law", *The Journal of Law and Economics*, (1983), Chicago, University of Chicago Law School, at p 401.

2 One key factor in the economic analysis is the 'rational actor' concept. Economists assume that when individuals make choice, they do it rationally. See generally Schwarts Alan and Scott Robert E., "Contract Theory and The Limits of Contract Law", *Yale Law Journal*, (2003), vol. 113, New Haven, Conn., Yale Law Journal Co., Yale University, School of Law at pp 3-6.

3 Jensen C. Michel and Meckling William H. "Corporate Governance and 'Economic Democracy': An Attack on Freedom", in *Procedures of Corporate Governance: A Definitive exploration of The Issues*, edited by C.J. Huizenga, UCLA Extension, (1983), at pp 8-9 available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/ABSTRACT ID= 321521>; Schwarts and Scott (above, note 2) at pp 5, 11-16; Posner Richard A., "Economic Analysis of Law", (1992), Boston, London, Little, Brown, at p 3; Cheffins Brian R, "Company Law: Theory Structure and Operation", (1997), Oxford, Clarendon Press, at p 41.

4 Easterbrook and Fischel (above, note 1); Maughan C.W. and Copp S. F., "Company Law Reform and Economic Methodology Revisited", 1999, *The Company Lawyer*, Vol. 21, No. 1, 20, London, Oyez Publishing Limited, at pp 20-21; Cheffins (above, note 3) at pp 7, 26-31.

5 Smith Adam, "An Inquiry into the Nature and Causes of the Wealth of the Nations", (1776), Vol. 2, Book V, Chapter 1, Part III, at p 731, London, Printed for W. Strahan and T. Cadell.

6 Department of Trade and Indusry, "Modern Company Law for a Competitive Economy: The Strategic Framework", (1999), at 2.4.

services and corporate control.⁷ At the initial public offering (IPO), founders who take their firms public, adopt whatever corporate governance arrangements which are most efficient. If they do not, the company will be penalised in the capital market through being faced with higher production costs and may eventually become insolvent as customers buy elsewhere.⁸ At the midstream stage, too, controllers have generally no incentive to use their power in a way which is inefficient.⁹ In addition, legal constraints may simply impose additional cost on contractual parties who may feel better off settling their issue privately.¹⁰ After all, the way of exit is always open to small shareholders who would be able rationally to choose to disinvest.¹¹

The theory, however, justifies the use of legal constraints on two limited grounds. One is the case of close corporations where a controlling majority is present and an open market for shares is absent.¹² The other concerns large corporations where mandatory

7 Stedman Graham & Jones Janet, "Shareholders' Agreement", (1998), 3rd ed., London, Sweet & Maxwell, at p 255. Schwarts and Scott (above, note 2) at pp 11-16. Ferran Eilis, "Company Law and Corporate Finance", (1999), Oxford, Oxford University Press, at p 244.

8 Ferran Ibid; Easterbrook Frank H. and Fischel Daniel R., "The Corporate Contract", *Columbia Law Review*, No. 7, (1989), Vol. 89, New York, Columbia University Press, at pp 1430-5; Black Bernard S., "Is Corporate Law Trivial?: A Political and Economic Analysis", *North-Western University Law Review*, 1990, Vol. 84, No 2, Chicago, North-western University Law School, at pp 570-3; Romano Roberta, "Answering The Wrong Question: The Tenuous Case for Mandatory Corporate Laws", *Columbia Law Review*, No. 7, (1989), Vol. 89, New York, Columbia University Press, at pp 1600-2; Gordon Jeffrey N., "The Mandatory Structure of Corporate Law", *Columbia Law Review*, No. 7, (1989), Vol. 89, New York, Columbia University Press, at pp 1557-8.

9 Manne Henry, "Some Theoretical Aspects of Share Voting in the Economics of Legal Relationships", *Columbia Law Review*, New York, Columbia University Press, 1964, Vol. 64, 1427; Gilson Ronald J, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers", *Stanford Law Review*, 1981, 33, 819 Stanford, Calif., Stanford University, School of Law; Fischel Daniel R, "Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers", (1978), 57, *Texas Law Review*, 1, Austin, Texas Law Review Association Quoted in Mitchell Charles, "Shareholders' Claims for Reflective Loss", (2004), *The Law Quarterly Review*, Vol. 120, 457, London, Stevens and Sons, at 483-4. Romano (above, note 10) at pp 1600-2; Black (above, note 10) at pp 566-7.

10 Easterbrook and Fischel (above, note 10) at pp 1442-4.

11 Easterbrook and Fischel (above, note 1) at p 420.

12 Black (above, note 10) at p 573; Miles Lilian and Proctor Giles, "Unresponsive Shareholders in Public Companies: Dial "M" for Motivate?", *The Company Lawyer*, (2000), Vol. 21, No. 5,

rules may be employed to reduce the risk of externalities¹³ which imposes the costs of company operation on third parties or on the society.¹⁴

Some contractarians go one step further and assume some regulatory role for the law as to large companies. They take the view that individuals for a number of reasons may not always have full knowledge of all relevant facts. The information asymmetry which exists in the market can give informational advantages to some individuals over others. It prevents investors from calculating the right share price at IPO stage and instances of investors being defrauded would discourage investment.¹⁵ The inefficiency threat may not completely discourage abuse of rights by controllers at midstream stage too. The law should interfere both to take informational privileges away, thereby to make it feasible for businessmen in order to compete fairly¹⁶ and to prevent controllers from any *ex post* opportunistic alteration of investors' rights.¹⁷

London, Oyez Publishing Limited, at p 142; Cheffins Brian R, "Minority Shareholders and Corporate Governance", *The Company Lawyer*, (2000), Vol. 21, No 2, London, Oyez Publishing Limited, at pp 41-42.

13 Easterbrook and Fischel (above, note 10) at pp 1434, 1436-41.

14 Even in such cases it is suggested that before using mandatory rules it is necessary first to determine whether proposed mandatory measures will act better than what market forces can offer. [See Easterbrook and Fischel (above, note 10) at pp 1431-2; Romano (above, note 10) at pp 1616-7].

15 Bebchuk Lucian Arye, "Asymmetric Information and The Choice of Corporate Governance Arrangements", (December 2002), Harvard Law School, Discussion Paper Number 398, at pp 1-2 available at Social Science Research Network (SSRN), Electronic Library at <http://papers.ssrn.com/abstract id=327842>; Bebchuk Lucian Arye, "The Debate on Contractual Freedom in Corporate Law", (1989), *Columbia Law Review*, No. 7, Vol. 89, New York, Columbia University Press, pp 1406-7.

16 Cheffins (above, note 3) at p 9.

17 Gordon (above, note 10) at pp 1573-80; Similar views can be found in Bebchuk Lucian Arye, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", *Harvard Law Review*, (1989), Vol. 102, Cambridge, Mass., Harvard Law Review Publishing Association, at pp 1827-9; Bebchuk Lucian Arye and Hamdani Assaf, "Optimal Defaults for Corporate Law Evolution", (December 2002), Harvard Law School, Discussion Paper Number 343, pp 3-9 available at Social Science Research Network (SSRN), Electronic Library at <http://papers.ssrn.com/abstract id=293585>; Brudney Victor, "Corporate Governance, Agency Costs, and The Rhetoric of Contract", (1985), *Columbia Law Review*, No. 7, Vol. 85, New York, Columbia University Press, at p 1444; Coffee John C. "The

The law matters approach, on the other hand, rejects the economists' view, arguing that legal constraints can help contractual parties to achieve optimum efficiency. They prevent the constitution to concentrate complete power in the majority¹⁸ where the market fails to discourage the likelihood of abuse of power by the majority.¹⁹ They are also normally designed with the intention to address concerns from the wider society, which means they regard not only interests of individual members but also those of the very group that can require imposition of constraints in order to curb the possibility of majority abuse in corporations.²⁰ In addition to these, they are not always devised to reflect parties' choice if they could have thought about them *ex ante*.²¹ In certain circumstances, they are intended to protect one party against abuse of discretionary power by the other party. This is especially the case as to company contracts²² in which

Mandatory/Enabling Balance in Corporate Law: An Essay on The Judicial Role", (1989), *Columbia Law Review*, No. 7, Vol., New York, Columbia University Press, at pp 1622-3 and "Privatization and Corporate Governance: The Lessons from Securities Market Failure", (1999), *The Journal of Corporation Law*, Iowa City, University of Iowa, College of Law, at p 4.

18 Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law" (2001), 18th ed., London, Blackstone, at pp 11-12, 38.

19 Parkinson J. E., "Corporate Power and Responsibility", (1993), Oxford, Clarendon Press; New York, Oxford University Press, at p 114; Ayres I. and Gertner R., "Filling Gaps in Incomplete Contracts; An Economic Theory of Default Rules", (1989), 99, *Yale Law Journal*, New Haven, Conn., Yale Law Journal Co at p 87.

20 Parkinson (above, note 23) at pp 9, 21; MacNeil Iain, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory", *Journal of Corporate Law Studies*, (June 2001), Oxford, UK, Hart Pub, at pp 110-117; Ogus A. "Regulation: Legal Form and Economic Theory", (1944), Oxford, Clarendon Press, New York, Oxford University Press, at pp 29, 55; Bamford Colin, "Directors' Duties: The Public Dimension", (2000), *The Company Lawyer*, Vol. 21, No. 2, London, Oyez Publishing Limited, at p 38; Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, A report to the OECD by The Business Sector Advisory Group on Corporate Governance, (1998), p 67.

21 Bebchuk (1989) (above, note 15) at p 1410; Easterbrook and Fischel (above, note 8) at p 1433. [See Clark Robert C., "Contracts, Elites, and Traditions in the Making of Corporate Law", (1989), *Columbia Law Review*, No. 7, Vol. 89, New York, Columbia University Press, at pp 1718-20; Gordon (above, note 8) at p 1585].

22 Coffee (1989), (above, note 17) at pp 1619-20; Drury R.R., "The Relative Nature of A Shareholder's Right to Enforce The Company Contract", (1986), *The Cambridge Law Journal*, 42(2), 219, Cambridge, Cambridge University Press, at p 222.

parties with unequally divided discretionary powers create, and continue to, a long-term relationship.²³ In such contexts, they function to restrict *ex post* opportunism.²⁴

The second issue to be addressed is to determine how much and what type of company law intervention is justified? Company contracts, no doubt, need the help of the law at least because of their incompleteness which cannot be avoided as a consequence of living a long life in a dynamic ever-changing environment.²⁵ Incomplete contracts may cause party disputes which can waste public budget²⁶ and, therefore, lawmakers have incentive to provide legal rules for contingencies that contracts fail either to anticipate or to consider thoroughly. Clearly, a substantial part of company law will be designed in a default format because it reduces costs of re-contracting, ensure freedom of shareholders, and facilitate contractually efficiency.²⁷ However, in certain circumstances, it is unable to facilitate achievements of such objectives in their full capacity.²⁸ In particular, where a case involves abuse of rights by the majority against minority shareholders, defaults may simply facilitate abuse. Some level of mandatory

23 Company contracts fall within the category of relational contracts. Relational contracts can be distinguished from discrete contracts in which parties have no expectation of an ongoing relationship. [See MacNeil (above, note 20) at p 114].

24 Clearly, the case for mandatory rules is wider than what I brought here which were only relevant in the relationship between majority and minority shareholders. For other justifications see Coffee (1989), (above, note 17) at pp 1624, 1676-7; Gordon (above, note 8) at p 1549; MacNeil (above, note 20) at pp 121-123.

25 MacNeil (above, note 20) at p 113; Schwarts and Scott (above, note 2) at p 60; Bebchuk & Hamdani (above, note 17) at p 10; Coffee (1989), (above, note 17) at pp 1676; Gordon (above, note 8) at p 1573.

26 See Bebchuk & Hamdani (above, note 17) at pp 3-9.

27 Bebchuk & Hamdani (above, note 17) at pp 3-4, 9; MacNeil (above, note 20) at p 119.

28 Defaults are not always at the economics of contractual parties. Once they are in operation, those who wish to escape from their scope have to suffer cost in doing so. They also apply to the parties who may not be aware of such rules *ex ante*. If defaults are unknown to the parties *ex ante*, *ex post* opportunistic enforcement can occur. [MacNeil (above, note 20) at p 119].

intervention, however, can ensure that there will be no or little abuse.²⁹ Yet, any excessive mandatory intervention can reduce the efficiency of the company law too. While, they can be used to protect minority rights as against the possibility of majority abuse, an unconsidered use of them can encourage opportunism by minority shareholders.³⁰ A compromise, therefore, is required to reconcile the two contrary goals³¹, something which is often difficult, as it requires the lawmakers to understand which consideration in what circumstances must be given priority. A further difficulty is that different socio-economic backgrounds can require different considerations and hence what parameters should be taken into account cannot be formulated in a single prescription.³² Take, for example, the case of a country in which respecting contracts and rights of individuals have become a tradition as part of an established culture of a nation. In such context, there may be less need to having mandatory minority

29 Recent empirical research by comparing legal rules across 49 countries has also shown that there might be a casual link between good investor protection in corporate law and existing of a strong company sector with investors wishing to take the risk of investment in companies. [LLSV (above, Chapter one note 82)].

30 Sealy L.S., "Cases and Materials", (2001), Chap 10, at p 477, London, Butterworths; MacNeil (above, note 20) at p 125.

31 MacNeil (above, note 20) at p 120; Coffee (1989), (above, note 17) at p 1618; Gordon (above, note 8) at p 1549; Clark (above, note 21) at p 1703; Bebchuk (1989), (above, note 15) at p 1395; Bebchuk (1989), (above, note 17) at pp 1820; Brudney (above, note 17) at p 1403; Mayson Et. Al. (above, note 18) at p 38; Sealy (above, note 30) at p 477; Sealy Len, "Shareholders' Remedies in the Common Law World", (1997), *Company, Financial and Insolvency Law Review*, 173, Oxford, Mansfield Press. For opponents view see Romano (above, note 8) at p 1599; Black (above, note 8) at p 543.

32 Kamba, W. J., "Comparative Law: A Theoretical Framework", (1974), *International and Comparative Law Quarterly*, vol. 23, 485, at pp 513-518; Orucu, Esin, "Law as Transplant", (2002), *International and Comparative Law Quarterly*, vol. 51, 505, at p 207; Bratton W. and McCahery, "Comparative Corporate Governance and The Theory of the Firm: The Case against Global Cross Reference", (1999), 38 *Columbia Journal of Transnational Law*, 213; Cheffins Brian R., 'Current Trends in Corporate Governance: Going from London to Milan via Toronto', *Duke Journal of Comparative & International Law*, (1999), Vol. 10, No. 5, at pp 7-11; Cheffins Brian R, "Corporate Law and Ownership Structure: A Darwinian Link?", University of Cambridge, (2002), available at Social Science Research Network (SSRN), Electronic Library at <http://ssrn.com/abstract=317661>, p 23; Roe, Mark J., "The Shareholder Wealth Maximization Norm and Industrial Organisation", 'Harvard Law School', (2001), available at Social Science Research Network (SSRN), Electronic Library at: <http://papers.ssrn.com/abstractid=282703>, at p 2.

protections. Less mandatory measures in such society command the greatest because they reflect social values and prevailing moral judgements.³³ Likewise, for nations with competitive market lower levels of mandatory measures compared to that of a monopolist one may suffice because a competitive economy through market forces, can remedy, to a greater extent, the flaws of private ordering.³⁴ On the other hand, if much of a nation's industry is monopolistically organised and its company sector has a concentrated shareholding pattern, pursuing the mere efficiency objective would maximise the profit of the monopolist majority. As a result, there may be greater need to develop wider levels of mandatory interference.

33 Mayson Et. Al. (above, note 18) at p 34.

34 Coffee (1989), (above, note 17) at p 1691; Brudney (above, note 17) at p 1444.

V.1. The case of England

As legal constraints on majority rule in current English corporation law consist of case law and statutory law, it would seem better in the interest of simplicity and deep understanding to examine each in a separate section. Thus, this part is divided into two sections, common law constraints and statutory constraints.

V.1.1. Common law constraints

There are two constraints in common law which have been developed over time by the judges primarily to protect rights of minority shareholders against abuse of corporate power by a controlling majority. One concerns with the 'bona fide for the benefit of the company as a whole' restriction which was created in the *Allen* case³⁵ and which constitutes an important constraint on the power of majority shareholders. This constraint was discussed elsewhere³⁶ and, therefore, I reject repeating that discussion here. The other relates to the so-called 'fraud on a minority shareholder' restriction which is known as a major exception to the rule in *Foss* case and which enables a minority shareholder to take corporate claims using the derivative form of action. This constraint is the subject of my consideration here.

V.1.1.1. Derivative action

Principally, when corporations are wronged they, rather than their shareholders, prosecute wrongdoers. They commence such prosecution normally through their

35 *Allen v. Gold Reefs of West Africa, Limited* (1900), 1 Ch. 656 per Lindley M.R. at p 671.

36 See Chapter three (above, at III.1.5).

representatives. It is, however, very unlikely that a prosecution is commenced where corporate representatives and wrongdoers are one and the same. The derivative action has been designed by the case law, using rules of equity, to allow shareholders to initiate such prosecution where the company, itself, fails to do so.³⁷ In continental countries that follow civil law system, the court, in case of oppression of a minority by the majority, can always fall back, as a remedy of the last resort, on the general “abuse of rights” (abus de droit) rule. Common law system lacks such a general rule.³⁸ Instead, it has designed equitable rules to remedy the flaw in specific occasions and the derivative action is considered one of those.³⁹ Such action is called ‘derivative’ because the cause of action derives from a right that belongs to the company rather than the plaintiff shareholder.⁴⁰ For the same reason, the probable remedy which will be given in a successful derivative action is a corporate one rather than personal.

The derivative action is exceptional which means it is not always open to shareholders to initiate derivative actions. A minority plaintiff must show that he has already tried

37 *Atwool v. Merryweather* (1867), LR 5 Eq 464n; *Menier v. Hooper’s Telegraph Works* (1874), 9 Ch App 350; *Dafn Tinplate Co. Ltd. v. Llanelly Steel Co.* (1920) 2 Ch. 124; *Edwards v. Halliwell* (1950), 2 All ER 1064; *Daniels v. Daniels*, (1978), Ch 406; *Prudential Assurance Co Ltd. v. Newman Industries Ltd. (No. 2)*, (1981), Ch 257; *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2.

38 Hahlo H.R., Farrar John H., “Hahlo’s Cases and Materials on Company Law”, (1987), 3rd ed., London, Sweet & Maxwell, at p 477; Cutteridge H.C., “Abuse of Rights”, (1935), 5 *The Cambridge Law Journal*, 22; Bolgar Vera, “Abuse of Rights in France, Germany, and Switzerland: A survey of a Recent Chapter in Legal Doctrine”, (1975), 35 *Louisiana Law Review*, 1015; Byers Michael, “Abuse of Rights: An Old Principle, A New Age”, (2002), *McGill Law Journal*, Vol. 47, 389.

39 Hale Christopher, “What’s Right With the Rule in *Foss v. Harbottle*?”, (1997), *Company Financial and Insolvency Law Review*, Oxford, Mansfield Press, at p 219; Wedderburn K. W., “Shareholder’s Rights and the Rule in *Foss v. Harbottle*”, (1957), *Cambridge Law Journal*, 196, Cambridge University Press, Cambridge, UK at pp 203-206; Hager Mark M., “Bodies Politic: The Progressive History of Organizational ‘Real Entity’ Theory”, *University of Pittsburgh Law Review*, (1989), Vol. 50, Pittsburgh, at pp 633-4.

40 Pettet Ben, “Company Law”, (2001), Harlow, Longman, at p 235; Reisberg Arad, “Indemnity Cost Orders Under s 459 Petition?” (2004), *The Company Lawyer*, vol. 25, No. 4 116, London, Oyez Publishing Limited, p 118 at note 4; Hale (above, note 39) at pp 222-4.

any other possible internal ways for the purpose of remedying the wrong done to the company, but his efforts has been suppressed by the controlling wrongdoers.⁴¹ As a result, if a minority shareholder has yet options other than taking a legal action, his derivative action will not be heard. Where his only option is taking a derivative action, he must show that the case involves 'fraud on a minority shareholder'. As the case law suggests the term 'fraud on a minority shareholder' refers to a situation where a wrongful conduct against company amounts to fraud and the wrongdoers who are in control of the company do not want to allow an action to proceed.⁴² Thus, two prerequisites, those of fraud and wrongdoer control, must be shown before the courts in order to allow a derivative action.

V.1.1.1.1. Prerequisites of a derivative action

1) Fraud

The term 'fraud' is too wide, complex, and indefinite and is capable of covering many quite different sorts of failures.⁴³ There is not any well-established definition of fraud to assist those involved in the process. It has been described in certain cases and by some academics, for example, as not just in the traditional common law sense, which was

41 Wedderburn K. W., "Shareholder's Rights and the Rule in Foss v. Harbottle", (1958), *Cambridge Law Journal*, 97, Cambridge, Cambridge University Press, at pp 95-7; Griffin Stephen, "Company law: Fundamental Principles", (1996), 2nd ed., London, Pitman, at pp 300-2; Thorne James (ed.), "Butterworth's Company Law Guide", (1995), Butterworths, London, UK, at p 187.

42 As the loss in a 'fraud on a minority' case is always suffered directly by the wronged company rather than its shareholders, it seems more pertinent if the mechanism is retermed as 'fraud on the company'. See Wedderburn (1958), (above, note 41) at p 93; Farrar John H., "Company Law", (1991), London, Butterworths, at p 449; Griffin (above, note 41) at p 302; Sealy L. S., "Cases and Materials in Company Law", (1996), Sixth Edition, London, Butterworths, at pp 497-8.

43 Sealy (2001), (above, note 30) at p 498, para "Note"; Conway Mark, "Minority Shareholder Protection and the Rule in Foss v. Harbottle: Increasingly a Foss about Nothing" in *Companies in the 1990s*, edited by Gary Slapper, (1995), London, Cavendish, at pp 3-6.

limited to the cases of appropriation of company assets, but also in the wider equitable sense covering an abuse or misuse of power.⁴⁴ Yet such description only provides a general picture and hence a discovery of the meaning of fraud will depend the most on case law which stretches back over 150 years. The concept of fraud, therefore, can only be understood through a case-by-case study.⁴⁵ This is in part due to the courts' reluctance to theorise the concept of fraud⁴⁶ and in part is resulted from the very method of the common law system that tends to work without a firm definition⁴⁷ believing that any firm definition may prevent the judiciary from tracing new and developing forms of fraud.⁴⁸

There are two approaches in the case law as to how to identify fraud. One regards fraud in the nature of certain wrongdoings rather than the state of mind of the wrongdoers.⁴⁹ This approach, which has substantial support among academics too⁵⁰, often limits the scope of fraud to cases in which directors breach their fiduciary duty to the company or fail to exercise proper care and as a result of such failure they get unduly enriched. The approach classifies wrongdoings into two categories of ratifiable,

44 *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2 per Megarry VC; See also *Wedderburn* (1958), (above, note 41) at p 96; *Farrar* (1991), (above, note 42) at p 449; *Griffin* (above, note 41) at p 302; *Thorne* (above, note 41) at p 186; *Stedman & Jones* (above, note 7) at p 77.

45 *Pettet* (above, note 40) at p 232; *Stedman & Jones* (above, note 7) at pp 77-8; *Conway* (above, note 43) at pp 4-6.

46 *Pettet* (above, note 40) at p 231.

47 Sealy L. S. and Hooley R. J. A., "Text and Materials in Commercial Law", (1994), London, Butterworths, at p 3.

48 *Estmanco (Kilner House) Ltd v. Greater London Council* (1982) 1WLR 2 per Megarry V-C.

49 *Atwool v. Merryweather* (1867), LR 5 Eq 464 n; *Menier v. Hooper's Telegraph Works* (1874), 9 Ch App 350; *Burland v. Earl* (1902) AC 83; *Daniels v. Daniels*, (1978), Ch 406.

50 *Wedderburn* (1958), (above, note 41) at pp 96-7; *Parkinson* (above, note 19) at pp 247-254; *Farrar* (1991), (above, note 42) at p 449; *Griffin* (above, note 41) at pp 301-4; *Ferran Eilis*, "Company Law and Corporate Finance", (1999), Oxford, Oxford University Press, at p 148; *Pettet* (above, note 40), at p 232; *Thorne* (above, note 41) at p 186; *Stedman & Jones* (above, note 7) at pp 77-8.

which is not fraud, and non-ratifiable which is fraud and which allows derivative action. Well-known instances of fraud according to this approach are mala fide deflecting of corporate assets, taking corporate profits and advantages at the expense of minority shareholders⁵¹ and bona fide negligence amounting to a benefit obtained by wrongdoers at the company's expense.⁵² Proceedings based on breach of duties and mere negligence in which wrongdoers were not benefited personally have been expressly excluded from the concept of fraud.⁵³ This approach is advantageous in the sense that its measure can provide a bottom line from which one can distinguish fraud from other wrongdoings which in turn will result, to some extent, in more certainty for those involved in such cases.⁵⁴ It is also advantageous in that it relieves the courts from taking a subjective investigation into the state of mind of the controlling wrongdoers.⁵⁵

However, one important difficulty of the approach is that it classifies certain not very interrelated conducts in the same category as fraud. Put it simply, it remains unclear, after all, that whether the test is deflecting corporate assets or failure to exercise proper care and in the latter case why a self-benefiting from the wrongdoing should make a difference.⁵⁶ Another difficulty is that identification of any fraud requires separate examination of every act and, therefore, there may be as many frauds as there are acts.

51 *Atwool v. Merryweather* (1867), LR 5 Eq 464 n; *Menier v. Hooper's Telegraph Works* (1874), 9 Ch App 350; *Burland v. Earl* (1902) AC 83.

52 *Daniels v. Daniels*, (1978), Ch 406.

53 *Pavlides v. Jensen*, (1956), Ch 565; *Turquand v. Marshall*, (1868-69), (L R), 4 Ch App 376 at p 386; *Bamford v. Bamford*, (1970) Ch. 212.

54 Ferran (above, note 50) at p 150.

55 Ferran *Ibid.*

56 *Prudential Assurance Co Ltd. v. Newman Industries Ltd. (No. 2)*, (1981), Ch 257 per Vinelott J; See also Hale (above, note 39) at p 224.

As a consequence, this approach never settles the difficult issue of separating ratifiable and non-ratifiable wrongs.⁵⁷

The other approach views fraud not in the nature of the wrong but in the motive of the wrongdoers and in the manner in which they have used their voting rights to prevent a corporate action being taken. It maintains that the courts should be able to interfere in the majority/minority relationship whenever the justice of the case requires, otherwise no shareholder decision could ever be a fraud because shareholders are free to vote whether they are interested in the transaction in question or not.⁵⁸ Thus, wherever justice requires, the courts should disregard votes cast or capable of being cast by shareholders who have an interest conflicting with that of the company. As a result, only a disinterested majority resolution can be authorised by the courts.⁵⁹

Although this approach tries to avoid conceptual difficulties and practical limits of the fraud exception and provides a wide jurisdiction for the courts to hear minority

57 This also resulted in delivery of inconsistent judgements in case law. See for instance *Prudential Assurance Co Ltd. v. Newman Industries Ltd. (No. 2)*, (1981), Ch 257; *Daniels v. Daniels*, (1978), Ch 406; *Pavrides v. Jensen*, (1956), Ch 565; *Hogg v. Gramphorn Ltd.* (1967), 1 Ch 254; *Bamford v. Bamford* (1970), Ch 212, (1969), 1 All ER 969; *Re a Company* (1987) BCLC 82 at 84 per Hoffman J; *Estmanco (killner House) Ltd. v. Greater London Council*, (1982), 1 All ER 437 per Megarry VC; *Dafen Tinsplate Co Ltd. v. Llanelly steel Co.*(1907)LTD, (1920), 2 Ch. 124.

58 *Prudential Assurance Co Ltd. v. Newman Industries Ltd. LTD. and Others* (No. 2) (1981), Ch 257 per Vinelott J.; Among academics see Beck Stanley M., "An Analysis of *Foss v. Harbottle*", J. S. Ziegel (ed.) *Studies in Canadian Company Law*, (1967), Toronto, Butterworths; Beck Stanley M., "The Shareholders' Derivative Action", (1974), *The Canadian Bar Review*, Vol. LII, No. 2, 159, Carswell for the Canadian Bar Association, Toronto.

59 Baxter Colin, "The True Spirit of *Foss v Harbottle*", *Northern Ireland Legal Quarterly*, (1987), Vol. 38, No. 1, Stevens & Sons, Belfast, at pp 6-8, 45; This was also recommended by the British government in its recent company law reform. [Modern Company Law for a Competitive Economy: Final Report, (London, DTI, 2001), URN/942 & URN/943, Para 7. 54 at p 168].

allegations, its proposed measure seems contrary with the decided cases.⁶⁰ It is also inconsistent with the traditional approach of the common law that views right to vote as a piece of property.⁶¹ Moreover, it is unworkable especially in large companies because most of the times it leaves untouched fraudulent activities of controllers who have the support of disinterested but unorganised and uninformed shareholders.⁶² The measure of justice of the case further lacks an objective and workable test⁶³ and seems like a double-edged sword. For, justice requires not only minority rights but also the corresponding rights of the majority. Therefore, justice by itself gives nothing.⁶⁴

2) Wrongdoer control

The wrongdoer control element, which is essential to a derivative action, can be defined as an abuse of voting right by one or few shareholders who are the very wrongdoers and in control of corporation. Control might simply be *de jure* which arises where a wrongdoer possesses at least fifty one percent of voting shares in the wronged company.⁶⁵ The *de jure* control is often found in small companies where one or few shareholders possess over fifty percent shareholdings. In a more complicated case, control might be *de facto* which means the wrongdoer is in a position in the company that can influence the results of meetings, though having less than fifty percent shareholdings. Such position which is normally created in large companies can be

60 See cases cited above, notes 60, 64; see also Davies, Paul L., "Gower's Principles of Modern Company Law", (1997), 6th ed., at p 646, Sweet & Maxwell, London, UK; Ferran (above, note 53) at p 149.

61 Ferran Ibid at pp 149-150; Baxter (above, note 59) at p 8.

62 Parkinson (above, note 19) at p 256.

63 Parkinson (above, note 19) at pp 255-6; Farrar (1991), (above, note 42) at p 445.

64 See Estmanco (Kilner House) Ltd v Greater London Council (1982) 1WLR 2 per Megarry VC; see also Griffin (above, note 41) at pp 301, 304-5.

65 Pavlides v. Jensen, (1956), Ch 565 AT 577 PER Danckwerts J.

obtained as a consequence of several factors.⁶⁶ In *Prudential Assurance Co Ltd. v. Newman Industries Ltd (No 2)*⁶⁷, the Court of Appeal observed that control embraces a broad spectrum extending from an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy.

Both types of control have advantages as well as disadvantages. As the *de jure* control is identified with formal ownership of shares, it is capable to offer a definite test to be used for the purpose of fraud identification. It, however, fails to cover cases in which a wrongdoer has *de facto* control or through its nominees and dummies controls the wronged company.⁶⁸ The *de facto* control, on the other hand, is capable to cover shortcomings of the *de jure* control⁶⁹, however, it fails to provide a bottom line in order to define what the control is. It can also require the courts to fall into an uneasy investigation in the voters' state of minds in order to determine whether they have voted independently, disinterestedly and on an informed basis or not.⁷⁰

66 Hirt Hans-Christoph, "In What Circumstances Should Breaches of Directors' Duties Give Rise to a Remedy under ss. 459-461 of the Companies Act 1985?" (2003), *The Company Lawyer*, Vol. 24, No. 4, 100, London, Oyez Publishing Limited, at p 107; See Griffin (above, note 41) at p 305; See also Farrar (1991), (above, note 42) at p 578; Parkinson (above, note 19) at p 248.

67 (1982), Ch 204, CA.

68 *Pavlidis v. Jensen*, (1956), Ch 565 per Danckwerts J; *Millers (Invercargill) Ltd. v. Maddams* (1938), N.Z.L.R. 490 per Myers C. J.; See also Wedderburn (1958), (above, note 41) at p 94; Sterling M. J., "The Theory and Policy of Shareholder Actions in Tort", (1987), *The Modern Law Review*, Vol. 50, 468, London, England, Stevens & Sons, at pp 479- 480; Law Commission, Consultation paper, No 142, Para 1.7; Law Commission, *Shareholder Remedies*, (1997), No 246, p 2.

69 *Prudential Assurance Co Ltd. v. Newman Industries Ltd (No 2)*, (1982), Ch 204, CA per Vinelott J.

70 Griffin (above, note 41) at p 305.

For the purpose of fraud, current company law tends to reject the idea of *de facto* control.⁷¹ Nonetheless, section 459 which will be discussed in the following section now permits a member of a company to bring action in his personal capacity against wrongdoers who have *de facto* control of the company.⁷²

V.1.1.1.2. Disinterested majority requirement

The disinterested majority requirement concerns with a situation in which an alleged fraud occurs against a group of minority shareholders who then fall in disagreement in respect of whether or not to pursue the wrongdoers. This requirement which was introduced by Knox J in the *Smith v. Croft* case denies a minority plaintiff any derivative remedy where the majority inside the minority do not wish the proceeding to continue. 'The usual reason in practice for wanting to abandon such an action is that there is far more to lose financially by prosecuting the right to redress than by abandoning or not pursuing it'.⁷³ Where, for example, the would-be defendants are the main providers of the corporate assets, to sue them might result in their exit thus jeopardising the company and its shareholders in the whole.⁷⁴

Disinterested majority measure is, however, liable to certain criticisms. It is suggested that it can stifle through creating an adapted version of majority rule the use of derivative action which was primarily designed to provide minority shareholders

71 See the arguments of the Court of Appeal in *Prudential Assurance Co Ltd. v. Newman Industries Ltd. (No 2)*, [(1982), Ch 204, CA.; See also *Wedderburn* (1957), (above, note 39) at p 194; *Miles and Proctor*, (above, note 12) at p 142; *Cheffins* (above, note 12) at p 41.

72 *Re R A Noble & Sons (Clothing) Ltd.*, (1983), BCLC 273 at p 287 per Nourse J.

73 *Smith v. Croft (No 2)*, (1988), Ch 114 per Knox J; See also *Taylor v. National Union of Mineworkers*, (1985), BCLC 237.

74 *Thorne* (above, note 41) at p 187; *Ferran* (above, note 50) at pp 152-3.

some protection against controllers' abuse in corporations.⁷⁵ It is, also, difficult to use as it can require the courts to fall into a subjective investigation into the mind of voters in order to discover that they were in fact disinterested or not.

Learning from the experience of the American courts⁷⁶, a theory has been developed by some English company lawyers of replacing the disinterested majority measure with views of other independent corporate organs in appropriate cases.⁷⁷ According to this theory, if in a given case an independent sub-committee has already been formed by the board of directors to do enquiries about allegations that institute the substance of minority claims, the views of such committee may be worth enough to block the derivative proceeding. Members of such sub-committee are often non-executive directors with much less likelihood of being involved in the wrongdoing or being under the influence of the very board.⁷⁸ However, this theory can worsen the circumstances for minority shareholders. The views of a sub-committee may simply serve to block minority claims and further it may signal potential plaintiffs that it is better not to take wrongdoings in companies seriously and perhaps it is even wise to allow them to proceed.

V.1.1.1.3. Proposed reform as to the derivative action

In 1996, the Law Commission was authorised to review and identify shortcomings of the shareholder protection mechanisms which already existed in company law. One of

75 Pettet (2001), (above, note 40) at p 240.

76 See *Zapata Corp v. Maldonado* in which the Delaware Supreme Court gave regard to the views of the sub-committee of the board and as a result struck out the action brought by the minority shareholder. [430 A 2d 779 (1981) quoted in Pettet (above, note 40) at pp 239-240.

77 Pettet *Ibid.*

78 Pettet *Ibid.*

the reviewed mechanisms that focused attention of the Commission was the derivative action. The Commission noticed that the scheme of the law relevant to derivative action is currently deficient mainly because of its inaccessibility.⁷⁹ The law in this area is dense and hidden in a labyrinth of over 150-year legal proceedings which are at times incoherent.⁸⁰ It fails to cover breach of duties of care and fiduciary and negligence and further qualifies commencement of a derivative action to two difficult to prove prerequisites.⁸¹ Inspired by recent developments which occurred in respect of derivative action in other commonwealth countries such as Canada⁸² and New Zealand⁸³, the Law Commission recommended that derivative action should be put in a statutory footing and be made available to shareholders under much more certain and easily accessible and provable circumstances. In its view, such circumstances will be created if the government considers a reform of the law which covers the following issues:

79 Law Commission, (above, note 68) at p 71; Department of Trade and Industry's Consultation Paper, "Modern Company Law for a Competitive Economy", Summary of Responses Received to The DTI, (1998), p 12.

80 Law Commission, (above, note 68) at p 71; Department of Trade and Industry's Consultation Paper Ibid.

81 See generally Conway (above, note 43); Boyle A. J. "The Derivative Action in Company Law", (1969), *Journal of Business Law*, London, Stevens, at p 120; Poole Jill and Roberts Pauline, "Shareholder Remedies-Corporate Wrongs and the Derivative Action", (1999), *Journal of Business Law*, London, Stevens, at p 99; Farrar (1991), (above, note 42) at p 453.

82 Statutory derivative action subject of Canada Business Corporation Act (1985), s. 239; For further study of the Canadian statutory derivative action see Miles Lilian, "Reforming The Common Law Derivative Action: A Bird's Eye View", *Business Law Review*, (July 1999), 180, London, Butterworths, at p 181; Cheffins Brian R., "Reforming the Derivative Action: The Canadian Experience and British Prospects", (1997), *Company, Financial and Insolvency Law Review*, Vol. 1 (2), 227-260, Oxford, Mansfield Press; MacIntosh Jeffrey G, "Minority Shareholder Rights in Canada and England: 1860-1987", (1989), *Osgoode Hall Law Journal*, vol. 27, No. 3, Toronto, Osgoode Hall Law School, at pp 636-640; Beck (1974), (above, note 58).

83 Companies Act 1993, s. 165 (New Zealand); For further study of the statutory derivative action in New Zealand see Watson Susan M., "A Matter of Balance: The Statutory Derivative Action in New Zealand", (1998), *Company Lawyer*, 19 (8), 236; Fitzsimons, Peter, "The

1) Derivative action should be limited to action against directors and should not cover actions against third parties or breach of duties by officers and employees unless directors are implicated in the wrongdoing. The rationale was twofold. On the one hand, it could avoid excessive shareholder interference and allows directors to deal with such actions as matters of management. On the other hand, it could ensure that there will be no more confusion and overlap in the use of the unfairly prejudicial and the derivative remedies as to addressing the majority/minority conflict, as such conflicts should fall only within the jurisdiction of the former remedy.⁸⁴

2) Derivative actions should be available to shareholders for breach of director's duties of care and fiduciary and should also extend to negligence cases⁸⁵ where directors were not benefited personally because while we accept investors take the risk of mistake by managers it does not mean that they have to accept that directors will fail to comply with their duties.⁸⁶

3) Derivative actions should be subject to a 28 days notice given by the plaintiff to the wronged company followed by taking action by such plaintiff for a leave of the court allowing the plaintiff to continue his action against the alleged wrongdoer director. A notice requirement, would allow the company to decide whether to bring the

Companies Act 1993: A New Approach to Shareholder Litigation in New Zealand", (1997), *Company Lawyer*, 18 (10), 306; Roberts and Pool (above, note 81).

84 Section 459 Companies Act 1985.

85 The same Commission later when reviewing the law relevant to directors' duties in 1999 implicitly revised this recommendation. [See Chapter Four (above, at IV.1.1.C.2, para note 133].

86 For a similar view see Department of Trade and Industry's Consultation Paper (above, note 79) at pp 45, 46 and Modern Company Law for a Competitive Economy: Final Report (above, note 59), para 7.46 at p 165.

proceeding itself or else to provide a proper answer hereby to make the use of a derivative action unnecessary.

4) Derivative actions should be subject to the discretion of the courts that, in substitute of the management, will make appropriate decision either to allow or to reject a derivative action and in doing so they should consider all circumstances including the good faith of the plaintiff, the interests of the company, whether the wrong has been ratified by the company, whether the company has resolved not to pursue the wrongdoer, the views of an independent organ and the availability of alternative remedies and the like.⁸⁷

The Law Commission pronounced its recommendations facilitative to derivative actions, as they will remove the common law basis for such an action and relieve a minority shareholder from the burden of having to show difficult to prove prerequisites of fraud and wrongdoer control. They will also entail certainty, as a minority shareholder will be able to identify circumstances in which it is very likely that a derivative action will succeed. They also curb opportunistic use of the derivative mechanism, as the decision to grant leave falls ultimately within the discretion of the courts.

The Companies Act 2006 has placed, as recommended by the Law Commission, the derivative action on a statutory form.⁸⁸ Excluding the 28 days notice requirement, it includes all the other recommendations of the Law Commission in this area.

⁸⁷ Law Commission (above, note 68) at pp 77-85.

⁸⁸ The Companies Act 2006, sections 260-264.

Accordingly, the Act restricts the use of derivative action to cases where the cause of action arises from directors' breach of duties extending to their negligence and where the action is against the wrongdoer director or other persons who hold assets that are the subject of the derivative action and confers discretion on the courts to decide whether to allow or reject such action after consideration of every relevant circumstance.

Whether a statutory derivative action, as recommended by the Law Commission and introduced by the Act, is capable to meet its declared objectives must be seen in the light of future court experience and hence cannot be answered with precision at this stage. Nonetheless, from a theoretical perspective and in the light of past experience one can raise reasonable doubts about the likelihood of reaching those objectives. Take, for example, certainty which appears to be the most important argument in the Law Commission's theory. The theory can generate uncertainty as to derivative action for a number of reasons. For one, it does not require the courts to entertain such actions while conferring a wide discretion on them to choose after considering varying factors either to allow or to reject a derivative action.⁸⁹ For another, where conflicting factors are present, which factor is to be prioritised is not determined. Also, while the courts will have discretion to review an authorisation or ratification of the wrong and a corporate decision which rejects pursuing the wrongdoer⁹⁰, nonetheless, the law does

89 Section 263 (3).

90 Section 263 (2, 3).

not offer guidelines as to determining when and under what circumstances such factors will not bar the continuation of a derivative action.⁹¹

There are also concerns about how should the courts make use of or assess some of the stated factors. For example, the proposed derivative action requires the courts to regard whether the wrong in question could be ratified by the company, while it fails to determine what sort of wrongs can be ratified. Another example is where it refers the courts to consider views of directors or an independent organ within the company. As to the views of directors, given that such views can be tainted with bad faith on the part of directors, it is not determined how should the courts make a distinction between views of directors which are truly genuine and those that are not so.⁹² The same criticism can be brought as to the views of an independent organ plus there is no guideline to show what can be considered as an independent organ and further how such organs perform their role.⁹³

In addition to these, discretion of the courts in authorising or rejecting derivative actions and in reviewing ratifications could mean to put the power to take corporate decisions into the hands of an inappropriate organ. To ask the courts to take such decisions is, in fact, to ask them to take the management of companies.⁹⁴

91 Garcia John "The Law Commission's Investigation into Director's Duties", (1998), *Company Lawyer*, 19 (9), 279-281; Roberts and Pool (above, note 81) at p 104; Miles (above, note 82) at pp 182-3.

92 Roberts and Pool (above, note 81) at p 108.

93 Miles (above, note 82) at p 183.

94 Hale (above, note 39) at p 225.

V.1.2. Statutory constraints

Substantive and procedural difficulties which associate with taking a derivative action, its insufficient jurisdiction and the fact that common law offers no “abuse of rights” principle in the model of civil law jurisdictions have contributed to convince the Parliament to take statutory steps in order to protect minority shareholders against the likelihood of abuse of rights by majority shareholders.⁹⁵ To this end, the Parliament made use of the equity principles and the idea was to enable the courts to remedy abusive conducts of majority shareholders which under the traditional common law often fell short of the concept of actual illegality.⁹⁶ This way of relaxation of rigidity of the law is a product of English legal history that has survived the amalgamation of the courts of common law and equity in order to ensure justice.⁹⁷ While the courts of common law had to observe only legal rights, courts of equity could dispense with legal rights in the interests of general principles of company law and equity.⁹⁸ The equity principles could subject the exercise of legal rights to equitable considerations where certain conditions existed⁹⁹ and, accordingly, the Parliament introduced two mechanisms of ‘just and equitable winding up’ and ‘unfairly prejudicial conduct’, respectively subjects of sections 122 (1) g Insolvency Act 1986 and 459 Companies Act 1985 which are the focus of my consideration in this section.

95 See generally Farrar (above, note 42) at p 454; MacIntosh (above, note 82) at p 615; Clark Bryan, “Unfairly Prejudicial Conduct: A Pathway Through the Maze”, *Company Lawyer*, (2001), 22 (6), 170, London, Oyez Publishing Limited.

96 Pettet (above, note 40) at p 246

97 Compared with the way through which the laws of the civil law jurisdictions address the issue of majority abuse, this, can be seen as being only a different way of doing the same thing. [O’Neill and another v. Phillips and Others, (1999), 2 All ER 961, HL at 969 per Lord Hoffmann].

98 Hahlo and Farrar, (above, note 38) at p 477; Hale (above, note 39) at 219.

99 Ebrahimi v. Westbourne Galleries Ltd. (1973), A.C. 360 at 379 per Lord Wilberforce.

V.1.2.1. Just and Equitable Winding up

The purpose of the just and equitable winding up is to enable an oppressed shareholder to take action to the courts for a winding up remedy on equitable grounds.

The remedy originally relied on case law in which earlier judges had created a jurisdiction for themselves to wind companies up on equitable grounds, as they did so in respect of partnerships.¹⁰⁰ Later, it was put into a statutory footing by the Insolvency Act 1986 which offers no definition of it and which gives a wide discretion to the courts in the exercise of it.¹⁰¹ The lawmaker thought that a formal definition not only is impossible but also could be wholly undesirable.¹⁰² Nevertheless, the case law has provided some guidelines as to showing under what circumstances an equitable winding up remedy can be given. According to it, equitable considerations may come to play whenever the relationship between two people is of personal character mainly based on verbal trust.¹⁰³ Such relationship is normally found in small companies which enjoy a quasi partnership character. In such companies, shareholders' relationship can go beyond the written articles of association and include their legitimate expectations.¹⁰⁴ Accordingly, the remedy has been given a very limited scope, being most suitable for deadlock situations¹⁰⁵ where, for instance, a company is essentially an incorporated partnership, involving two partners with equal shareholdings, and thus

100 *Re Yenidje Tobacco Company* (1916), 2 Ch 426, Per Lord Cozens Hardy MR; *Loch and Another Appellants v. John Blackwood, Limited Respondents* (1924), A.C. 783; *Re Davis and Collett, Limited* (1935), Ch. 693; See generally Pettet (above, note 40).

101 See Insolvency Act 1986, Section 122 (1): "A company may be wound up by the court if- (g) The court is of the opinion that it is just and equitable that the company should be wound up.

102 *Ebrahimi v. Westbourne Galleries Ltd.* (1973), A.C. 360 at 379 per Lord Wilberforce; see also Farrar (1991), (above, note 42) at pp 454-457.

103 *Ebrahimi v. Westbourne Galleries Ltd.* (1973), A.C. 360 at 379 per Lord Wilberforce; *Clemens v. Clemens*, (1976), 2 All ER 268(Ch D).

104 *MacIntosh* (above, note 82) at pp 616-617.

105 *Re Yenidje Tobacco Company*, (1916), 2 Ch 426, Per Lord Cozens Hardy MR.

dependent on mutual confidence, but has ceased to operate properly owing to an unsolvable disagreement between the partners.¹⁰⁶ Yet deadlock is by no means a requirement and a mere break of trust may suffice.¹⁰⁷ A familiar example is the case of exclusion from the management in which a member who legitimately expects to continue the office might lose his trust owing to an unfair dismissal on the part of those in control.¹⁰⁸

One important implication of the case law guidelines is to make it clear that equitable remedies such as winding up have little relevance to the large companies because such companies often lack a quasi partnership character.¹⁰⁹

A relevant issue is to determine whether the remedy works on the basis of a no fault divorce or a minority plaintiff is required to show a fault of controllers? There are two approaches both in case law and between company law scholars. One argues that a minority shareholder is required to prove some fault of the defendant majority.¹¹⁰ The proponents of this approach seek, by analogy, to extend to the just and equitable winding up remedy the principles which are primarily relevant to the unfairly

106 *Re R A Noble & Sons (Clothing) Ltd.*, (1983), BCLC, p 273.

107 *Loch and Another Appellants v. John Blackwood, Limited Respondents*, (1924), A.C. 783; *Re Davis and Collett, Limited*, (1935), Ch. 693; *Re R A Noble & Sons* *Ibid.*; See also Farrar (1991), (above, note 42) at p 458.

108 Pettet (above, note 40) at p 246.

109 Acton Stephen, "Just and Equitable Winding Up: The Strange Case of the Disappearing Jurisdiction", *Company Lawyer*, (2001), 22(5), 134, London, Oyez Publishing Limited, at 135.

110 Clark (2001), (above, note 95) at pp 173-4; Clark Bryan, "Unfairly Prejudicial Conduct", *Scots Law Time*, (1999), 38, 321, Edinburgh, W. Green & Son Ltd, at 324; Clark Bryan, "Just and Equitable Winding Up: Wound Up", *Scots Law Time*, (2001), 12, 108, Edinburgh, W. Green & Son Ltd, at pp 110-111.

prejudicial remedy.¹¹¹ The *Re Guidezone Ltd.* case¹¹² is a common law support for this approach. The case involved a break of relationship between company partners and Jonathan Parker J. who was asked for an equitable remedy rejected the case taking the view that the defendant majority had acted in a manner which equity would not regard as a breach of good faith.¹¹³ According to him, equitable remedies should not enable a member to escape from consequences of a valid bargain; otherwise they will produce commercial uncertainty and would fundamentally contradict the sanctity of contract principle.¹¹⁴

The other approach rejects any extension of some sort of fault requirement to the just and equitable winding up remedy and suggests that this remedy has a wide jurisdiction which can be resorted to on a no fault divorce basis.¹¹⁵ It relies on the *Ebrahimi v. Westbourne Galleries Ltd.* case¹¹⁶ which involved a private corporation with three shareholder/director members. They were entitled to profits of the business which were distributed among them in the form of remuneration. Two of them, a father and son, who held a majority of shares, removed the plaintiff from the office and Lord

111 These principles which were announced by Lord Hoffman in the *O'Neill and Another v. Phillips and Others*, (1999), 2 All ER 961, will be later discussed in the following section. See below at V.1.2.2.

112 *Re Guidezone Ltd* (2002), 2 BCLC 321.

113 *Re Guidezone Ltd.*, *Ibid.*

114 Law Commission (above, note 68) at 3.66; *O'Neill and Another v Phillips and Others*, (1999), 2 All ER HL 961 at 968 per Lord Hoffman J; *Ebrahimi v. Westbourne Galleries Ltd.* (1973), A.C. 360 at 379 per Lord Wilberforce; See also Clark, (2001), (above, note 110) at p 111.

115 Acton (2001), (above, note 109) at pp 134-137; Conway (above, note 43) at pp 17-18; Poole Jill and Roberts Pauline "Shareholder Remedies-Efficient Litigation and the Unfair Prejudice Remedy", (1999), *The Journal of Business Law*, London, Stevens, at p 57; Boyle A. J., "Unfair Prejudice in the House of Lords", *Company lawyer*, (2000), 21(8), London, Oyez Publishing Limited, at p 253; Farrar (1991), (above, note 42) at pp 455, 457.

116 *Ebrahimi v. Westbourne Galleries Ltd.* (1973), A.C. 360 at 379.

Wilberforce who was in charge of the case regarded such removal as an act which is legally effective, meanwhile deserving a winding up remedy on equitable grounds.¹¹⁷

Which approach reflects the positive law on this issue cannot be answered with precision, as the law currently is not sufficiently clear. Nonetheless, for a number of reasons, one can accept that the second approach constitutes a more acceptable interpretation of the law on this matter. For one, section 122 (1) g Insolvency Act 1986 does not speak of any fault requirement, while giving wide authority to the courts in order to grant remedy.¹¹⁸ For another, the remedy would have seemed redundant, if fault had been a requirement for it. A fault based winding up order can always be given to a minority plaintiff who petitions for a remedy under section 459 Companies Act 1985. Hence, there will be no rationale for section 122 which offers a just and equitable winding up remedy, unless we believe that it has a jurisdiction wider than that of the section 459 and as a result fault is not a requirement.¹¹⁹

V.1.2.2. Unfairly Prejudicial Remedy

Where the courts find that the affairs of the company is being conducted in a manner which is unfairly prejudicial to interests of its members generally¹²⁰ or some parts of its

117 Ibid.

118 It must yet be bore in mind that according to the section 125(2) Insolvency Act 1986, the winding up is the residual remedy. This means a fair offer to purchase the shares of the petitioner, made by the controllers will often disentitle the plaintiff from pursuing the winding up proceeding. Also the possibility of an unfair prejudice petition may produce the same result. See further in Pettet (above, note 40) at p 247.

119 Acton (2001), (above, note 109) at p 134-137.

120 Section 145 Companies Act 1989 has amended section 459 Companies Act 1985 in order to enable the new mechanism to cover situations in which all shareholders suffer loss. The wording of the section is as follows: 'to the members generally or part of the membership, including the petitioner'. See Meyer & Another v. Scottish Textile and Manufacturing Co Ltd & Another (1954), SC 381 at 392 per Lord Cooper; See also Griffin Stephen, "Negligent

members, a grant of the unfairly prejudicial remedy will matter.¹²¹ The background of the remedy goes back to the section 210 Companies Act 1948 that, in disregard of the rule established in *Foss v Harbottle*¹²², had allowed minority actions to be taken against the majority who conducts the affairs of the company oppressively against minority interests. As the wording of the section was narrow, it had failed to address the possibility of majority abuse effectively. The section had also required a minority shareholder to establish a course of oppressive conducts. This was to mean that omissions, future conducts or a single conduct were not recognised as oppressive. Furthermore, the oppression was required to be suffered in one's capacity qua shareholder rather than in any other capacities. Hence, exclusion from management could not constitute oppression, though it was one of the most common grounds for a complaint under the old section 210. It was a requirement for a conduct to be regarded as oppressive that it would have justified an order to wind up the company too.¹²³ Besides, the courts tended to interpret the word oppression in its narrowest meaning that could hardly cover conducts other than those of illegal and unconstitutional.¹²⁴

These deficiencies were identified by the Jenkins Committee that suggested the remedy should be amended in order to include a wider sense of abuse of rights by majority shareholders. In particular, it highlighted two instances of such abuse, exclusion from

Mismanagement as Unfairly Prejudicial Conduct", (1992), *The law Quarterly Review*, Vol. 108, 389, London, Stevens and Sons.

121 Section 459(1) Companies Act 1985.

122 *Re Saul D Harrison & Sons plc* (1995), 1 BCLC 14 per Hoffman J at p 18; See also Davies (above, note 60) at p 738.

123 See Clark (above, note 95) at pp 170-1; Clark (1999), (above, note 110) at pp 321-2; Conway (above, note 43) at p 13-15.

124 This tendency was reflected in the House of Lords decision in *Scottish Competitive Co-operative Wholesale Society Ltd v. Meyer* once defining oppressive conducts as something 'burdensome, harsh and wrong'. [(1958), 3 All E.R. 6, HL]

management and cases where minority shareholders suffer indirect loss that most importantly needed to be included.¹²⁵ Accordingly, the Parliament replaced section 210 with section 75 companies Act 1980 (now subject of sections 459-461 Companies Act 1985) that introduced the new unfairly prejudicial remedy. The wide wording of the new section, which enjoyed the terms 'interests' and 'unfairly prejudicial' in substitute of 'rights' and 'oppression', its generous relief plus the liberal attitude of the courts have largely remedied deficiencies associated with the old section 210 and removed obstacles to which minority complains were tied.¹²⁶

The new section, however, has raised uncertainty concern among scholars of company law, as it gave no definition of its underlying equity principles.¹²⁷ It could not offer a reasonable level of precision in order to allow the involved persons to predict consequences of their acts or omissions. Its vagueness could cause the judges to fall into disagreement with the likelihood of litigants and their solicitors become mislead. It could even enable oppression of the majority by an opportunist minority.¹²⁸ One could further point to the lengthy proceedings, more complicated case law, inefficiency of the statutory remedies, waste of public time and money and increased uncertainty in commercial decisions that could ensue from the new section.¹²⁹

125 Jenkins Committee, Report of the Company Law Committee, Cmnd. 1749, (1962), at 206; See also Clark (above, note 95) at pp 170-1; Clark (1999), (above, note 110) at pp 321-2; Conway (above, note 43) at pp 13-15; Davies (1997), (above, note 60) at p 737.

126 Sealy (above, note 31) at 175.

127 Clark (above, note 95) at p 170; Clark (1999), (above, note 110) at p 322.

128 Farrar John H., "Company Law", (1985), London, Butterworths, at p 474; See also Clark (1999), (above, note 110) at 322.

129 Sealy L. S., "Company Law and Commercial Reality", (1984), London, Sweet & Maxwell, at pp 15, 30; Clark (1999), (above, note 110) at p 322.

Yet, it is generally accepted that the Parliament has intentionally drafted the section in such an uncertain format.¹³⁰ The idea, it is said, is to confer on the courts unlimited jurisdiction to hear unfair prejudice claims because this is the only way with which they can deliver maximum justice in each case.¹³¹ The uncertainty associated with the section frees the courts from technical considerations of legal rights and confers on them wide power to do what appears to be just and equitable.¹³²

The Law Commission, too, recommended, in its consultation paper, that the term unfairly prejudicial should not be defined in section 459 and it is preferable to keep the very general wording of the section as it now stands in order to cover the conducts which may fall short of actual illegality hereby to avoid the risk of further limitation to the section.¹³³ In its view, uncertainty could be controlled through using several techniques including: 1) to empower the courts to exercise effective case management; 2) to amend the section to cover specific conduct rather than the overall conduct of the affairs of the company and; 3) to impose time limit for bringing claims under this section. Nonetheless, the proposed techniques have limited capacity to address the uncertainty concern, as they only serve as a pain relief rather than cure. The Law Commission's recommendation also seems inconsistent with its already publicised

130 Goddard Robert, "Closing the Categories of Unfair Prejudice", *Company Lawyer*, (1999), 20(10), 333 London, Oyez Publishing Limited, at p 334; Clark (above, note 95) at p 171; Davies (1997) (above, note 60) at p 735.

131 Vinelot J., "Minority shareholders", (1985), *Company Lawyer*, Vol. 6, London, Oyez Publishing Limited, at p 31; Prudential Assurance Co Ltd v. Newman Industries, (1981), Ch, p 257; for an analysis of the approach see Boyle A. J., "The Judicial Interpretation of Part xvii of the Companies Act 1985" in '*Company Law in Change*' (1987), Edited by Pettet B.G., London, Stevens, at pp 23,24; Boyle (2000), (above, note 115) at p 253; Mayson Stephan, French Derek and Ryan Christopher, "Mayson, French & Ryan on Company Law", (2003), 19th ed., Oxford, Oxford University Press, at pp 619-620.

132 Re Saul D Harrison & Sons plc (1995), 1 BCLC 14 at 17-20 and O'Neill and Another v. Phillips and Others, (1999), 2 All ER HL 961 at 966 both per Hoffman J.

133 Law Commission (above, note 68) at pp 41-44.

objectives that seek for codification of the present law through introduction of clear set of rules concerning derivative actions and unfair prejudice remedy with more flexible and accessible criteria.¹³⁴

Unlike the law commission, the company law steering group proposed in the interests of greater certainty for making a connection between the unfair prejudice concept and cases that involve either a breach of constitution or a breach of directors' duties.¹³⁵ The government, which seems to have taken side with the Law Commission, did not show any intention to amend the current section 459, as its proposed Companies Bill does not include a reform of the section.¹³⁶

V.1.2.2.1. Under what circumstances a s 459 remedy can be given

The common law offers some guidance to shed light on circumstances under which a section 459 remedy can be given. Lord Wilberforce¹³⁷, who by analogy extended equitable principles relevant to partnerships to companies, gave the first guidance which is the element of personal relationship.¹³⁸ According to him, equitable principles can be used only where the relationship between members relies on personal commitments and mutual trust. This was to mean that a member, when his legitimate expectations are put at risk, might be allowed to flee from his contractual duties. A criticism was that the term 'legitimate expectations', as stated by Lord Wilberforce

134 Ibid., at pp 72, 42.

135 The Company Law Steering Group, "Modern Company Law, "Final report, (2001), Vol. I, p 33.

136 The Companies Bill (108-20 Jul 2006) available from the DTI website at the following address: <http://www.publications.parliament.uk/pa/pabills/200506/companies.htm>.

137 *Ebrahimi v. Westbourne Galleries Ltd.* (1973), A.C. 360

138 Hirt (2003), (above, note 66) at p 101; Clark (1999), (above, note 110) at 322; Poole and Roberts (above, note 115) at pp 41-43.

could excessively enable escape of parties from contractual duties. *Re RA Noble & Sons (Clothing) Ltd*¹³⁹, *Re Saul D Harrison & Sons plc*¹⁴⁰ and particularly *O'Neill and another v. Phillips and others*¹⁴¹ offered further guidance, trying to avoid the criticism. According to these authorities, legitimate expectations, which allow escape from contractual duties, should not be viewed as something which sits 'under a palm tree'.¹⁴² They must be taken into account in combination with certain equitable principles that increase certainty in law.¹⁴³ These principles suggest that the use of the measure of legitimate expectations must be exceptional and limited to cases in which some form of mutual understanding and informal agreement in excess of the written contract is present.¹⁴⁴ These have led the case law to view the remedy under section 459 as having a contractual nature. The view has been supported by the House of Lords¹⁴⁵, the Company Law Steering Group¹⁴⁶ and the government.¹⁴⁷

Several implications can derive from the view. The first implication is that the unfairly prejudicial remedy is suitable almost only for small companies where members' relationship continues a pre-existed quasi partnership. Although the remedy can in theory be used in companies of any size and for unfairness of any kind, it is normally relevant in cases where there is a breakdown in relationships between

139 (1983) B.C.L.C. 273.

140 (1995) 1 B.C.L.C. 14.

141 (1999), 2 All ER 961, HL.

142 *Re J E Cade & Sons Ltd.* (1992) B.C.L.C. 213 at 227 per Warner J.

143 *O'Neill and Another v. Phillips and Others* (1999), 2 All ER 961, HL at pp 967-8 per Hoffman J. See also Goddard (above, note 133) at pp 334-5.

144 *Re R A Noble & Sons (Clothing) Ltd*, (1983) B.C.L.C. 273 at 287 per Nourse J.; *Re Saul D Harrison & Sons plc*, (1995) 1 B.C.L.C. 14 at pp 17, 18 per Hoffmann L. J.

145 *O'Neill and Another v. Phillips and Others* (1999), 2 All ER 961, HL per Lord Hoffman.

146 *Modern Company Law for a Competitive Economy: Final Report*, (London, DTI, 2001), URN/942 & URN/943, para 7. 41.

owner/managers of small private companies.¹⁴⁸ As to large companies, the remedy seems irrelevant because the relationship between members of such companies commonly rely on company constitutions and the documentation shown to them by controllers at the outset.¹⁴⁹

The second implication is that the view avoids being interventionist. Relying on such view, the courts, when granting a section 459 remedy, would only enforce the contract between members.¹⁵⁰ As the remedy has a contractual nature, it can be waived by private contracting so long as no wider public purpose is at stake.¹⁵¹ A carefully drafted articles can make the use of section 459 remedy unnecessary¹⁵² and where a reasonable offer is made to buy out a dissatisfied minority, he should not be able to ask for such a remedy.¹⁵³ This, however, can be criticised for its contrariety to the regulatory role of company law rules¹⁵⁴ and especially seems to fall in disagreement with the primary objective of the Parliament which wanted to offer some protection to minority

147 Modernising Company Law: White Paper, (London, DTI, 2002), Cm 5553, Volume 1, para 3.3.

148 Law Commission (above, note 68) at pp 24, 25; Law Commission, Consultation paper, No 142, Para 1.7.

149 Clark, (above, note 95) at p 172; Conway (above, note 43) at pp 19-20; Thomas Katherine Reece and Ryan Christopher L., "Section 459, Public Policy and Freedom of Contract: Part 1", *Company Lawyer*, (2001), 22 (6), 177, London, Oyez Publishing Limited, at pp 180-181; Poole & Roberts (above, note 115) at pp 41-43; Hirt (above, note 66) at pp 100, 102; Mayson, French & Ryan (above, note 131) at p 620.

150 Boyle (above, note 115) at p 253; Goddard Robert, "Unfair Prejudice after O'Neill: A View from Scotland", *Company Lawyer*, (2000), 21 (8), 254, London, Oyez Publishing Limited, at p 255; Thomas & Ryan (above, note 149) at pp 179-181; Hirt (above, note 66) at pp 101-2; Pettet (above, note 40) at p 250.

151 Thomas & Ryan (above, note 149) at pp 178-182.

152 Clark (above, note 95) at p 174; Thomas & Ryan, (above, note 149) at p 181.

153 'the unfairness does not lie in the exclusion alone but in exclusion without a reasonable offer' [O'Neill and another v. Phillips and Others [(1999), 2 All ER 961, HL at p 974-5 per Hoffman]] See also Thomas & Ryan Ibid. at pp 181-182.

154 Goddard (above, note 130) at p 335.

shareholders.¹⁵⁵ Also, company contracts rarely provide a satisfactory buy-out procedure¹⁵⁶ and this can further evidence that a non-negotiable section 459 is needed.

The third implication is that it would become possible for the courts, as a result of such viewing, to measure the unfair prejudice concept stated in section 459 objectively.¹⁵⁷

The section requires, a minority plaintiff to show that his prejudice has also been unfair.¹⁵⁸ This unfairness, according to the authorities, must be assessed objectively which means the courts should take the case of a reasonable bystander and ask whether the complained conduct is regarded by such person as unfairly prejudicial.¹⁵⁹

The reasonable bystander test must be used in the light of the context of the complained conduct rather than the mere conscience of a particular judge. Context for the purpose of section 459 may include the type of company, previous business relationship and transactions between corporate members, pre-contract negotiations and mutual trust.¹⁶⁰ The objective measure relieves a minority plaintiff from having to show the element of bad faith on the part of controllers. Prejudicial conducts of controllers even shown to have been done with good faith still might qualify for

155 Cheffins (above, note 3) at p 260-1; Riley Christopher, "Contracting Out of Company Law: Section 459 of the Companies Act 1985 and The Role of The Courts", (1992), *Modern Law Review*, 782, London, England, Stevens & Sons, at p 797.

156 Farrar (1991), (above, note 42) at p 475.

157 Hirt (above, note 66) at p 102; Boyle (1987), (above, note 131) at p 24; Thomas & Ryan (above, note 149) at p 181; Goddard (1999), (above, note 130) at pp 334-5; Pettet (above, note 40) at p 249; Griffin (above, note 120) at p 389.

158 Davies (1997), (above, note 60) at p 746.

159 See Boyle (1987), (above, note 131) at p 24; Leader Sheldon & Dine Janet, "United Kingdom", in *The Legal Basis of Corporate Governance in Publicly Held Corporations*, Edited by Arthur R. Pinto and Gustavo Visentini, Kluwer Law International, (1998), 219, The Hague, London, at p 229; Pettet (above, note 40) at pp 249-250.

160 Jenkins Committee (above, note 125) at 204; See also Hirt (above, note 66) at p 102; Clark (above, note 95) at p 171.

unfairness.¹⁶¹ Yet, while a minority plaintiff does not need to show bad faith¹⁶², he must prove fault on the part of the defendants.¹⁶³ If a case involves no fault in its broad sense (covering that of common law and that of equity), no remedy under the section 459 is available. This further suggests that the scope of the unfairly prejudicial remedy is much narrower than that of the winding up remedy discussed earlier.¹⁶⁴

The last implication is that the unfairly prejudicial remedy is viewed as exceptional rather than being a general principle of the law, as is viewed in the civil law jurisdictions. Accordingly, a minority shareholder has no recourse to exceptional ways so far as there are no ordinary ways of action.¹⁶⁵ Therefore, a section 459 remedy is not suitable to an oppressed majority who seeks to pursue wrongdoer directors because he often has the power to displace such directors from the office.¹⁶⁶ A corollary of such viewing is that a case must meet certain case-specific conditions to qualify for a s 459 remedy and therefore the courts' judgements in such cases have very limited capacity to extend. The courts tend to escape drawing a general principle¹⁶⁷ while their judgements often share the underlying equity principles. The same or similar principles of equity can also be used to address different examples of abuse of rights

161 Boyle (2000), (above, note 115) at p 253; Boyle (1987), (above, note 131) at p 24; Clark (above, note 95) at p 171; Conway (above, note 43) at pp 13-15.

162 For a different view see Hirt (above, note 66) at pp 106-7.

163 Boyle (2000), (above, note 115) at p 253; Clark, (above, note 95) at p 173; Conway (above, note 43) at pp 13-15; Clark (2001), (above, note 110) at pp 109-111; Thomas & Ryan (above, note 149) at p 181.

164 Acton (above, note 109) at p 134; Farrar (1991), (above, note 42) at pp 473-4; for a contrary view see Clark who suggests that both remedies of unfairly prejudicial and winding up ought to operate on a fault based mechanism. [Clark (above, note 95) at pp 173-4 and Clark (2001), (above, note 110) at p 111].

165 See the Outer House of the Court of Session's argument in Scottish case of Anderson v. Hogg, 2000, S.L.T., 634 at 644 per Lord Ordinary.

166 Clark (above, note 95) at p 171; Pettet (above, note 40) at p 253; Hirt (above, note 66) at p 107.

which fall within the scope of other remedies. Thus, the formula is: the same principles in different circumstances can generate different remedies and this has caused development of different mechanisms to deal with the question of abuse of right in English company law.¹⁶⁸ In the courts' view, a general principle on the model of civil law jurisdictions is practically hard, if not impossible, to draw.¹⁶⁹ They may also argue that there is no need for drawing a general principle, as the existing method is only a different way of doing the same thing.¹⁷⁰ A criticism is that this way of addressing the abuse of rights possibility, though might enable the judges to tailor justice to each case, generally suffers from the uncertainty problem. The facts that the courts have extensive equitable discretion which might be exercised any time 'in a novel and unpredictable fashion'¹⁷¹ and that their judgements have limited capacity to teach other similar cases created a blurred picture of litigation in this area.

V.1.2.2.2. What sort of wrongs fall within the scope of s 459

Previous to the introduction of s 459, the law in this area had a limited scope covering perhaps only conducts which were illegal.¹⁷² Since the introduction of the s 459 and because of the wide wording of the section which enjoys the term 'interest' in substitute of 'right', the scope of the section has extended from conducts which violate members' legal rights to behaviours which were against their legitimate

167 *Estmanco (Kilner House) Ltd. v. Greater London Council* (1982), 1 All ER 437 (ChD) Megarry VC.

168 *Estmanco (Kilner House) Ltd. v. Greater London Council*, (1982), 1 All ER 437 (ChD); *North-west transportation Co Ltd. v. Beatty* (1877), 12 App Cas 589; *Allen v. Gold Reefs of West Africa, Limited*, (1900), 1 Ch. 656; *Greenhalgh v. Ardern Cinemas Ltd*, (1950), 2 All ER 1120; *Ebrahimi v. Westbourne Galleries Ltd* (1973), A.C. 360; *Clemens v. Clemens Bros Ltd. and Another* (1976), 2 All ER 268 (Ch D) at 282.

169 *Clemens v. Clemens Bros Ltd. and Another* (1976), 2 All ER 268 (Ch D) at 282 per Foster J.

170 *O'Neill and Another v. Phillips and Others*, (1999), 2 All ER 961, HL at 969 per Lord Hoffmann.

expectations.¹⁷³ This can follow that a minority shareholder is now able to pursue the company and its directors not only for breach of constitution which extends to irregular matters¹⁷⁴ but also for breach of expectations which equity regards legitimate, even though that involves no breach of constitution.¹⁷⁵ Also, a shareholder is now able to initiate a s 459 proceeding in respect of breach of directors' duties. Although, directors owe their duties to the company, a shareholder can expect them to act without unfairly prejudicing their interest.¹⁷⁶ The concept of prejudice in the wording of the section is inclusive of any harm defined in a broad sense to the petitioner's interest¹⁷⁷ and obviously a wrong to the company can affect interests of its members too.¹⁷⁸ A shareholder does not need to show that the value of his/her shares has been reduced as a consequence of the defendant's unfairly prejudicial conduct and further he/she can now use section 459 to take action against persons who exert *de facto* control in companies.¹⁷⁹ In summary, any unfair disregard of controllers from members' interests can constitute a source of liability under s 459. Some of the more familiar examples are: a refusal to pay dividend¹⁸⁰; abusive share issues; excessive managerial remuneration; and exclusion from management.¹⁸¹

171 Cheffins (1997) (above, note 3) at pp 260-1.

172 See above, at V.1.2.2.

173 Davies (1997), (above, note 60) at p 737.

174 Davies *Ibid*.

175 Clark (above, note 95) at p 172; Hirt (above, note 66) at p 101; Poole & Roberts (above, note 115) at p 42; Thomas & Ryan (above, note 149) at p 181.

176 Sterling (above, note 68) at pp 474, 484.

177 Hirt (above, note 66) at p 102.

178 Davies (1997), (above, note 60) at p 737; Hirt (above, note 66) at p 103.

179 *Re. R. A. Noble & Sons(Clothing) Ltd.*, (1983), BCLC 273 at p 287 per Nourse J.; For a contrary opinion see *Leader & Dine* (above, note 159) at p 229.

180 See Sealy (above, note 31) at p 180.

181 *Conway* (above, note 43) at pp 13-14; Clark (above, note 95) at pp 170-171; Clark (1999), (above, note 110) at pp 321-2; *Pettet* (above, note 40) at pp 259-260.

Whether section 459 can cover mere mismanagement; i.e. wrongs that fall short of a breach of directors' duties¹⁸²; has been a matter of controversy. For some good reasons, the courts are reluctant to review managerial decisions, using their discretion to identify unfair prejudicial conducts.¹⁸³ They may think that they are not informed and experienced enough to decide questions of business. Also, they often see hard to find the element of unfairness in cases involving questions of mismanagement and often concede that business decisions is normally taken in uncertain conditions which make them often risky and thus directors must not be blamed for taking such decisions.¹⁸⁴ A recent example of such reluctance is the *Re Elgindata* case in which Warner J. held that 'Short of a breach by director of his duty of skill and care...there is prima facie no unfairness to a shareholder in the quality of the management turning out to be poor'.¹⁸⁵

In addition to matters of judicial reluctance, the use of section 459 to address the issue of mere mismanagement can fall in contradiction with certain principles of company law. Most commonly the primary victim of mismanagement is the company, itself, rather than its shareholders. Shareholders assume loss only reflectively. Recent decided cases suggest that when the loss is reflective,¹⁸⁶ a shareholder cannot recover it unless the company, itself, is unable to pursue and the wrongdoers owe a separate duty in

182 See Chapter four (above, at IV.1.1.C).

183 Davies (1997), (above, note 60) at p 746; Clark (above, note 95) at p 171; Conway (above, note 43) at p 16.

184 See Chapter four (above, at IV.1.1.C).

185 *Re Elgindata Ltd.* (1991), BCLC 959 at 994.

186 For reflective loss see generally Sterling (above, note 68); Mitchell (above, note 9); Bowen Andrew, J., "Professional Negligence and the No Reflective Loss Principle", (2002), *Greens Business Law Bulletin*, 59, 2, Edinburgh, W. Green & Son Ltd.; Bowen, Andrew J., "Giles v. Rhind", (2003), *Greens Business Law Bulletin*, 65, 1, Edinburgh, W. Green & Son Ltd.; Watts, Peter, "The Shareholder as Co-Promisee", (2001), *The Law Quarterly Review*, Vol. 117, 388, London, Stevens and Sons; Ferran, Eilis, "Litigation by Shareholders and Reflective Loss", (2001), *The Cambridge Law Journal*, 245 Cambridge, Cambridge University Press; Sagar, David,

his/her favour.¹⁸⁷ Exclusion of the shareholder action in such cases is the logical consequence of the proper plaintiff limb of the rule in *Foss v. Harbottle*.¹⁸⁸ It respects the corporate personality¹⁸⁹ and avoids unnecessary shareholder actions.¹⁹⁰ Considering these principles, the Law Commission also opined that section 459 would not probably be suitable for pursuing negligent directors.¹⁹¹

Some commentators have taken the view that the judicial reluctance is concerned with mere negligence rather than mismanagement that involves gross negligence. Gross negligence is to be distinguished from both mere and serious mismanagement and although falling short of breach, it ought to be treated like breach of duty or even fraud. With the gross negligence measure it is possible for the courts to extract some more disastrous negligence of directors out of the mere mismanagement category hereby to hold negligent directors liable.¹⁹²

Despite its attractiveness, the very idea of gross negligence lacks a clear definition and is unable to offer a criterion by which one may distinguish gross negligence from the two other types of negligence; i. e. that of mere and that of breach of duty. English

“Reflective Loss”, (Feb-2003), *Accountancy*, London, Society of Incorporated Accountants and Auditors.

187 *Prudential Assurance Co Ltd v. Newman Industries LTD. and others (No. 2)* (1981), Ch 257; *Gardner v. Parker*, (2004), 1 BCLC (Ch D) 417; *Giles v. Rhind*, (2002), 4 All ER (CA), 977; *Johnson v. Gore Wood & Co*, (2001), 1 All ER (HL), 481; *Day v. Cook*, (2002), 1 BCLC (CA), 1; *Stein v. Blake and Others (No 2)*, (1998), 1 BCLC (CA), 573; *George Fischer (Great Britain) Ltd. v. Multi Construction Ltd, Dexion Ltd (third party)*, (1995), 1 BCLC (CA), 260; *Gerber Garment Technology Inc v. Lectra Systems Ltd.* [(1997), RPC 443; *Lee v. Sheard* (1955), 3 All ER 777; *Giles v. Rhind*, (2002) 4 All ER (CA) 977; *Christensen v. Scott*, (1996), 1 N.Z.L.R., 273 at 280 (NZCA); See also *Bowen* (2002) (above, note 186); *Sterling* (above, note 68) at p 474.

188 *Foss v. Harbottle*, (1843) 2 Hare 46.

189 *Hale* (above, note 39) at p 219.

190 *Gray v. Lewis*, (1873), 8 Ch App, 1035, p 1051 per James L. J; See also *Sagar* (above, note 186) at p 88; *Sterling* (above, note 68) at p 485.

191 Law Commission (above, note 68) at pp 84-85.

judges have always had 'a healthy disrespect' for differentiating between mere negligence and gross negligence.¹⁹³ They tend to make the difference between fraud, on the one hand, and mere negligence, however gross, on the other hand. The doctrine of the common law is that 'gross negligence may be evidence of mala fides, but is not the same thing'¹⁹⁴ and has often cautiously been employed in a few areas of law such as trust, particularly when it involves exemption clause,¹⁹⁵ and criminal law when negligence causes the death of a victim in manslaughter cases.¹⁹⁶ The gross negligence measure can be pertinent as to jurisdictions such as US where the courts tend to make a distinction between process and substance and hold directors liable for negligence made only in relation to the latter. English company law does not know such distinction¹⁹⁷ and consequently, in spite of the breadth of the section 459, it can be concluded that the current position of the English company law is to exclude mismanagement, however serious, from the scope of section 459 unless it entails a breach of duty.

192 Griffin (above, note 120) at pp 390-392.

193 Armitage v. Nurse and Others, (1998) Ch 241, (1997) 2 All ER 705; See also Willes J in Grill v. General Iron Screw Collier Co (1866) (LR) 1 C P 600 observing that gross negligence is ordinary negligence with a vituperative epithet; And further in Hinton v. Dibbin (1842) 2 QB 646, 114 ER 253 Lord Denman C.J. doubted whether any intelligible distinction exists.

194 See Goodman v. Harvey (1836) 4 A & E 870 at 876, 111 ER 1011 at 1013 per Lord Denman; Armitage v. Nurse and others, (1998) Ch 241, (1997) 2 All ER 705 per Millett LJ.

195 See generally Gerard, McCormack, 'The Liability of Trustees for Gross Negligence', *Conveyancer and Property Lawyer*, (1998) Mar/Apr, 100-114, London, Sweet & Maxwell; "Trustee Exemption Clauses", *New Law Journal*, 11 April 2003, 153.7075, London, Butterworth; and see particularly Armitage v. Nurse and others, (1998) Ch 241, (1997) 2 All ER 705.

196 See generally Brian, Napier, "Disciplinary Procedure, Unfair Dismissal and the Contract of Employment", *New Law Journal*, 25 (March 1988) Vol. 138 No. 6349 p 197, London, Butterworth; Rakhi, Talwar and Andrew, Dawson, "Corporate Killing", *New Law Journal*, (13 June 2003), 153.7084(908), London, Butterworth; "The Zeebrugge Disaster: Crime or Negligence?", *New Law Journal*, 16 October 1987 Vol 137 No. 6327, 959, London, Butterworth; "Manslaughter: Corporate Liability for Manslaughter-Gross Negligence", *Criminal Law Review*, (2000), June, 475-479, London, Sweet & Maxwell.

197 See Chapter four (above, at IV.1.1.C.2).

V.1.2.2.3. Nature of the unfairly prejudicial remedy

The remedy under s 459 is generally seen to be fulfilling part of a shared task between the Parliament and the courts to review the exercise of rights by persons either natural or legal so far as that exercise may involve unfair consequences for individuals and the society.¹⁹⁸ It is a special statutory invention of the common law system functioning along with other devices such as 'derivative action'¹⁹⁹, 'bona fide for the benefit of the company as a whole'²⁰⁰ and 'just and equitable winding up'²⁰¹ to fill a decisive gap in laws relating to companies so far as they fail to prevent legal rights being instrumentally abused. In creating the remedy, the Parliament made use of equity principles in order to extend rules of liability to conducts which fall short of the concept of actual illegality but involving some sort of abuse of rights by the majority.²⁰² Equity principles enable the courts to intervene, in a discretionary case-by-case basis, into the contractual relationship of shareholders²⁰³ so as to stop abusive exercise of rights by the majority in companies.²⁰⁴ This type of intervention constitutes what is generally known and represented in usage by using the phrase 'supervisory role' of the courts. It is a discretionary power acquired by the courts under the law to review companies' activities.²⁰⁵

198 Davies Paul L., "Gower and Davies' Principles of Modern Company Law", (2003), 7th ed., London, Sweet & Maxwell, at p 517.

199 Wedderburn (1957), (above, note 39) at p 206.

200 *Allen v. Gold Reefs of West Africa, Limited* (1900), 1 Ch. 656 per Lindley M.R. at p 671.

201 Insolvency Act 1986, Sec. 122 (1).

202 Pettet (above, note 40) at p 246.

203 Goode Roy, "Commercial Law in the Next Millennium", (1998), London, Sweet & Maxwell at pp 16, 31- 32; Bradgate Robert, "Commercial Law", (2000), 3rd ed., London, Butterworths, at pp 3-4 and 26-34.

204 Sealy (above, note 31) at 181.

205 *Baird v. Lees*, (1924), S.C. 83, 92 per Lord Clyde; See also Sealy Len Ibid; Sinclair Michael, "Companies and Judicial Review", (1994), *Company Lawyer*, 15 (8), 235, London, Oyez Publishing Limited, at p 239.

The courts' discretion under section 459 must be distinguished from their other discretions. Generally speaking, there are two other discretions. One is the courts' discretion to sanction private contracts. In the exercise of this discretion, the courts emphasise on legal rights and duties hereby sanctioning a relationship that is already recognised under the law. A court's decision here is only important for the involved parties, but is not important, at all, in case law terms, as no legal rule is created. This function is common to most legal systems which work on the basis of rights and duties in order to regulate the relationship between private persons. The exercise of this discretion is in fact an example of the law's respect to the party autonomy.²⁰⁶ The other is the courts' discretion to create law in particular cases through delivering judgements which are not only important for the parties to a particular case but are also important for future similar cases. This discretion constitutes a unique feature of the common law courts, as they, unlike their counterparts in civil law jurisdictions, create law in order to fill statutory gaps. The discretion is linked with the case law in terms of binding precedent - the idea that, for example, all other courts in the hierarchy must follow the view of the House of Lords on a particular issue. Binding precedents commonly emerge from those areas of law that are created by the judges. They may also be created when a court gives an authoritative opinion as to the proper interpretation of a statutory provision.²⁰⁷

Now, while the analysis of the writer is to describe discretion of the courts under section 459 as an example of the supervisory discretion, recent case law suggests

206 Goode (above, note 203) at p 31; Bradgate (above, note 203) at pp 4, 6, 35-36.

207 For example, see the decision of the House of Lords in *O'Neill and Another v. Phillips and Others*, (1999), 2 All ER 961, HL.

differently.²⁰⁸ According to it, because legitimate expectations do not constitute independent excuse the courts in cases of unfairly prejudicial conducts function not to interfere but to enforce the contract between members and company.²⁰⁹ A criticism is that the courts' functioning in such cases can require imposition of standards of fairness to substantive elements of corporate members' contract.²¹⁰

V.1.2.2.4. Section 459 and the reflective loss recovery

Although a grant of corporate remedy is a possibility in the list of remedies prescribed by section 461 Companies Act 1985, the unfairly prejudicial remedy is generally seen as personal. Records of the reported cases proceeded under section 459 evidence that the most sought and ordered remedy under this section has been buy out order, which benefits the petitioner personally.²¹¹ The wide meaning of the word 'interest' expressed in the section allows a petitioner to apply to the court for a personal remedy in relation to any unfair prejudice to his interests either direct or indirect. These features connect unfairly prejudicial remedy to the issue of reflective loss. While principally a shareholder cannot recover his reflective loss²¹², section 459 seems to be capable of giving way to a likely petitioner in order to recover such loss. Reflective loss allegations can now get the form of petitions under section 459 for an exit order. While recent decided cases suggest that when reflective loss is at issue, a shareholder cannot

208 See above, notes 150-3.

209 Boyle (2000), (above, note 115) at 253; Goddard (2000), (above, note 150) at p 255; Thomas & Ryan (above, note 149) at pp 179-181; Hirt (above, note 66) at pp 101-2; Pettet (above, note 40) at p 250.

210 See generally Goode (above, note 203) at pp 16-18; Bradgate (above, note 203) at p 226.

211 Pettet (above, note 40) at pp 252-3; Hirt (above, note 66) at pp 101-2; Stephen Copp, "Company Law: Individual Shareholder Rights", (2000), *International Company and Commercial Law Review*, 11(1), N 6-8 London, UK, Sweet & Maxwell, at p 8.

212 *Prudential Assurance Co Ltd v. Newman Industries LTD. and others* (No. 2) (1981), Ch 257.

recover his personal loss²¹³ a grant of the personal remedy under section 459 can fall in disagreement with the 'no reflective loss' principle. An interesting question is whether a shareholder can take a personal action using section 459, while a corporate action by the company and in failure of the company a derivative action is available? The question becomes particularly important in relation to buy out orders where shares are priced at a date prior to the wrongdoing.²¹⁴ Several issues are to be addressed before we could answer the above question. The following discussion respectively examines these issues.

V.1.2.2.4.1. Background

The 'no reflective loss' principle can be traced back in the judgement of the Court of Appeal in the *Prudential* case.²¹⁵ In this case, two directors of the Newman company, Mr B and L, by breaching their fiduciary duty to the company conspired to buy for the company a land at an overvalue from another company called TPG in which they have had substantial personal interest. When it became aware of directors' tricks, a minority shareholder, the Prudential Company, took two actions, (derivative for the recovery of loss suffered by the company and personal for the recovery of its personal loss). The personal action was successful at first instance²¹⁶ but in appeal judges dismissed it taking the view that the claimed loss in situations like this is reflective of the loss suffered by the company. It is not personal and consequently cannot be recovered by a

213 Gardner v. Parker, (2004), 1 BCLC (Ch D) 417; Giles v. Rhind, (2002), 4 All ER (CA), 977; Johnson v. Gore Wood & Co, (2001), 1 All ER (HL), 481; Day v. Cook, (2002), 1 BCLC (CA), 1; Stein v. Blake and Others (No 2), (1998), 1 BCLC (CA), 573; George Fischer (Great Britain) Ltd. v. Multi Construction Ltd, Dexion Ltd (third party), (1995), 1 BCLC (CA), 260.

214 Hirt (above, note 66) at p 109.

215 Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2), (1982) Ch. 204; (1982) 1 All E.R. 354 (C.A.).

216 Ibid., at pp 302-3.

shareholder.²¹⁷ The *Prudential* principle, the principle that no shareholder in his personal capacity can recover reflective loss, was later amended by the judgement of the House of Lords in *Johnson*.²¹⁸

V.1.2.2.4.2. Nature of reflective loss

Whether reflective loss can be considered personal has been until recently controversial. Traditionally, English judges have tended to view it as corporate rather than personal. This was mainly because in such cases the direct victim of the loss is normally the wronged company rather than its shareholders. Shareholders only suffer indirectly and their loss 'would be made good if the company had enforced its full rights against the party responsible'.²¹⁹ In *Prudential* case, a diminution in the market value of the company's shares and a cut off of the likely dividends which occurred as a result of a reduction in the wronged company's assets and profits were sought by the plaintiff. However, the judges of the Court of Appeal viewed the claimed loss as reflective rather than personal and as a result they rejected the claim.²²⁰ In their view, because corporations are separate legal persons and corporate shares only grant participatory right to shareholders, in cases where reflective loss is at issue only the former can take action.

Similar views have also been taken by some company law scholars. For instance, in Leader and Dine's view, a share is only an instrument by which a shareholder

217 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2)*, (1982) Ch. 204 at 223.

218 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481.

219 *Ibid.*, at 504 per Lord Bingham.

220 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2)*, (1982) Ch. 204 at pp 223-4.

participates in determining what forms general interests of the company. A share has a contractual nature but does not confer proprietary rights.²²¹ Proponents of the economic analysis of the law even go one step further by arguing that shares confer neither proprietary nor participatory rights, though having contractual nature. Hence, a shareholder cannot take action in respect of any reduction of the value of his shares because his role is only to put money at risk in companies to be used by them in exchange for financial return and that explains why a share (ordinary share) is named equity distinguished from other securities.²²²

These views, however, sit uneasily with a range of decided cases in English company law which suggest a share is a thing which can be owned.²²³ According to these cases, a share is a piece of property giving the holder almost all proprietary rights that an owner may enjoy.²²⁴ Of those rights, one is the right of every owner to take action to the courts in order to recover damages to his property caused by a wrongdoer.²²⁵ English academics, also, have tended to regard shares as having contractual nature and conferring property rights which enable shareholders to take action in respect of them.²²⁶ From a property law perspective, shares are 'things in action' which refers to rights of one person to certain benefits and privileges that may be enforced through actioning in the courts when they are denied. Shares, particularly, and other forms of

221 See Leader & Dine (above, note 159) at p 230.

222 See Farrar (1991), (above, note 42) at pp 224, 318; Easterbrook and Fischel, (above, note 1) at p 403.

223 *Burland v. Earle*, (1902), A.C. 83; *North West Transportation Co. Ltd. v. Beatty*, (1887), 12 App CAS 589; *Pender v. Lushington*, (1877), 6 Ch. D. 70.

224 Davies (2003), (above, note 198) at p 618.

225 Sterling (above, note 68) at p 470.

226 Birds John Et. Al. (eds.), "Boyle & Birds' Company Law", (1995), 3rd ed., Jordans, Bristol, at pp 209, 214, 368; Farrar (1991), (above, note 42) at p 226; Lee Hazen Thomas, "Silencing the

investment securities in general are, therefore, personal property capable of being owned by persons and when owned they will confer proprietary rights.²²⁷ This will not cause any overlap between a shareholder's property in the company and the company's own property because the shareholder will not be considered as a joint owner of the company's property.²²⁸ He/she only owns share represented by share certificates²²⁹ in the company's property²³⁰ which is itself separate in the legal sense.²³¹ That means while a share confers on its holder personal right of recovery, it represents a physically unidentifiable unit of the company's capital, which belongs to the company.²³² In *Prudential* case, only this latter side was given attention, whereas later cases have shown that the other side must also be considered.²³³ In addition to these, shares are bought and sold in the market, meaning that they enjoy and represent financial value for which interested people are ready to pay money. This financial value derives not merely from the participatory aspect but rather from the proprietary

Shareholders' Voice", *North Carolina Law Review*, (2002), Vol. 80, Chapel Hill, North Carolina Law Review Association, at pp 1900, 1910.

227 See generally MacNeil Iain, "An Introduction to the Law on Financial Investment", (2005), Oxford, Hart Publishing Ltd. at Ch. 1 p 7; Mayson, French & Ryan, (2003), (above, note 131) at p 183.

228 For the same reasoning see *Macaura v. Northern Assurance Co. Ltd.* in which the House of Lords took the view that a shareholder did not have an insurable interest in the company's property. [(1925) AC 619 HL].

229 Section 186 Companies Act 1985.

230 See section 744 Companies Act 1985: "share means share in the share capital of a company".

231 Section 182 Companies Act 1985:

"(1) The shares or other interest of any member in a company--
(a) are personal estate or, in Scotland, moveable property and are not in the nature of real estate or heritage...".

232 'although a share is an identifiable piece of property, which belongs to the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets...' [Johnson v. Gore Wood & Co. (2001), 1 All ER (HL), 481 at 528 per Lord Millett].

233 Johnson v. Gore Wood & Co. (2001), 1 All ER (HL), 481; Gerber Garment Technology Inc v. Lectra Systems Ltd., (1997), RPC 443; George Fischer (Great Britain) Ltd v. Multi Construction Ltd, Dexion Ltd (third party), (1995), 1 BCLC 260; Christensen v. Scott (1996), 1 N.Z.L.R., 273 at 280 (NZCA). See also Bowen (2002), (above, note 186).

aspect of shares.²³⁴ If it was so, non-voting shares should not have had marketable value because they do not confer right of participation. As Farwell J. observed in *Borland's Trustees v. Steel Bros. Ltd*, 'a share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all shareholders inter se'.²³⁵

V.1.2.2.4.3. What justifies the 'no reflective loss' principle?

Although, in principle, an individual shareholder ought to be able to recover reflective loss, he might be debarred from taking action to the courts if the case involves some important considerations of policy that are ranked prior to protection of property rights. As the case law reveals, there are certain policies which should be considered before the courts could allow a claim of reflective loss to proceed. These policies will be examined below.

1) Where a reflective loss case involves the risk of double recovery by individual shareholders, it must be rejected.²³⁶ Suppose, for example, a company with three shareholders of equal shareholdings. Due to some wrongdoing, the company suffers £1500 loss and each of its shareholders initiate a separate personal action for the recovery of his share of £500 loss, which is reflected to him in the form of diminution in the value of the shares, and gets a judgement in his personal favour. Then the company itself pursue the wrongdoer for the recovery of £1500 loss caused by the defendant and

234 Sterling (above, note 68) at 470; Mitchell (above, note 9) at 459.

235 *Borland's Trustees v. Steel Bros. Ltd.*, (1901), 1 Ch 288.

the court holds the defendant responsible for the recovery of the demanded loss. While the entire damage to the company and its shareholders caused by the defendant is only one £1500, at the end of the two trials he may be held liable for that £1500 twice. The question of double recovery has root in English restitution law particularly in cases that involve actions by two co-promisees who seek to recover damages caused by a promisor in respect of the same property or activity.²³⁷ The traditional example is found in a bailment case where both the bailor and the bailee are given right to recover damages caused by a third party to the thing bailed.²³⁸ In such cases, there will be no risk of double recovery because the courts allow both actions to proceed but as soon as one first obtains full recovery they preclude the other.²³⁹ This solution was clearly rejected by the House of Lords in the *Johnson* case that chose to bar the personal claim in favour of the corporate one. Members of the House thought 'protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder.'²⁴⁰

The view of the House, however, does not simply seem, for a number of reasons, good enough to deprive a shareholder from the benefits of his cause of action. For one, it fails to work where the wronged company is not insolvent and possesses good

236 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2)*, (1982) Ch. 204 at 223; *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 528 per Lord Millett; see also Bowen (2003), (above, note 186) at p 2.

237 McMeel Gerald, "Complex Entitlements: The Albazero Principle and Restitution", (1999), *Restitution Law Review*, 21, London, Mansfield; Mitchell (above, note 9) at pp 463-4; Watts (above, note 186) at p 390.

238 Palmer Norman E, "Bailment", (1991), 2nd ed., London, Sweet & Maxwell, at pp 308-380; See also *Henderson v. Merrett Syndicates Ltd* (1995) 2 A.C. 145.

239 McMeel (above, note 237) at pp 24-28, 49; at 463-4; Mitchell (above, note 9) at pp 463-4; Watts (above, note 186) at pp 390-2.

240 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 528 per Lord Millett; see also *Ibid*, per Lord Bingham at p 503; Ferran (2001), (above, note 186) at p 246.

financial position to meet its creditors' likely claims.²⁴¹ For another, while interests of creditors can bar personal claim of an individual shareholder, it is not very certain why the same consideration fails to prevent the very wronged company from failing to pursue the wrongdoer or from compromising the claim at an undervalue with him. Further, the double recovery argument ceases to be forceful where the company chooses not to enforce its right of action against the defendant, or settles its claim at undervalue, or cannot recover because the defendant has a good defence.²⁴² In such cases, permission of a personal action would not seem inconsistent with creditors' interests because it is the wronged company's inaction rather than the shareholder action that may harm such creditors.

2) According to the analysis of the House of Lords either the wronged company sues successfully to recover the loss with the effect that all its shareholders would be fully and equally compensated, or the company decides not to pursue and settles its claim. In either case, the company's decision will bind the individual shareholders because in the first contingency there remain no reflective loss to be recovered and in the second the loss to individual shareholders is caused by the company's decision.²⁴³ This is, however, misconceived. There seems no causal link between the company's decision and a shareholder's reflective loss. When the company refuses to pursue or settles at undervalue, this only means that the reflective loss to the shareholder is not going to be

241 Watts (above, note 186) at pp 391-2.

242 Mitchell (above, note 9) at 464; See also Thomas J. in Christensen v. Scott arguing that the problem of double recovery does not arise where the company had settled its claim [(1996), 1 N.Z.L.R., 273 at 280 (NZCA)] Also see Day v. Cook (2002), 1 B.C.L.C. 1 Para 38 per Arden L. J.

243 Johnson v. Gore Wood & Co. (2001), 1 All ER (HL), 481 at p 532 per Lord Millett.

compensated through the company's action. It does not mean that the company has caused loss to the shareholder.²⁴⁴

3) To allow shareholder action is to mean to outflank the company's autonomy which can result in undermining the company's compromises.²⁴⁵ However, the argument fails to explain why a shareholder action which seeks to recover a loss that is not yet compensated through the company can form damage to the autonomy of the wronged company. Difficulties of establishing a successful negligence case against directors²⁴⁶ and of derivative actions plus time and costs of such proceedings²⁴⁷ suggest that permission of personal action in reflective loss cases can 'ensure that the party who has, in fact, suffered loss is not arbitrarily denied fair compensation'.²⁴⁸

4) Permission of a shareholder action can put corporate directors in a position where their interests conflict with their duties.²⁴⁹ Clearly, this can occur in small companies where shareholders and directors are one and the same, as were the case in *Johnson v. Gore Wood*. However, that will not always be the case because many companies now use non-shareholder directors.²⁵⁰ Moreover, directors' conflict of interests is principally

244 For a similar line of argument see Mitchell (above, note 9) at pp 468-9.

245 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 532 per Lord Millett; see also Ferran (2001), (above, note 186) at p 247.

246 For further study see Sterling (above, note 68) at pp 483, 486-7; Davies (1997), (above, note 60) at p 746; Clark (2001), (above, note 95) at p 171; Conway (above, note 43) at p 16; Sealy (above, note 129); Deakin Simon, Ferran Ellis and Nolan Richard, "Shareholders' Rights and Remedies: An Overview", (1997), *Company Financial and Insolvency Law Review*, 163, Oxford, Mansfield Press, at 163.

247 Sterling (above, note 68) at 485; Deakin, Ferran and Nolan (above, note 246) at p 163; Hale (above, note 39) at p 219.

248 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 503 per Lord Bingham.

249 *Ibid.* at p 532 per Lord Millett.

250 Watts (above, note 186) at p 392; See also Mitchell (above, note 9) at p 470.

curbed in law through the mechanism of fiduciary duty and, thus, there is no need to create extra devices; i.e. to exclude shareholder action.²⁵¹

The choice between shareholder and corporate action is a difficult one. It is possible to disallow the corporate claim in favour of shareholder action. This way opens the gate for an individual shareholder to recover reflective loss. It requires every shareholder to sue individually and in the end he will be given his share in the loss and nothing more. However, certain drawbacks associate with this method. To begin with, the prospect of too many individual shareholders who take personal actions to the courts can make the proposition impractical.²⁵² Furthermore, in large companies where shareholders often passively choose not to take actions this can encourage extensive escape of wrongdoers from liability. In addition, it can discourage investors who will find corporations unsafe and troublesome for financing. Alternatively, It is possible to disallow shareholder action in favour of the corporate one because otherwise shareholder action can give some extra benefit to the person who initiates the action at the expense of other shareholders in the wronged company.²⁵³ Moreover, corporate action is not only for the benefit of shareholders and creditors but also is for the benefit of other interested groups such as employees and consumers who might be prejudiced due to exclusion of the corporate recovery.²⁵⁴

251 Watts (above, note 186) at 392; Mitchell (above, note 9) at p 470.

252 Gray v. Lewis, (1873), 8 Ch App, 1035, p 1051 per James L. J; Sagar (above, note 186) at p 88; Sterling (above, note 68) at p 485.

253 Johnson v. Gore Wood & Co. (2001), 1 All ER (HL), 481 at p 528 per Lord Millett; see also Ferran (2001), (above, note 186) at p 246.

254 Sterling (above, note 68) at pp 488-9.

One way to make optimal use of positive points in both actions is to view them as supplement devices. This does not follow that they are retained and permitted to be used by corporations and their shareholders simultaneously. That, as Lord Millett suggested, might cause either the problem of double recovery or a shareholder might recover at the expense of the company's creditors and other shareholders. It is only to mean that where the rationale for a corporate action is absent shareholders' personal action ought to be allowed.

V.1.2.2.4.4. What sort of loss is considered reflective?

Reflective loss is normally taken to its quite clear examples of diminution in the market value of shares and the likely diminution in dividend.²⁵⁵ Whether it is limited to these two instances or it can extend to all other types of payments which a shareholder might have received from the company should the company was not deprived of its money due to the wrongdoing, is not determined.²⁵⁶ Clearly, reflective loss differs and must be distinguished from distinct loss which is considered recoverable.²⁵⁷ An example of the latter was provided in the *Prudential* case where the Court of Appeal considered as distinct expenses of attendance in a fraudulently called meeting.²⁵⁸ The distinct loss aside, it is not very clear whether the reflective loss can include some more the complicated examples of loss such as where a shareholder's deprivation of the

255 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2)*, (1982) Ch. 204 at 223.

256 Hirt Hans-Christoph, "Companies In General", (Jul-2003), *Journal of Business Law*, 420-429, London, Stevens, at pp 422-3, 428.

257 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 530-1 per Lord Millett, and at p 503 per Lord Bingham.

258 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and others (No. 2)*, (1982) Ch. 204 at 223.

opportunity to accept the higher offer in a take-over bid case²⁵⁹ and where a reduction in the saleability of the plaintiff's shares in the market²⁶⁰ were at stake. According to the Lord Millett for the same policy reasons 'the same applies to other payments which the company would have made if it had had the necessary funds even if the plaintiff would have received them qua employee and not qua shareholder and even if he would have had a legal claim to be paid'.²⁶¹ This view was later interpreted differently in the *Humberclyde Finance Group Ltd Hicks* case where²⁶² Neuberger J. observed that only where the plaintiff shareholder is the sole owner of the company, these types of loss can be considered reflective. His reading, however, can fall in contradiction with corporations' separate corporate personality and further fails to explain why should the amount of a shareholder's shareholding in the company play any role in determining what loss is and what loss is not reflective?²⁶³ As Lord Millett pointed out the test is to see whether the alleged loss primarily relates to the claims of a plaintiff over the company's assets or not, no matter the plaintiff is a shareholder or is an employee in the company and no matter if he owns the company or not. More recently, in the *Giles v. Rhind* case Waller L. J. opined that a shareholder/employee's capacity to recover his loss of salary would not be hurt simply because he is also a shareholder in the company.²⁶⁴ This view seems to have been inspired from the Lord Bingham's

259 *Heron International Ltd v. Lord Grade* (1983), BCLC 244.

260 *R.P. Howard Ltd and Others v. Woodman Matthews and Co* (1983) BCLC 117.

261 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at pp 532-3 per Lord Millett; See also Crisp Morris Ashurst, "Shareholders' Recovery", (2001), *Practical Law Companies*, 12 (9), 59-60, London, Sweet & Maxwell; "Shareholders Cannot Recover Loss That Company Is Not Pursuing", (2001), *Insolvency Intelligence*, 14 (8), 63, London, Sweet & Maxwell; Mitchell (above, note 9) at pp 473-5; Bowen (2002), (above, note 186) at p 3; Alistair Alcock, "Some Temporary Relief for Auditors", (2002), *Company Lawyer*, 23 (7), 217, London, Oyez Publishing Limited, at p 219.

262 (2001) All E.R. (D) 202 (Nov).

263 See Blackburn J's argument in *Gardner v. Parker*, (2004), 1 BCLC Ch D 417 at pp 437-438.

264 *Giles v. Rhind*, (2002) 4 All ER (CA), 977 per Waller LJ at p 991. See also Hirt (above, note 256) at p 428.

statement in the *Johnson* case in that loss of dividend and a diminution in the value of a shareholding are clear instances beyond them 'a finer judgement will be called for...(and) any reasonable doubt must be resolved in favour of the claimant'.²⁶⁵

5) When a shareholder may recover reflective loss?

As authorities suggest, two requirements must be met when a shareholder seeks to recover his reflective loss.²⁶⁶ One is that the plaintiff needs to have a separate duty in his favour made by the wrongdoer.²⁶⁷ Thus, where a company suffers loss due to a breach of duty on the part of defendant who owes no duty to any individual shareholder in that company, only the company can take action against the wrongdoer simply because the cause of action belongs to the company and shareholders hold no cause of action.²⁶⁸ Nonetheless, if conditions are met, a shareholder may only initiate a derivative action. The other is the plaintiff must show that the wronged company no longer has a cause of action. A shareholder action is only heard where the company suffers loss without having a cause of action. In such a case, the plaintiff cannot initiate a derivative action simply because the wronged company itself has no cause of action.²⁶⁹ One question which must be addressed is to determine circumstances within

265 *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 504 per Lord Bingham; See *Mitchell* (above, note 9) at pp 473-5; *Hirt* (above, note 256) at pp 427-8.

266 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and others (No. 2)*, (1982) Ch. 204 at 223; *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481 at p 528 per Lord Millett and at p 503 per Lord Bingham; *Giles v. Rhind*, (2002) 4 All ER (CA), 977 at p 988-990 per Waller LJ; *Stein v Blake and Others (No 2)*, (1998), 1 BCLC (CA) 573; *Gardner v. Parker*, (2004), 1 BCLC Ch D 417; See also *Hirt* (above, note 256) at pp 421-2; *Bowen* (2002), (above, note 186); *Crisp* (above, note 261); *Hale* (above, note 39) at p 219.

267 *Bowen* (2002), (above, note 186); *Sterling* (above, note 69) at p 474.

268 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and others (No. 2)*, (1982) Ch. 204; *Stein v. Blake and Others (No 2)*, (1998), 1 BCLC (CA) 573; *Gardner v. Parker*, (2004), 1 BCLC Ch D 417.

269 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. and Others (No. 2)*, (1982) Ch. 204 at 223; *Johnson v. Gore Wood & Co.* (2001), 1 All ER (HL), 481; *Giles v. Rhind*, (2002) 4 All ER (CA), 977; *Lee v. Sheard* (1955), 3 All ER 777; *George Fischer (Great Britain) Ltd v. Multi*

which a company may suffer loss without having a cause of action for it. Authorities suggest that such circumstances could be found where there is neither a contractual nor a tort-based cause of action between the company and the wrongdoer.²⁷⁰ These authorities, however, are silent where a case involves a company which has a cause of action but the cause is simply not good enough to allow a successful corporate action against the wrongdoer. For instance, where a case involves directors' mere negligence²⁷¹ or when the corporate cause of action becomes procedurally time barred²⁷², the wronged company cannot take action. Whether a shareholder action in such cases can be authorised is not clear.²⁷³ Recently, the *Giles* case took the view that term 'cause of action' should be taken to mean a good cause of action so as to enable a shareholder action.²⁷⁴ The rationale of the *Giles* case can perhaps be used to extend a shareholder's right of action to cases where the company simply decides not to pursue its cause of action, or where its action is rejected due to a good defence by the wrongdoer, and where it compromises its action at undervalue. The permission of a shareholder action in such cases is justified on the principle that there will be no wrong without a remedy²⁷⁵ and that the law should provide remedy to a person who suffers

Construction Ltd, Dexion Ltd (third party), (1995), 1 BCLC (CA) 260; Gerber Garment Technology Inc v. Lectra Systems Ltd. [(1997), RPC 443.

270 Johnson v. Gore Wood & Co. (2001), 1 All ER (HL), 481 at p 503 per Lord Bingham and at p 528 per Lord Millett; George Fischer (Great Britain) Ltd v. Multi Construction Ltd, Dexion Ltd (third party), (1995), 1 BCLC (CA) 260; Gerber Garment Technology Inc v. Lectra Systems Ltd. [(1997), RPC 443; Lee v. Sheard (1955), 3 All ER 777.

271 In Galoo Ltd. v. Bright Grahame Murray, for example, the alleged negligence of the accountants in auditing the accounts caused the company to carry on trading at accumulating losses, for which the auditors could not be held liable. [(1994), 1 W.L.R. 1360]; See Alistair (above, note 261) at p 219.

272 John v. Price Waterhouse, (2001), EWHC 438 (Ch).

273 Mitchell (above, note 9) at p 473.

274 Giles v. Rhind, (2002) 4 All ER (CA) 977 at No. (34) p 990 per Waller LJ; For analysis of the Giles case see Bowen (2003), (above, note 186) at p 2; Mitchell (above, note 9) at pp 468-473.

275 Mitchell (above note 9) at pp 468-479; Hirt (above, note 256) at pp 428-9; Crisp Morris Ashurst, "Reflective Loss", (2002), *Practical Law Companies*, 13 (11), 59, London, Sweet &

unfair loss.²⁷⁶ This interpretation can also be of very help to extinguish any likely conflict with section 459 petitions. According to this analysis, a shareholder cannot use section 459 to outflank the 'no reflective loss' principle if the company itself has a good cause of action. However, if the company has no cause of action, or in the light of the *Giles* case, if it is not going to exercise its cause for any reason excluding the observation of the company's best interest, a shareholder may initiate his own action, either in the form of a personal action for the recovery of his reflective loss or in the form of a petition under section 459, for a court order to oblige other shareholders or the company to buy his shares at a compensating rate.²⁷⁷

V.1.2.2.5. Section 459 and the derivative action

Whether or not section 459, since its introduction, has taken over the derivative action has been controversial in English company law. Technically seen, although they are possible to be sought interchangeably, they importantly differ. The former is mostly classified as personal. This means that a section 459 petitioner normally seeks to preserve his personal interests and the total benefit of his action, if any, goes directly to his pocket. But, the latter is corporate in the sense that the plaintiff seeks on behalf of the wronged company to make good any wrong done to the company and for the benefit of the company. If the classification was that simple, there might arise no or little confusion because one could assure that while derivative is only corporate, unfairly prejudicial remedy is absolutely personal. However, the issue is more

Maxwell; Crisp Morris Ashurst, "Reflective Loss", (2003), *Practical Law Companies*, 14, (7), 49, London, Sweet & Maxwell.

²⁷⁶ *Giles v. Rhind* (2002) 4 All ER 977 (CA) at 989 per Waller L. J.; See also Sagar (above, note 186) at p 87; Hirt (above, note 256) at p 427; Bowen (2003), (above, note 186) at p 3; Crisp (2002 and 2003), (above, note 275); Mitchell (above, note 9) at pp 468-479.

²⁷⁷ Section 461 (2d) Companies Act 1985.

complicated, as a section 459 action might also be considered corporate because of its contents²⁷⁸ and of the remedy sought.²⁷⁹ The complication can become worse where a case involves a breach of duty by directors, as the very same breach may constitute under the section 459 a wrong both to the company and to its shareholders. In such cases, a minority plaintiff can petition for either a personal or a corporate remedy, no matter what majority shareholders choose.²⁸⁰ This can cause some overlap between corporate and personal rights of actions and further can immeasurably harm the rule in *Foss v. Harbottale* case. An interesting question, which must be addressed, is whether a shareholder can petition using section 459 while a corporate action is available?

Generally speaking, there are two differing lines of arguments. One argues that although the same set of facts may constitute fraud and unfairly prejudicial conduct, it is not possible to choose between taking a derivative action and petitioning under section 459 interchangeably. There are distinguishable limits on the use of each action. Proponents of this argument, however, have diverged in proposing what constitutes the dividing element. In Hirt's view, when the alleged wrong constitutes fraud, a shareholder may only use the derivative form of action.²⁸¹ The touchstone argument for this view, which seems to be inspired by the views of the Jenkins Committee²⁸², is

278 As Millett J. observed the same set of facts may give rise to a complaint both of breach of duty owed to the company which is prosecuted by the company or by a minority shareholder derivatively, and of unfair prejudice, which is prosecuted by a petitioning shareholder. [Re Charnley v. Davies Ltd. (No. 2), 1990, B.C.L.C. 760].

279 Sec. 461 (2c) Companies Act 1985.

280 See Re Charnley v. Davies Ltd. (No. 2), 1990, B.C.L.C. 760 per Millett J.

281 Hirt (above, note 66) at pp 106-7.

282 The Jenkins Committee's proposition was that company law should provide relief for those corporate wrongs the relevant decision makers of which fail to pursue wrongdoers in circumstances where the very wrong does not constitute fraud. [Jenkins Committee's Report (above, note 125) at 206]; See also Hirt (above, note 66) at pp 104-5; For a different interpretation of the Jenkins Committee's proposition see Davies (above, note 60) at p 737.

the one suggesting that so far as a minority shareholder has ordinary ways of action in hand, no turn goes to exceptional ways.²⁸³ The essence of a complaint under section 459 is unfairness while in a derivative action the essence is unlawfulness. Claims of unfairness if not involving any unlawfulness have always been exceptional and only available where no legal ways remain.²⁸⁴ There is, however, some drawback with such view. First, the wide wording of the very section 459 implies that any unfair disregard from a member's interest may trigger a section 459 petition. Second, it would seem unreasonable, if we require a plaintiff to use a much easier way of action under section 459 for less serious cases while he is required to use the difficult way of derivative for fraudulent behaviours. Third, the proposition ties the prospect of petitions under section 459 to the difficult concept of fraud in the sense that a likely petitioner will be asked to show that his case does not involve fraud. Finally, and most importantly, this view seems to be inconsistent with a number of decided cases.²⁸⁵ In fact, the courts have tended to hear allegations of unfairly prejudice on the basis of conducts which were or could have been wrongs to the company and consequently eligible for a derivative action.²⁸⁶

283 Gardner v. Parker, (2004), 1 BCLC Ch D 417; Re Charnley v. Davies Ltd. (No. 2), 1990, B.C.L.C. 760; See also Crisp (2002 and 2003) (above note 275).

284 See the Outer House of the Court of Session's argument in Scottish case of Anderson v. Hogg, (2000), S.L.T., 634 at 644 per Lord Ordinary.

285 Anderson v. Hogg, (2002), S.L.T., 354 (Inner House); Lowe v. Fahey (1996), 1 B.C.L.C., 262; Re Charnley v. Davies Ltd. (No. 2), 1990, B.C.L.C. 760; Re A Company (No. 00370), 1988, 1 W.L.R 1068; Re London School of Electronics Ltd. (1986) Ch. 211; Re A Company (No 005278 of 1985), (1986) 1 W L R 281.

286 Davies (above, note 60) at pp 737-9; Pettet (above, note 40) at pp 261-2; Hirt (above note 66) at p 103; Gray Joanna, "A Derivative Action by Way of s. 459", (1997), *Company Lawyer*, 18 (4), 121-2, London, Oyez Publishing Limited; Reisberg (above, note 43); Hale (above, note 39) at pp 221-2.

Leader and Dine proposed another dividing element. In their view, the use of section 459 should be restricted to cases where there is a chain of unfair policies that target a particular shareholder.²⁸⁷ If controllers act to prejudice interests of a shareholder, but their acts does not contribute to form any policy, no action under the s 459 would be allowed. The proposition, however, seems to fall largely in contradiction with the very wording of the section where it expressly states that a single and a future act or omission might constitute ground for the unfairly prejudicial petitions.²⁸⁸ It also falls in contradiction with a number of decided cases which did not require the petitioners to show the course of unfair conducts.²⁸⁹

The judgement of Millett J. in the *Re Charnley v. Davies Ltd. (No. 2)* case²⁹⁰ offers another dividing element. According to it, although the very same facts may trigger either a derivative action or a section 459 petition, but they differ at nature and relevant remedies. The essence of a section 459 petition should be a disregard by controllers of the petitioner's interests when conducting company affairs rather than pursuing a breach of duty by directors.²⁹¹ It is personal in nature and must be accompanied by a personal remedy while derivative actions are considered corporate in nature and can only be granted a corporate remedy. Although this view has attracted considerable support²⁹², it 'sits rather oddly with the fact that one of the remedies which the

287 Leader & Dine (above, note 159) at p 229.

288 Sec. 459(1) Companies Act 1985.

289 See above note 285. Also see Clark (above, note 95) at p 171; Conway (above, note 43) at pp 13-15; Farrar (1991), (above, note 42) at p 470.

290 *Charnley v. Davies Ltd. (No. 2)*, 1990, B.C.L.C. 760.

291 *Ibid.* at 783-4.

292 For support of this view, see Hirt (above, note 66) at pp 104-5; Reisberg (above, note 40) at p 118; Hale (above, note 39) at p 222.

statute²⁹³ expressly empowers the courts to grant is to authorise civil proceedings to be brought in the name and on behalf of the company'.²⁹⁴

The other line of argument states that it is a matter of choice between two absolutely interchangeable procedures, as there is no identifiable limit on the use of section 459.²⁹⁵

A plaintiff shareholder has option to choose between taking a derivative action or a section 459 petition especially where he seeks a corporate remedy.²⁹⁶ The argument is consistent with the general wording of the very section 459 and is further beneficial to minority shareholders because it allows them to choose between alternatives the one which is more advantageous. Section 459 facilitates taking action by minority shareholders, as it no longer requires complainants to establish difficult elements of fraud and control²⁹⁷ and that explains why there have been relatively few derivative actions since the introduction of the unfairly prejudicial remedy.²⁹⁸

293 Section 461 Companies Act 1985.

294 Davies (above, note 60) at p 739.

295 Pettet (above, note 40) at pp 262-4; Davies (above, note 60) at pp 737-9; Gray (above, note 286) at pp 121-2; Hale (above, note 39) at pp 219, 221-2; Reisberg (above, note 40) at p 116.

296 *Lowe v. Fahey* (1996), 1 B.C.L.C., 262 (Ch D) at 268 per Aldous Q.C.; See also *Re Elgindata Ltd* in which Warner J. considered an alleged diversion of company's assets by those in control to their own benefit or that of their associates as an example of unfairly prejudicial conduct. [(1991), BCLC 959 at 1004.

297 Reisberg (above, note 40) at p 118.

298 See Poole and Roberts (1999), (above, note 81) at p 100; Reisberg (above, note 40) at p 117.

V.2. The case of Iran

This part concerns the rules and mechanisms which have been devised by the Iranian lawmaker either to prevent abuse of rights generally or in particular to protect minority shareholders against the possibility of abuse of rights by majority shareholders in corporations. These mechanisms, thus, fall into two categories. One includes the 'no abuse of rights' which is a general principle of law and the other comprises of four corporate law mechanisms which are meant to protect minority shareholders specifically.

V.2.1. The 'no abuse of right' principle

The 'no abuse of right' which is a general principle in the Iranian law requires persons to take care when exercising rights in certain circumstances. The principle which is stated in the Art 40 of the Constitution of the Islamic Republic of Iran (CIRI) provides that 'no one is entitled to exercise his rights in a way injurious to others or detrimental to public interests'. While the Art recognises abuse of rights as a general principle, it provides no definition of circumstances within which an exercise of right could constitute abuse. A proper understanding of the abuse of right would then require interpretation of the principle and any such interpretation will inevitably be dependant on understanding the issue in the light of both the Islamic law and the European law which were sources of learning for the Iranian lawmaker. On the one hand, codification of the Iranian law on the European model which occurred in the early

twentieth century²⁹⁹ and which required proclaiming rights in general terms could generate the same problem of abuse of right as existed in the European countries and hence the experience of the European countries could help the Iranian law to address abuse of right cases effectively. On the other hand, as the reliance on the European model as to drafting of the Civil Code was mainly in form rather than contents, Islamic law remained decisively relevant as to defining the concept of abuse of right.³⁰⁰ Hence, I shall briefly review these two sources in order to discover how they have played a part in the development of the 'no abuse of right' principle in the Iranian private law.

Islamic law knows no 'abuse of right' principle, though it offers a 'no harm' principle which has been relevant. Historically, development of the 'no harm' principle goes back to a very famous incident which occurred between two persons in the lifetime of the prophet Mohammad. The incident, which is known as the 'incident of the Somarat-ebn-Jandab 'or' Hadis-e-Somarat-ebn-Jandab, was quoted by a Zorareh named person who was one of the students of the Imam Mohammad-ebn-Bagher (the Prophet's grand child) who told the story after the Prophet's death.³⁰¹ The incident involved a person who had bought a property for the living of his family and a person (Somarat-ebn-Jandab) who owned a date tree in the property bought by the former. A dispute rose when Somarat repeatedly and without a prior notice entered in the said property

299 See Chapter one (above, at I.2).

300 Ibid.

301 Alsheikh Mohamad-ebn-al-Hasan-al-Toosi, "Altahzib", Vol. 7, p 146 at Hadis no. 36, Dar-ol-Kotob-ol-Islamieh Publication, Tehran, Iran; Mohammad-ebn-al-Yakgoob-al-Koleini, "Al-Kaafi", Vol. 5, p 292 at Hadis no. 2, Dar-ol-Ketab-ol-Eslamieh Publications, Tehran, Iran; Sheikh Mohammad-ebn-al-Hassan-ebn-al-Yoosof-ebn-al-Motahhar-al-Helli (Known as Fakhr-ol-Mohagheghin), "Al-Eizah (Eizah-ol-Favaed)", Vol. 2, p 48, para Ketab-ol-Din at Fasl-ol-Tanazo, 1st edition, Ghom, Iran; Al-Akhoond Sheikh Mohammad Kazem-ol-Khorasani, "Kefayat-ol-Asool, Al-Maghsad-ol-Sabe, Al-Osool-ol-Amalie, at pp 380-1, Moas-sa-sat Al-ol-Beit, Ghom, Iran; Shikh Morteza Ansari, "Makaseb", 1997, Ghom, Iran, Daroleslam Publications, at p 372.

in order to take care of his tree, whereas by doing so he could see the owner of the property's family who were unlawful for him to see. The dispute was taken to the Prophet and his lordship held that 'Islam authorises neither injury nor intention to injure people. That ruling later became one of the key principles in the Islamic jurisprudence which commands Muslims to avoid injuring their fellow Muslims generally.³⁰² It, however, could clash in certain circumstances with another principle that recognises for people full dominion over property. The latter which is termed as 'Taslit' or 'A'nNas Mosalatoon'a Ala Amvalem' also relies on a famous saying (hadis) from the Prophet Mohammad³⁰³ and was capable of authorising in general terms every owner to do any activity in his property even injurious to others.³⁰⁴ Traditionally, Islamic law jurists have tended to resolve the said clash by prioritising the 'Taslit' principle.³⁰⁵ In their view, private property must be respected in every contingency and there is hardly a limitation on it. They were reluctant to rely on the 'no harm' principle in order to hold a person liable for the exercise of his rights. The question for them was how an action exercised within the limits of a legally stated right could be construed as abuse. As a result, the 'no harm' principle was often taken

302 The 'no harm' principle is most manifested in sections 328-335 of the Iranian Civil Code 1925 which concern civil liability.

303 Mohamad-ebn-Ali-ebn-al-Hosseini-al-Ghomi, "Man La Yahzar-al-Faghih", Dar-ol-Kotob-ol-Eslamieh Publications, Tehran, Iran; Ayatollah Al-seied Al-Borojjerdi, "Jame-o-al-Ahadis-al-Shia", Dar-ol-Ketab-ol-Eslamieh Publications, Ghom, Iran; Mohammad-ebn-al-Hassan-al-Hor-al-Ameli, "Vasa-el-ol-Shia", Edited by Abdolrahim-al-Shirazi-al-Rabani, Dar-ol-Ehia-ol-Toras-ol-Arabi Publication, Beirut, Lebanon.

304 The 'Taslit' principle is reflected in Section 30 of the Iranian Civil Code 1929.

305 This is the traditional view taken by the Hanbali, Shafeai, Hanafi Schools of Thoughts and by a minority of jurists in the Shia Jafari School. See Fitzgerald Seymour Vesey, "An Abridgement of Muhammadan Law", (1931), Oxford University Press, London at 188-195; Mohamad-ebn-al-Hasan-al-Toosi, "Al-Mabsoot", 1351 (Persian calander year), Al-Maktabat-ol-Mortazavieh Publication, Tehran, Iran; Mohaghegh-ol-Sani, "Al-Jame-ol-Maghased", 1408 (Arabic calander year), Al-ol-Beit Publication, Ghom, Iran; Mohamad-ebn-al-Edris-al-Helli, "Al-Saraer", 1408 (Arabic calander year), Moasasat-ol-Nashr-ol-Eslami Publication, Ghom, Iran.

to be used as a source of civil liability in areas of the private relationship which involved no exercise of rights (Al-Javaz-al-Shariea Yonafi-ol-Zeman).

Over time, other jurists who thought that the traditional view could cause imposition of disproportionate damage on other persons' property started to extend the use of the 'no harm' principle to cases involving exercise of rights in certain circumstances. Their view, which reflects the prevailing approach among contemporary jurists, holds that if a person who exercises his right could not reasonably be taken to have considerable and legitimate interest in a disputed exercise, he will be held liable to restore the wronged person's situation. To put it simply, the harm to the plaintiff must outweigh the benefits which go to the defendant as a result of an exercise of right by the latter (Dora'-al-Mafased-Aola Men Jalb-el-Manfa'at).³⁰⁶ They, however, viewed the whole issue from the angle of preventing damage to rights of anyone rather than of restricting the exercise of rights³⁰⁷ and as a result they have restricted the use of the 'no harm' principle in this area only to resolve disputes between owners of neighbouring properties. In summary, the respect for private property in Islamic law has prevented evolution of a general theory of the 'no abuse of right' that requires limiting individual rights.

306 Mohammad-ebn-al-Maki Ameli (known as Shahid Avval), "Al-Ghavaed Va-l-Favaed", Ketab-forooshi Mofid Publication, 784 (Arabic calander year), Ghom, Iran; Zein-ol-Din Ameli (known as Shahid Sani), "Tamhid-ol-Ghavaed-ol-Osoolieh va-al-Arabieah Letafri'o Ghavaed-ol-Ahkam-al-Sharia, Daftar-e-Tablighat-e- Islami Publication, 1416 (Arabic calander year), Ghom, Iran; Sheikh Mohammad-ebn-al-Hassan-ebn-al-Yoosof-ebn-al-Motahhar-al-Helli (Known as Fakhr-ol-Mohagheghin), "Al-Eizah (Eizah-ol-Favaed)", Vol. 2, para Ketab-ol-Din at Fasl-ol-Tanazo, 1st edition, Ghom, Iran; Roohollah Khomeini (known as Imam Khomeini), "Al-Rasael", Esmailian Publication, 1385 (Arabic calander year), Ghom, Iran.

307 Schacht, Joseph, "Islamic Law in Contemporary States", *The American Journal of Comparative Law*, 133 at p 143.

Islamic law aside, another source of law, which has been influential on the Iranian lawmaker as to drafting the 'no abuse of right' principle, has been the laws of the continental Europe countries which recognise the 'no abuse of right' as a general principle.³⁰⁸ A common feature of these countries, which all fall in the civil law camp, is to proclaim rights in general terms and where this is the case abuse of right is likely to occur because rights are not initially hedged with qualifications.³⁰⁹ A general principle of 'no abuse of right' could prevent this. The development of the principle owes especially to the late 19th century French scholarship and in particular to the writings of Louis Josserand who thought rights should no longer be considered absolute. In his view, an exercise of right must be compatible with its social function. His view which was in fact a revision of the traditional philosophy was subsequently put to use by the French courts in order to develop a general principle of 'no abuse of right'. Hence, the courts liberally construed sections 1382 and 1383 of the French Code Civil, which fix liability on the author of any harm, in order to cover abusive exercise of rights where they involve intention to harm. It was at this point that abuse of right became a source of civil liability subject to fault. Nevertheless, fault for the purpose of abuse of right had a narrow scope. While in other torts every act or omission which causes damage could be a source of liability, in an abuse of right case such act or omission could generate liability only where certain extra conditions existed. In a case of normal tort, the tortious activity is never legal while in an abuse of right case an activity which is otherwise legal can be a tort when certain conditions are present. These conditions were summarised by the courts within one formula which stated: to be an abuse of right, the person who exercise right must have intention to harm which is ascertained

308 See generally Cutteridge (above, note 38); Bolgar (above, note 38); Byers (above, note 38).

objectively; i.e. the enquiry is whether the defendant can reasonably be taken to have had any serious and legitimate interest in what he was doing.

The French initiative was later followed by other European countries which gradually accommodated the principle in their Codes of laws in one form or another. In Germany³¹⁰ Austria³¹¹ and Italy³¹², intention to harm was chosen as the test with which an abuse of right is identified. For Russia³¹³ and Czechoslovakia³¹⁴, the test is whether an exercise is contrary to its social and economic purpose. Spain gives regard to both intention to harm and the circumstances of the harm caused.³¹⁵ In Netherlands, a number of elements (intention to harm, purpose of the right, and whether the harm has been disproportionate) are considered³¹⁶ while the Swiss law of the abuse of rights relies on the element of good faith.³¹⁷

As we have seen earlier, the Iranian version of the 'no abuse of right' principle which is reflected in Art 40 is too wide with no precise definition and hence is capable to seriously defunct individual rights. It currently makes no distinction between harms, which are allowed to be borne by other persons and the society, and harms, which are not so allowed. In certain conditions, harms may ensue not from one's action but rather

309 Catala P. and Weir J.A., "Delict and Torts: A Study in Parallel, Part II", (1964), 38 *Tul. L. Rev.*, 221 at pp 237-8; Byers (above, note 38) at p 396.

310 Section 226 of the German Civil Code of 1900.

311 Section 1295 (2) of the Austrian Civil Code of 1811.

312 Section 833 of the Italian Civil Code of 1939.

313 Soviet Code 1923, para Preface.

314 Section 7 of the Czechoslovak Civil Code of 1964.

315 Section 7 of the Spanish Civil Code of 1898.

316 Section 13 (2) of the 1992 Civil Code.

317 Section 2 of the Swiss Civil Code of 1907

from some exogenous risks.³¹⁸ For example, when a person builds a dam in his property to avoid the risk of an imminent flood, he will not be held liable if the flood destroys his neighbour's property.³¹⁹ In such case, the harm to the said neighbour is attributed to exogenous events. Also, the enjoyment of one from the exercise of his rights may sometimes require some harm to be borne by other persons. Thus, it is lawful, for example, for a man to open air holes and windows on his walls for purposes of light, even if by so doing he can see his neighbour's family who are unlawful for him to see.³²⁰ Everyone can deal with his own property in any manner that would not damage his neighbour's property, although it might harm him by opening such windows. These considerations were taken by the Iranian Civil Code which is in contents based on Islamic law³²¹ and which defines the general principle stated in Art 40. It holds in section 132 that:

"No owner is allowed to do in his property an activity which requires one's neighbour to incur harm unless to the extent that it is exercised reasonably for meeting one's necessary need or for saving him from the risk of damage".

The section determines circumstances within which an act or omission can be assessed as constituting abuse of right. As it suggests, the 'abuse of right' occurs where a person exercises his right unnecessarily and carelessly which entails injury to other persons' property or rights. Accordingly, not every harm to other persons or to the public interest, which might arise from the exercise of one's right, could trigger the

318 Riley CA, "The Company Director's Duty of care and Skill: The Case for an Onerous But Subjective Standard", (Sep-1999), *The Modern Law Review*, vol. 62, 697, London, England, Stevens & Sons, at p 706.

319 Al-Akhoond Sheikh Mohammad Kazem-ol- Khorasani, "Kefayat-ol-Aosool", Al-Maghsad-ol-Sabe, Al-Osool-ol-Amalie, at p 383, Moas-sa-sat Al-ol-Beit, Ghom, Iran.

320 Section 133 Civil Code 1929.

321 See Chapter one (above, at I.2, para note 119).

mechanism of abuse of right. Only harms, which are not borne as stated, can generate liability for a person who acts within the stated frame of his rights. To put it simply, the abuse of right is subject to fault which is construed more narrowly than it is done under the general law relevant to the civil liability.³²² Although, the section concerns property law and specifically disputes between owners of neighbouring properties, its rationale in the light of the very Art 40 can be extended to other areas such as labour law, contracts including companies, and legal proceeding, though a judicial willingness to include these areas will have to be forthcoming.

Currently, Iranian company law gives no specific regard to the issue of majority abuse of rights. In the absence of any such specific regard, company law scholars have approached differently. Some recognises no possibility for any extension of the rationale from section 132 to companies because shareholders are absolutely free to exercise their voting rights in any manner they like. The only exception is where a motion to be voted constitutes a crime and shareholders knowingly vote for its adoption.³²³ Others draw analogy between the existing 'no abuse of right' principle, and the issue of majority abuse of rights and state resolutions of meetings can be set aside, if it becomes evident that the majority once exercising their voting rights in meetings was pursuing interests other than that of the company.³²⁴

322 See Chapter four (above, at IV.2).

323 Sotoodeh Tehrani Hasan, "Trade Law", (1997), Tehran, Dekhoda Publication, vol. 2, pp 175-6.

324 Erfani Mahmood, "Trade Law", (1999), Vol. 2, Tehran, Jehade Daneshgahi Institute Publication (Majed), at p 180; Erfani Mahmood, "Abuse of Position and Power in the Law of Iran", 'Comparative Law Institution Monthly', (1981), No 7, University of Tehran Publication, Tehran, at pp 148-231.

V.2.2. Minority protection mechanisms

Generally speaking, there are four statutory mechanisms to protect minority rights in Iranian company law. These mechanisms are: convention of meetings by shareholders³²⁵; cumulative voting system³²⁶; disinterested majority³²⁷; and corporate action by shareholders³²⁸ which will be discussed respectively below.

V.2.2.1. Right to convene shareholder meetings

As a minority protection measure, company law allows shareholders to convene shareholder meetings where certain conditions exist³²⁹, though the right to convene such meetings is considered corporate and hence falls principally within the power of directors.³³⁰ This statutory right can be utilised where shareholders who possess one fifth of a corporation's issued shares choose to have a shareholder meeting convened. The exercise of the right is also subject to observation of certain procedural steps to be taken by minority shareholders. They must demand corporate directors and upon such demand it will become the duty of the directors to convene the requested meeting within 20 days. If directors refuse to do so, demanders can ask inspectors to convene the meeting within 10 days and in a likely failure of inspectors case, demanders will have the right to convene the attempted meeting personally. These requirements are intended to guard against any likely opportunistic use by minority shareholders of the statutory right.³³¹

325 Section 95 JSCA.

326 Section 88 JSCA.

327 Section 129-131 JSCA.

328 Section 276 JSCA.

329 Section 95 JSCA.

330 Sections 89 and 138 JSCA.

331 Sotoodeh (above, note 323) at p 175.

The right offers some protection to minority shareholders against controllers in Iranian companies.³³² As the power to call a shareholder meeting and to determine its agenda fall within the authority of corporate management and because most Iranian corporations are dominated by one or few shareholders who can control corporate management³³³, it would become very likely that controllers do not allow a matter of minority concern is raised at meetings.³³⁴ This is particularly problematic when minority shareholders are trying to bring up issues to which controllers are not interested; for instance, where minority shareholders seek to restrict management's power or want to dismiss them from the office. The right allows minority shareholders to have the purported meeting convened and 'in such meetings, only issues which are determined by demanders are discussed.'³³⁵ Nonetheless, the statutory right is considered not very important because, while it allows minority shareholders to convene a meeting and raise matters, at the end of such meeting issues will be resolved by a simple majority resolution.

Minority protection aside, the right can constitute effective protection for shareholders generally which guards them against management's abuse of corporate powers. Such abuse could mainly occur in companies that have no controlling shareholders. Collective action problem in such companies allows wayward management to continue with impunity the office and therefore a statutory right which is exercised despite such

332 Erfani Mahmood, "Trade Law", (1999), Vol. 2, Tehran, Jehade Daneshgahi Institute Publication (Majed), at p 96.

333 See Chapter one (above, at I.2).

334 Sotoodeh (above, note 323) at pp 160-162.

335 Section 96 JSCA.

problem could ensure that shareholders are always able to exert effective control on management.

V.2.2.2. Cumulative voting

Cumulative voting is a method of voting through which directors are appointed at shareholder meetings. According to it, when the matter to be decided at a shareholder meeting is appointment of directors, the number of votes owned by a shareholder is multiplied to the number of directors to be appointed. If, for example, five directors are to be appointed in a company, according to the corporate articles and corporate law, and a shareholder of the company holds five shares each of which bear one vote then he will have twenty five votes to give to one candidate or to distribute them among candidates. This is exceptional to the principle of majority rule which requires shareholders to take resolutions by a simple majority vote on the basis of 'one share, one vote'. It is stated in section 88 JSCA and is a mandatory rule of company law³³⁶ especially designed to enable minority shareholders to organise their dispersed votes and send one or two representatives to the board.³³⁷ It is not applied where the attempted appointment concerns the first company directors. In the latter case, the

336 "In Ordinary general meetings decisions must be taken by a simple majority vote of attendees in a formally valid meeting except in relation to appointing directors and inspectors for which a relative majority vote suffices. In the latter case, the number of votes of every member are multiplied to the numbers of directors to be appointed. Shareholders can allocate their votes to one nominee or spread them among nominees. A shareholder contract cannot displace this mechanism'. [Section 88 JSCA].

337 Erfani (above, note 332) at pp 105-107; Rastiin Mansoor, "Commercial Law", (1975), 3rd ed., Tehran, University of Tehran Publications, at p 115; Meshki Siroos, "Legal Organization of Management in Joint Stock Companies", Ph.D. Thesis, (1979), Tehran, University of Tehran, Faculty of Law and Politics, Guiding Code 86, at p 39.

authority to appoint the first corporate directors falls within the power of a founders' meeting which follows different rules.³³⁸

One important weakness of the cumulative voting is that it simply concerns with choosing directors and has no application when a removal of directors is to be decided. The latter still remains within the realm of the general rule of 'one share, one vote' and as a result, majority shareholders will always be able to remove and replace a minority-selected director. In other words, current company law allows the cumulative voting which was enacted to protect minority shareholders to be outflanked by controllers.³³⁹ In addition to this, its effectiveness will depend on the actual commitment of minority shareholders who might not want to, or could not, coordinate.

V.2.2.3. Disinterested ratification

The disinterested ratification which is stated in sections 129-131 JSCA concerns with ratification of directors' intentional faults in companies. The company law drafters enacted it with the intention to ensure that shareholders always respond such faults effectively. According to it, any self-interested transaction of a corporate director, which causes damage to company, is a source of liability that can be exonerated only by effective shareholder ratification. For the purposes of the sections 129-131, ratification is effective when it is adopted by a shareholder resolution which does not comprise of votes cast by directors who were interested in the very objected transaction. As directors, according to the Iranian company law, are appointed among

338 See Chapter two (above, at II.2.1).

339 Meshki (above, note 337) at p 50.

shareholders³⁴⁰, they normally enjoy voting rights which could be used as a self-help device in shareholder meetings. This could potentially cause problems for minority shareholders given that Iranian corporations tend to have one or few shareholders who can either seize or control the corporate management. To exclude wrongdoer directors' votes from being cast in meetings could mean to exclude interested majority vote in certain circumstances. However, directors may commit faults in which they are not personally interested and there are also situations in which not the very wrongdoer directors but interested shareholders may want to support wrongdoer directors, using their votes. On the one hand, a shareholder resolution which concerns directors' negligence can yet be affected by the very wrongdoer directors' self-help. On the other hand, directors can fix some private benefits not for themselves but rather for the controlling shareholders who will support them in hard times. Current company law, thus, permits fraud to occur in companies. Sections 129-131 do not address these issues. Whether the rationale of the sections 129-131 could be used to impose as a general rule a limitation on shareholders in meetings which excludes not only directors' votes but also interested shareholders' votes from being cast in meetings as to ratification of directors' faults (which broadly interpreted covers both self-interested and negligent activities) cannot be answered with comfort. Perhaps, if sections 129-131 were the only source of reference, the answer would become negative, as the formal scope of the above sections are expressly limited to directors' votes as to their self-interested transactions. However, in addition to specific statutory provisions, the spirit of the law in this area can be taken into account, as the general law authorises the courts to consider such spirit in the case of obscurity or silence of the specific provisions. In the

340 Section 107 JSCA.

light of such consideration one can notice in the current company law a number of sections whose purpose of provision are to regulate the relationship between shareholders so as to prevent some shareholders from taking extra advantages. For example, section 93 JSCA requires a special ratification to be given by affected shareholders as to an ordinary resolution which seeks to change rights attached to a particular set of shares. Likewise, where a shareholder meeting considers granting of certain advantages to one or few corporate members, the votes of such members must be excluded.³⁴¹ Similarly, when a shareholder meeting intends to resolve to exclude certain shareholders' pre-emption right as to buying new shares in the interest of one or few other shareholders, its resolution must not reflect the votes cast by those who are allocated new shares.³⁴² Therefore, it does not seem very odd to suggest on the basis of such consideration that not only directors vote but also interested shareholders' vote can be excluded when directors' fault in its wide meaning is the subject of a shareholder meeting's resolution.

V.2.2.4. Commencing corporate claims by shareholders

Company law permits shareholders to take corporate claims against directors in certain circumstances.³⁴³ According to section 276 JSCA, which is mandatory³⁴⁴, shareholders may raise claims of liability against corporate directors when the latter commits fault in connection with managing affairs and business of companies. This is often known as

341 Section 77 JSCA.

342 Sections 166-168 JSCA.

343 Erfani (above, note 332) at P 177; Meshki (above, note 337) at pp 205-207.

344 Section 277 JSCA states that a resolution of shareholder meeting and a clause in the corporate constitution which fall in contradiction with the statutory right offered by the section 276 is inoperative.

'corporate claims initiated by shareholders'³⁴⁵ and is exceptional to the principle which exist in general law of procedure³⁴⁶ and suggests such claims must be commenced by the company itself³⁴⁷ rather than by its shareholders.³⁴⁸ As companies enjoy legal personality, they can have property and rights of their own³⁴⁹ and further can prosecute persons who commit wrong to them. This is normally done through an appropriate corporate decision taken by directors.³⁵⁰ Directors represent the company and as agents of the company exercise the company's power to pursue wrongdoers. This includes the circumstances where directors are themselves wrongdoers. In cases where one or two of directors, for example, commit wrongdoing, it is the responsibility of other directors to make a proper decision to pursue or not to pursue wrongdoer directors and even if every director in the board is involved in the wrongdoing the responsibility will rest on the new board who will make such decision.³⁵¹ In any case, a shareholder is not allowed to initiate a corporate action unless there is a special permission either in the corporate constitution or in laws to that effect. While constitutions rarely authorise shareholders to take corporate actions, company law exceptionally allows such actions to be commenced by shareholders. The rationale for this is to deter corporate management from committing of fault. To this end, company

345 Meshki (above, note 337) at pp 205-6.

346 See Section 2 of the Civil Procedure Act 2000 (Hereafter is cited CPA):

"No court can hear a claim unless a person or persons having proprietary interest or a person or persons who are their agents (lawyer), successors or legal representatives initiate action and demand judicial trial according to the law."; Also see Section 84 (10) of the same Act: "In following issues defendant when responds in substance can make a procedural objection to the claim initiated against him/her...(10) Plaintiff is not of interest in the claim".

347 Sections 142 and 276 JSCA.

348 Unlike English company law which offers a common law rule of proper plaintiff, Iranian company law provides no such rule. Instead, that corporate claims are to be commenced by the company itself is an instance of the general rule of procedure which regulates taking actions by persons as to their property and rights. [See Sections 2 and 84 (10) CPA (above, note 346)].

349 See section 583 TC which provides that "All types of commercial companies prescribed in the Code own separate legal personality".

350 Principally, legal persons take decisions and act through their incumbents. [Section 589 TC]

law imposes civil liability, which can be enforced by shareholders, on negligent directors.³⁵² Where directors are personally involved in the wrongdoing against the company, they are unlikely to pursue themselves and hence a statutory permission which authorises shareholder action against wrongdoer directors can ensure that such directors are always liable to prosecution. To prevent any potential abuse of the statutory right, a check was put on the exercise of it which requires a shareholder plaintiff to qualify as to owning of at least one fifth of the corporate shares.³⁵³

The shareholder action stated in section 276 has similarities and differences with the English derivative action. They both are exceptional devices and principally target mismanagement. These aside, they differ in a number of aspects. They diverge in the sort of wrong which can be addressed. While only wrongs which qualify as fraud fall within the scope of derivative action, a section 276 action can cover any wrong which involves directors' fault, in its wide meaning. A further difference is that an English shareholder is allowed to take derivative action against third parties who were involved in the fraudulent transaction. An Iranian shareholder can prosecute only the wrongdoer director even if a third party was involved in the fraudulent transaction. Under the derivative mechanism, even a tiny shareholder can initiate the action whereas according to the section 276 the one-fifth-shareholding requirement must be met.

351 Section 118 JSCA.

352 Erfani (above, note 332) at p 177; Meshki (above, note 337) at pp 205-207.

353 Section 276 JSCA provides that "a person or persons who own at least one fifth of the total shares in a company can in case of commission of fault by board members and 'director general' initiate legal proceedings in the name and for the benefit of the company but at their personal expense, against them and ask for recovery of any damages suffered by the company. When directors found liable, the courts' judgement will be executed for the benefit of the company

Whether the statutory right has been of any assistance as to protecting minority shareholders against abuse of power by majority shareholders can be answered in negative. It only concerns with directors' faults and cannot be used to address wrongs which are caused by the majority shareholders or other persons.³⁵⁴ Also current company law allows directors' fault to be ratified by an ordinary resolution of shareholder meeting. Given that in Iranian corporations often the same persons hold majority of shares and control management, this could mean the statutory right really serves no or little function. In addition to these, the section 276 which offers the statutory right is uncertain. It is not clear whether a minority plaintiff is required to take the issue first to the shareholder meeting or he is free to take action at his expense when it is liable to ratification by majority shareholders. Lastly, section 276 requires a plaintiff minority to come up with the money for the costs of a purported litigation. This can constitute a major disincentive for a likely plaintiff given that normally minority shareholders have not resource enough to fund such claims and even where they do, the prospect of a refund order at the end of a successful action is lost at the outset where the fate of the very action is quite gloomy. It is hard for a minority shareholder to show directors' fault and lack of adequate information often makes any purported action risky and unpredictable and hence a minority shareholder is very

except in relation to the costs of such action to which the judgement will be executed for the benefit of the plaintiff who initiated the action..."

354 By making analogy Sotoodeh suggested a contrary opinion where he argues that it is possible to extend the rule provided by Section 276 to the situations where wrongdoers are the majority of shareholders. His argument rests on a general understanding from various sections in Joint Stock Companies Act that impose civil liability on promoters, directors and inspectors when they commit fault in certain situations which for example involve formation and registration of company (Sec.23), issuing share certificate when the company has not been registered (Sec. 28). [Sotoodeh (above, note 323) at p191] However, the argument falls in

likely to see him/herself better off to exit from the company rather than to stay and take action.

contradiction with the wording of the very section 276. [See Meshki (above, note 337) at pp 205-207].

V.3. Conclusion

In Chapter five, my intention was to see what and how company laws in England and Iran have done as to preventing the possibility of abuse of right by majority shareholders and whether the law in each system has been any successful to facilitate formation of a just and efficient reconciliation between the majority/minority interests in companies. I examined three major minority protection mechanisms; i. e. derivative action, just and equitable winding up, and unfairly prejudicial conduct; as to the English company law. All three mechanisms rely on equity principles and serve, in one way or another, to protect minority shareholders against a likely abuse of rights by majority shareholders. They are meant to offer tailored solutions to different cases of majority abuse and such solutions are often considered as case specific rather than being a general principle. Derivative actions concern a corporate wrong in circumstances where wrongdoers and corporate controllers are one and the same. They often involve some sort of unjust enrichment on the part of controllers who try to ratify such enrichment, using their voting rights. When successful, they are normally given remedies like damages or compensation, restitution of the company's property and account of the profits taken. They are beneficial as to protecting rights and interests of minority shareholders, as they require controllers/wrongdoers to make good any damages inhered by the wronged company whereby prevent majority rule from working in cases which clearly involve fraud. Quite the different, the just and equitable winding up cases often involve no question of wrong in its common law sense and hence there is no unjust enrichment at issue. Instead, such cases normally concern circumstances within which certain activities of controllers are regarded by the equity as involving abuse in the exercise of rights. As a result, a suitable remedy for such

cases is winding up which ensures that there will be no more damages to shareholders' interests. The unfairly prejudicial conduct, on the other hand, concern any unfair disregard of minority interests by controllers which results in breach by the company of the contract between the company and its wronged minorities. The breadth of it enables the mechanism to be inclusive of abuse of rights and powers against minority interests which can occur in various shapes and ways in corporations. By providing a number of reliefs which are not conclusive and which can fall to the minority plaintiff either directly or indirectly, it can respond each abuse of right and power case appropriately.³⁵⁵

Although the first two mechanisms offer some advantages, they have shown in practice to be short of ability to address majority abuse sufficiently. The derivative action fails to cover cases which involve directors' negligence and breach of duties of care and fiduciary. Its elements of fraud and control can hinder any commencement of derivative actions by minority shareholders³⁵⁶ and further factors like disinterested majority vote and independent sub-committee's view which are regarded by the courts could function as barrier rather than being a simple check.³⁵⁷ Too, the Law Commission's proposed derivative action in its current format can increase uncertainty associated with such actions and can further require a shift of authority from corporations (put it precisely, a shift of authority from corporate organs; i. e. management and meetings) to the courts. The just and equitable winding up remedy, too, is sometimes rigid and prejudicial because it simply winds the company up,

355 Companies Act 1985, Section 461 (1 and 2).

356 Law Commission (above note 68) at p 71; Department of Trade and Industry's Consultation Paper (above note 79) at p 12.

whereas ideally neither the plaintiff minority nor the defendant majority would have wished to have the company wound up. Instead of solving the problem, it simply dissolves the company, killing the patient instead of curing the cause of his illness. This particularly seems disastrous when the company prospers.³⁵⁸ The break-up value of the corporate assets could worth less per share than its going-concern value and this would follow that every shareholder may lose some of their investment.³⁵⁹ Although, viewed by the courts as being exceptional and the last resort remedy, it has proved in practice to be widely open to every sinister shareholder who can cause corporations to get involved in time consuming, tiresome and disruptive winding up proceedings.³⁶⁰

In addition to these, both mechanisms have little relevance to large companies. A successful derivative action requires plaintiff to show control of the wrongdoers and clearly it is very unlikely for a plaintiff to be able to show such control, as large companies tend to have dispersed shareholders. Also, since large companies tend not to accommodate any personal relationship which is a requirement for a grant of the just and equitable winding up remedy, it will be very unlikely that that remedy is given as to such companies. When entrusting his money to a company, an investor trusts to the documents that were shown to him and not to the people who control the

357 Conway (above, note 43); Boyle (1969), (above, note 81) at p 120; Poole and Roberts (above note 81) at p 99; Farrar (1991), (above, note 42) at p 453.

358 Pettet (above, note 40) at p 247.

359 Pettet (above, note 40) at p 247; Instone Ralph "Unfair Prejudice to Shareholders", *New Law Journal*, (1981), London, Butterworths, p 1316; Bastin N. A., "Minority Protection: A Plea for Reform", *New Law Journal*, (1977), London, Butterworths, p 230.

360 Law Commission recognised this problem and proposed that bringing action in winding up cases should become subject to a leave of the court. [Law Commission (above, note 68) at p 46].

company. Besides, no deadlock might occur in large companies because the general meeting resolves any deadlock.³⁶¹

In contrast, the third mechanism remedies, as intended by its drafters, most shortcomings of the first two mechanisms. Many issues that were considered in the past as internal matters could now be reviewed by the courts and a minority plaintiff is no longer required to face difficulties of standing.³⁶² The mechanism also avoids the rigidity of the winding up remedy. It puts strong check on corporate controllers and helps minorities to bring such controllers to the negotiation table.³⁶³ An aggregate of the above properties have helped the unfairly prejudicial remedy to leave behind the derivative and winding up forms of actions. Nonetheless, the mechanism, which is sometimes described as being an English innovation³⁶⁴, suffers from some deficiencies. For a start, it is liable to abuse, as it enables minority shareholders to make opportunist use of the statutory right.³⁶⁵ This is because under the current unfairly prejudicial conduct a minority shareholder will become able to demand a remedy for almost any act of the company which might seem inconsistent with their interests. It thus disconnects the link between the majority rule and the logic that minority claims should sensibly be curbed.³⁶⁶ Likewise, every dissatisfied shareholder can now use the mechanism to expose the company and its shareholders to some fallacious and

361 Farrar (1991), (above, note 42) at p 458.

362 Davies (above, note 60) at pp 735-6; Pettet (above, note 40) at p 249; Hirt (above, note 66) at p 101.

363 Pettet (above, note 40) at p 249; Farrar (1991), (above, note 42) at p 474.

364 Sealy (above, note 31) at p 172.

365 Clark (2001), (above, note 96) at p 171; Clark (1999), (above, note 110) at p 322; Sealy (above, note 31) at 173.

366 Clark (2001), (above, note 95) at pp 174-5; Clark (1999), (above, note 110) at pp 321-2; Farrar (1991), (above, note 42) at p 474; Davies (above, note 60) at pp 737-9.

disruptive litigation in order to extract some extra advantages for themselves.³⁶⁷ That can explain why litigation in this area has tended to become notorious.³⁶⁸ Further, there are some uncertainties with the mechanism. As Cheffins observed, 'because of its broad scope, the possibility always exists that a judge will apply section 459 in a novel and unpredictable fashion'.³⁶⁹ As the choice of a suitable remedy is always one for the courts to make, litigants can hardly predict consequences that their action may generate. Such uncertainties can further generate unwanted costs to be borne by shareholders, as they 'will either have to pay legal fees in order to try to clarify matters or carry on without being sure whether they are acting in a legally valid manner'.³⁷⁰ In addition to the costs, the mechanism can sometimes be tiresome. Its equitable nature can cause any claim of unfairly prejudicial conduct to require historical investigations and evidential discovery in the affairs of companies.³⁷¹ Above all, the mechanism can serve inefficiently in relation to small companies and be a mismatch for large companies. As to small companies, it may discourage financing. This is the context where normally those who wish to have both voting and managerial control provide the large part of finance required for corporations' business and they would feel uncomfortable if the company law lays too much attention to the protection of minorities.³⁷² In large companies, on the other hand, it offers little use for two reasons.

367 *O'Neill and Another v. Phillips and Others*, (1999), 2 All ER 961, HL per Lord Hoffman J.; See also Farrar (1991), (above, note 42) at p 319; Clark (1999), (above, note 110) at p 322; Clark (2001), (above, note 95) at pp 174-5.

368 *Re Unisoft Group Ltd. (No 3)*, (1994), 1 BCLC 609 at p 611 per Harman J.

369 Cheffins (above, note 3) at pp 260-1.

370 Cheffins *Ibid.*

371 Clark (1999), (above note 110) at p 322; Clark (2001), (above, note 95) at pp 174-5.

372 Posner (above, note 3) at pp 91-6; Cheffins (above, note 3) at pp 18-19; Farrar (1991), (above, note 42) at p 319; Jensen and Meckling (above, note 3) at p 6; MacNeil (above, note 20) at p 117; To study contrary opinion see Copp who argued that not a narrowly interpreted but a broadly construed section 459 would encourage financial investment in small companies. Otherwise, substantial investors may be deterred from investing in a small company out of a fear of being locked in. [Copp (above, note 211) at p 8].

One is that the courts have construed the unfairly prejudicial conduct in order to apply only in cases where the relationship between corporate members is built on some personal connections. Such connections are normally found in small companies. The other is that the availability of market for shares which normally provides an adequate exit procedure for shareholders of large companies, makes the use of the mechanism in that area unnecessary and redundant.³⁷³

As to the Iranian company law, I considered five mechanisms; i. e. the 'no abuse of right', right to convene shareholder meeting, cumulative voting, disinterested ratification, and shareholder action; which provide, in different ways, some protection to minority shareholders. The first mechanism; i. e. the 'no abuse of right'; has a high potential to curb abuse of rights by majority shareholders. Using its measure and without requiring a separate and specific law, the courts can identify and stop many instances of majority abuse in corporations. For example, the principle can be used to stop abuse by controllers where corporations are dominated by one or few shareholders who attempt, using their statutory and constitutional right and without having a good excuse, to remove a minority shareholder/director from the office. Likewise, the principle can be used to avoid a resolution of meeting which implicitly involves some discrimination against minority shareholders. Nonetheless, as the courts are often under the influence of the Islamic law which limits application of the principle to the relationship between neighbouring owners, they seem reluctant to utilise this high potential in its full capacity.

373 Deakin, Ferran and Nolan (above note 246) at 163; Leader & Dine (above, note 159) at p 243; Ferran (above, note 50) at p 339.

The second mechanism; i. e. right to convene shareholder meeting; was designed to provide shareholders with the opportunity to convene a shareholder meeting in default of corporate directors' action. It serves more as a protection for shareholders in a shareholder/management dispute rather than being a protection for minority shareholders against majority shareholders. Where directors are, in one way or another, involved in the wrongdoing against their corporations, the right allows shareholders to control and stop such directors. Directors' involvement in the wrongdoing often occurs where one or few shareholders do not dominate a corporation. It can also occur in corporations that have a controlling shareholder who exert weak control on directors. The latter is normally the case for most Iranian public industrial and financial enterprises that are dominated by the government and its dependant organisations. Dominant shareholders in such corporations monitor directors weakly as a consequence of their control mechanisms which have hierarchic, bureaucratic, and administrative nature and because those who represent the government normally have no or little incentive to exert control effectively. The right is of little use where directors have ownership control, because even if a meeting is convened at minority shareholders' demand, it is very unlikely to result in anything favourable to the demander. Considering that private corporations in Iran tend to have one or few controlling shareholders who control the management, the right does little as to protecting minority shareholders in such corporations too.

The third mechanism; i. e. cumulative voting; was intended to empower minority shareholders to have one or few representatives in corporate boards, which take most

corporate decisions. It, however, concerns only with appointing directors rather than their removal from the office. The latter is resolved through a normal majority decision based on 'one share, one vote'. The result is there is always a possibility that a minority elected director is removed from the office by a simple resolution of majority shareholders.

The fourth mechanism; i. e. disinterested ratification; is a mechanism through which exerting effective shareholder control over directors' activities in corporations is facilitated. It seeks to prevent wrongdoer directors from having the ability to ratify their wrongdoings. It, however, seems to be specific to small private corporations where wrongdoer directors often have ownership control too. As to large corporations, it is irrelevant because persons other than the very wrongdoer directors often control such corporations. It is also deficient in the sense that it concerns only wrongs which involve directors' self-interested transactions rather than their faults in a wider sense.

The fifth mechanism; i. e.; shareholder action; allows shareholders to pursue as a matter of exception and on behalf of the wronged companies directors who commit fault. Being mainly a mechanism for protection of shareholders generally as against abuse of power by directors, it is relevant and can be utilised in cases in which different persons manage corporations and hold ownership control. It does not concern wrongs which are caused by the majority shareholders and since directors' faults are considered ratifiable the protection serves little use to minority shareholders where the same persons hold management and ownership control.

In summary, English company law seems to be dynamically responsive to the possibility of the majority abuse of rights. While corporations, excluding private corporations, in

England tend not to have a controlling shareholder and consequently are less liable to the problem of majority abuse and need as a result less legal protections for minority shareholders, company law has provided a number of mechanisms that provide various effective and appropriate remedies which can sensibly curb the possibility of majority abuse. They provide focussed solutions that target majority abuse of rights which occurs in different ways and shapes in corporations.

In contrast, company law in Iran seems to be under developed as to the majority/minority conflict in corporations. It provides some weak and at times irrelevant mechanisms as to preventing abuse of rights by majority shareholders, whereas most Iranian corporations are dominated by one or few controlling shareholders and are inevitably liable to abuse by the controlling shareholders. Four of the five considered mechanisms that exist in Iranian company law mainly concern preventing abuse of power by corporate directors and hence are pertinent to the shareholders/directors conflict rather than being minority protections. This aside, the only mechanism; i. e. the 'no abuse of right'; which is relevant to the majority/minority conflict has lost its potentials because of a lack of statutory definition which authorises the use of principle in company law and determines its circumstances, consequences and available remedies plus an unwillingness on the part of judiciary in extending the mechanism from disputes between neighbouring owners to the majority/minority conflict in corporations.

Conclusion

In this thesis, I studied, from English and Iranian company law viewpoints, the principle of majority rule and its likely clash with rights and interests of minority shareholders. Given that majority/minority shareholder conflict commonly occurs in both English and Iranian corporations, the study concerned examination of that conflict and the response of the company laws in the two mentioned systems. As a matter of principle, accepted by corporate members and company laws, shareholder conflicts in corporations are to be resolved internally, using the rule of majority. In some occasions, however, the way the rule is used could itself generate conflicts between majority and minority shareholders. The governing majority shareholders can use it as an instrument in order to extract some private benefits. Majority shareholders may also adopt or authorise, through directors, policies that are considered, in the view of a minority shareholder, poor and harmful to companies and their shareholders' interests. The implication is that while the rule of majority can have unfair consequences as to the rights and interests of minority shareholders, it allows no recourse to be taken by a wronged minority and this can generate conflicts between majority and minority shareholders.

As shareholder conflicts, if not resolved fairly, could damage corporations thereby undermine their service to the society, I intended to discover why and how such conflict could occur in corporations of each system. I also wanted to determine what and how company law in each system has done to resolve such conflict plus providing an explanation for the question of why each system did the way it did. Finally, I intended to take some lessons from the results of the research which could improve the

quality of the law in this matter. To reach these objectives, I had to examine, from varying aspects, the very rule of majority and the mechanisms that the two corporate laws have introduced in order to curb abuse of majority rights against minority shareholders. The examination was therefore twofold. One concerned direct and indirect factors which allow majority rule to be used opportunistically against minority shareholders. Here, I emphasise on four factors which are considered respectively in Chapters one, two, three and four. In Chapter one, in addition to considering the question of why the rule is justified, I showed also how such justifications could be used by the majority shareholders in order to ignore appropriate minority complaints. Chapter two considered the relevance of general laws and constitutions, as they draw the field within which the rule of majority can work, and showed that the two mentioned factors, although restricting the rule of majority and thereby providing some safeguards for minority rights, are unable to address a great part of majority abuses which occur in corporations. In Chapter three, which was about demonstrating and examining the voting mechanism, I explained how majority shareholders could make opportunistic use of their voting rights in order to take private benefits or hurt minority shareholders. Chapter four concerned the role of corporate directors. It cautiously accepted the idea that corporate directors can offer some solution to the majority/minority conflict in corporations. In varying degrees, they are liable to mismanagement and further they can sometimes serve to empower majority shareholders hereby to facilitate majority abuse of rights. In summary, Chapters one to four made it clear why and how the rule of majority can be abused. They also showed that contractual and market mechanisms plus general laws have limited capacity to prevent such abuse. They, thus, urge intervention by the law for protection of minority shareholders.

The other, which was the subject of my consideration in Chapter five, concerned examination of the existing mechanisms in company laws of the two countries that seek to protect minority shareholders against the possibility of abuse of rights by majority shareholders. The examination showed that although minority shareholder protection mechanisms in both company laws have some weaknesses, the English company law mechanisms seem to be more focussed and more responsive on the majority/minority conflict compared to its Iranian counterparts.

Chapter one demonstrated and examined justifications which are used in order to support application of the principle of majority rule in corporations. It considered three approaches, political, economic, and doctrinal, which originally evolved in England and other western economies and which were later adopted as part of the imported package of corporation by the Iranian law. While they agree to support the majority rule generally, they use different reasoning for its application. For the political approach, it matters because corporate directors who are liable to abuse should be controlled and majority rule by solving the collective action problem can facilitate such control. The economic approach, on the other hand, regards shareholder control as irrelevant. In its view, majority rule facilitates the collective action and this is something desirable not because it enables shareholder control but rather because it allows shareholders to react to unpredicted events quickly and appropriately when the contract is incomplete. Besides, by placing governance in the hands of those who have more shares, it facilitates and encourages risk taking and financing in companies and, thus, it is efficient too. The doctrinal approach which accommodates the rule within the corporate laws, justifies the rule of majority, using certain legal reasoning and policy considerations. In its view, the rule of majority saves companies' and the judiciary's

resources, respects the corporate autonomy, and frees management of companies from noxious allegations.

There are some advantages and disadvantages with each of the three approaches. The political approach recognises shareholder control which is desirable and necessary as to preventing mismanagement. At the same time, it can be inefficient as individual shareholders rather than their capital are given weight. The approach, thus, offers excessive safeguards for minority rights. The economic approach, on the other hand, respects corporate capitalism, which is efficient generally, but at the same time it can be injurious, unjust and perhaps sometimes even inefficient by rejecting any idea that relies on shareholder control or supports protection for minority shareholders. The doctrinal approach avoids criticisms that are made to the two mentioned approaches. In its view, the majority rule facilitates both shareholder control and financing. Yet, on the issue of minority rights, it seems deficient too, as it rigidly ignores minority shareholders' rights.

The Chapter went on to explain why Iranian lawmaker adopted company law on the model of Europe, as distinguished from the Anglo-American model. It was made clear that, unlike the latter, the former model could successfully penetrate into the Iranian society and could fit effectively with the existing business vehicles and laws, considering the political, economic, religious and legal backgrounds. This divergence between the two systems on their corporate governance structures can further mean that the rule of majority in English corporations will not be as strong as is in its Iranian counterparts. While corporations in the former tend not to have one or few controlling shareholders who could utilise the rule effectively, their counterparts in the latter rely on the presence of such shareholders. A corollary could be the majority/minority

conflict and hence protection of minority shareholders could matter less in the former than in the latter.

In summary, it is possible to conclude that the way in which the rule of majority is justified can affect the majority/minority conflict sharply. While a justification which supports absolute governance of capital majority in corporations can be risky for minority shareholders, the one that justifies majority rule, relying on personality of shareholders, can be risky towards majority shareholders. Meanwhile, both can be inefficient when they are put to use in inappropriate context. In countries like Iran where corporations take finance internally and shareholder control dominates, a relaxed majority rule plus excessive emphasis on protection of minority rights could discourage corporate initiatives. In contrast, such rule could serve efficiently for English companies, as they tend to attract finance externally and have no controlling shareholder. The conclusion is that an acceptable justification is the one that is able to accommodate an appropriate balance of majority/minority rights, considering the context within which the rule works.

Chapter two considered two important factors, general laws and constitutions, which contribute to shape the framework within which the rule of majority works. The former concerned rules that limit companies and their majority shareholders' power as a matter of public order and regulation rather than being a matter of minority protection. The latter concerned with rules that regulate corporate members' relationship through private contracting. These rules can address some of the majority/minority conflicts deriving from abusive exercise of rights by majority shareholders. They generally prevent an unlawful or unconstitutional decision of the majority from being binding on minority shareholders. It must, however, be borne in

mind that they can do so effectively only if they clearly state the framework. Unclear rules can be construed, in the light of the courts' unwillingness to interfere with corporations' internal affairs, in favour of majority shareholders. This aside, general laws and constitutions cannot avoid an abuse of right that may occur where the majority act both lawfully and constitutionally. This inability explains the need for intervention of the law in the majority/minority relationship for the protection of minority shareholders.

Chapter three considered the mechanism of voting through which the rule of majority works. It meant to examine the mechanism in order to show how opportunistic majority shareholders could exert control against minority interests while relying on the majority rule. It was made clear that shareholder control depends on, and can be exerted by, voting which itself relies on share ownership. As the rule is 'one share, one vote', every shareholder will have and exert some degree of control, but principally only those who own majority of shares will be in control of corporations. That means majority shareholders can take decisions that affect minority shareholders and further their judgement will resolve any majority/minority dispute. As a matter of principle, majority control is desirable and necessary, even seen by minority shareholders. It offers some ease to collective action, resolves internal disputes, enables shareholder control over management, encourages financing, and saves corporate as well as public resources. These explain why it is often accepted by contract parties and supported by company laws. It can, however, be risky as to minority shareholders' interests where those in control use the rule of majority opportunistically. By voting to discriminatory resolutions at shareholder meetings, majority shareholders can use it in order to take some private benefits. This can occur in the majority/minority relationship mainly because voting is regarded as right which enables shareholders to exercise it freely.

Majority shareholders while voting can consult with their personal interests with no obligation to accommodate minority interests. The result is that they can simply pass a shareholder resolution which is binding upon minority shareholders and which offers discriminatory benefits to the controlling majority. In summary, the gist of my argument here is to evidence that the mechanism of voting through which the rule of majority works is liable to abuse and such abuse occurs in the light of the element of majority control plus controllers' absolute freedom in exercise of it.

Having observed how the mechanism of voting can be abused, the Chapter also raised the question of how such abuse could be curbed. It considered relevance of company law and other factors which could function, or could have functioned, in order to curb the abuse. The first factor, which was considered, was private contracting. It was explained that the mechanism of majority rule is only a default rule that can be displaced by private contracting. Thus, private contracting can shift away control from majority shareholders. Private contracting is often put in the form of limitations in corporate constitution or shares, which allow deviation from the 'one share, one vote' rule. Nonetheless, such private contracting often only affects the very element of control which means instead of curing abuse of majority control, it simply displaces it. As such displacement can have disproportionate disadvantages, contract parties normally do not want it and as a consequence the use of it is uncommon. The second factor concerned variability of the majority rule. The argument was that it could offer some guarantee to minority shareholders because it prevents the same group from being able to compose the majority rule all the times. Nevertheless, any such guarantee can only be relevant as to corporations that lack a controlling majority. Where one or few shareholders dominate corporations, the factor fails to work. Furthermore, even in the former corporations, dispersion of shareholdings can sometimes serve only to

reduce the degree of control, which means in the light of shareholder apathy and collective action problem some relatively small but active shareholders may be able to exert control constantly. The third factor, which was considered, concerned company law. I explained that company law in both England and Iran are aware of and have been responsive to the possibility of abuse in the exercise of voting right and as a result they both imposed some limitation on majority shareholders which require them to avoid discrimination when voting at shareholder meetings. Nonetheless, as I further explained such limitation could prohibit only clear discriminations while informal discriminations will escape a review. Lastly, the Chapter considered the relevance of institutional shareholders and concluded that they do nothing remarkable as to the majority/minority conflict while they can be relevant as to preventing mismanagement in English large corporations which tend to suffer from weak internal control over corporate management.

Chapter four examined the role of directors as to the majority/minority conflict. It meant to challenge the idea already referred briefly in Chapter two¹ that directors can serve greatly to reduce the likelihood of abuse of rights by majority shareholders. The gist of the idea was to argue that because a great deal of corporate power falls within the discretion of corporate directors who are under duties to exercise power carefully, disinterestedly and impartially, and who are disciplined through market constraints, and whose duties can be enforced by shareholders, there will be a remarkable reduction in the size of any likely abusive exercise of rights by majority shareholders. I generally accepted the idea, but made two comments on it. The first comment

¹ See Chapter two (above, at II.2.1).

concerned mismanagement which can occur in different ways and varying degrees in both English and Iranian corporations. The gist of my comment here was to argue that a concentration of power in the hands of directors should only be allowed where company law, shareholders and the market are able to curb mismanagement effectively otherwise majority abuse can be substituted by managerial abuse whose harms outweighs those of the former. My second comment concerned corporations that are dominated by one or few controlling shareholders. In such corporations, empowering corporate directors can simply serve to facilitate control by majority shareholders. In such corporations, normally the same people hold a majority of shares and managerial positions. Even if different persons hold them, majority shareholders can exert indirect control over management, using the majority rule.

Chapter five considered legal constraints on the majority rule. It concerned examination of limitations and mechanisms in English and Iranian laws that either were designed as a minority shareholder protection or can be used for such purpose. The intention was to see how they respond to the possibility of majority abuse of rights and what are their weaknesses and strengths. Four mechanisms, two common law made and two statutory, were identified as to the English company law. Of them, one mechanism i. e. constraint on voting had already been examined in Chapter three where I showed that the constraint which is a general principle of company law concerns majority abuse of rights which is put in the form of discriminatory resolutions of meetings. While advantageous for addressing formal discriminations, it cannot, however, avoid discriminations which occur informally. The other three were mechanisms devised to target special cases of majority abuse. The first mechanism, the derivative action, concerns obvious cases of fraud; i. e. cases that often involve direct or indirect stealing of the corporate assets or profits by directors who possess shares

enough to hold ownership control of the corporation. Derivative actions cannot cover cases that simply involve negligence or a breach of duties by directors, though they can be used to address a breach of fiduciary duty and negligence which benefits the wrongdoer director. As they are corporate claims, they always require the plaintiff to show the element of wrongdoer control and because the element of control is required, they are often specific to small corporations where a controlling shareholder is normally present. The second mechanism, 'just and equitable winding up' remedy, concerns an abuse of rights by majority shareholders which involves no stealing but is instead so against legitimate expectations of minority shareholders which hurts the core basis of the corporate contract. This is so, even if the controlling shareholder exerts his right lawfully which means a plaintiff is not required to show controllers' fault. Cases that commonly fall within the ambit of the remedy include, but are not limited to, breach of mutual trust, exclusion from management and deadlock situations. The remedy is only suitable for small corporations where shareholders' relationship relies on not only corporate constitution but also mutual trust and legitimate expectations. As a personal remedy, it can sometimes be severe because it dissolves the corporation while nobody wants it so dissolved. The third mechanism, 'unfairly prejudicial conduct' remedy, concerns any unfair disregard of controllers, majority shareholders or directors, from minority interests. It allows minority shareholders to take either corporate or personal claim in respect of any violation done by controllers to constitution and laws as well as their legitimate expectations in the company. Unlike the two other remedies, it has a considerably wider scope. It covers breach of directors' duties without requiring the plaintiff to show the elements of fraud and control. It also covers any unconstitutional acts of controllers that were categorised under the common law as simply an irregular issue. The remedy can also be used as a substitute to the just and equitable winding up remedy for cases like breach of mutual trust,

exclusion from management and deadlock situations which previously fell within the conclusive ambit of the latter.² Yet, like the two other remedies, it is suitable mainly for addressing abuse of rights by majority shareholders in small corporations.

An important advantage of these various remedies that all focus on preventing and responding abuse of rights by majority shareholders has been provision of adequate, relevant and tailored safeguards for protection of rights and interests of minority shareholders in English company law. They generally recognise the link between ownership control and abuse of rights by controllers, which can be direct and indirect and which can occur in various ways and shapes, and hence they provide solutions to prevent such abuse. Their solutions are tailored which means each focusses on specific type or types of abuse and provides relevant solution. As tailored solutions, they are specific to small corporations because large corporations often lack presence of a controlling shareholder and hence they are very unlikely to be liable to abuse of rights by majority shareholders. At the same time, they are inclusive because they provide solutions which are wide enough to cover new forms of abuse. Nonetheless, a criticism, which concerns the most the third mechanism, is that troublesome minorities could now opportunistically outflank the majority rule, as a result of uncertainty which is incurred by the remedy.

² Conway Mark, "Minority Shareholder Protection and the Rule in *Foss v Harbottle*: Increasingly a Foss about Nothing" in 'Companies in the 1990s' edited by Gary Slapper, 1995, London, Cavendish, at pp 13-14; Clark Bryan, "Unfairly Prejudicial Conduct: A Pathway Through the Maze", *Company Lawyer*, (2001), 22 (6), 170, London, Oyez Publishing Limited, at pp 170-171; Clark Bryan, "Unfairly Prejudicial Conduct", *Scots Law Time (S.L.T.)*, (1999), 38, 321, Edinburgh, W. Green & Son Ltd, at pp 321-2.

Majority/minority conflict aside, English company law does not seem very successful at handling shareholder/management conflicts, which dominate English large corporations. It was made clear in Chapters one and four that such corporations tend to have weak internal control which could follow they are more likely to incur mismanagement. Market forces fail to sufficiently discipline negligent managers and company law, by providing impunity for managers who commit mere mismanagement, is too friendly towards them. The reviewed remedies, while good at addressing abuse of rights by majority shareholders in small corporations, are basically irrelevant as to mismanagement that occurs in large companies.

As to the Iranian company law, five mechanisms were examined. The first mechanism, the 'no abuse of right' that is a general principle of law, is potentially capable to cover abuse in the exercise of rights that can occur in various forms and ways in any relationship including the one between majority and minority shareholders in corporations. In practice, however, because of the Islamic law background which limits the scope of it to owners of neighbouring properties' relationships and because the existing Iranian Codes of laws (The Civil Code) define the principle only in such relationship and in the light of an absence of a specific and separate definition in laws relevant to corporations including JSCA, the courts have been reluctant to utilise the principle in its full capacity. The other four mechanisms; i. e. right to convene shareholder meeting, cumulative voting, disinterested ratification, and shareholder action; mainly concern preventing abuse of power by corporate directors and hence are pertinent to the shareholders/directors conflict rather than being minority protections. In summary, Iranian company law, unlike its English counterpart, seems to be less responsive to the possibility of majority abuse of rights, while laying emphasis on preventing abuse of power by directors. It provides some weak and at times irrelevant

mechanisms as to preventing abuse of rights by majority shareholders, whereas most Iranian corporations are dominated by one or few controlling shareholders and should, therefore, inevitably be liable to abuse by the controlling shareholders. At a glance, such low responsiveness of the Iranian company law can seem odd. However, when viewed in its cultural, political and economic backgrounds, as considered in Chapter one, the method of company law can be explained. Attention to minority shareholders' rights could reduce control of the dominating shareholder (the government) over the private sector and could further discourage majority financing. Furthermore, because the government as the dominating shareholder was represented in corporations by its human agents who could generate agency costs, it wanted, through rules of directors' liability, to make sure its agents will stay in line. After all, the very concept of abuse of right (in the sense of imposing a general limitation on the exercise of rights by owners and other persons) was relatively unknown to the Iranian lawmaker who was influenced by the Islamic law teachings. Instead of 'abuse of rights', the question that mattered much for the lawmaker was 'abuse of power' which is found in the relationship between agents and principal and which was well known to the Iranian lawmaker and the Islamic law.

These explanations are no longer forceful. Art 40 of the Constitution of the Islamic Republic of Iran (CIRI) has already offered the potential that 'abuse of rights' which is a modern law concept is recognised. Also Islamic law seems on the move towards recognition of the 'no abuse of right' in a wider sense. Furthermore, the government has recently decided on efficiency reasons, which was considered in Chapters one and four, to reduce its control over the economy and to empower the private sector through adopting and implementing a number of privatization programs. If privatization is that urgent and desirable, then providing political as well as economic securities for

private sector and regulating of shareholders' relationship and in particular provision of adequate minority shareholder protection will become inevitable and forthcoming.

Now that we have learned why and how majority rule is liable to abuse against minority shareholders' rights and interests and further how company laws in England and Iran have responded to such abuse plus what have been their weaknesses and strengths, my intention is to suggest as a conclusion that minority protection mechanisms which exist in the English model and which reflect more than a century experience and achievements of that model on the issue of majority/minority conflict can be worth learning by the Iranian lawmaker. No doubt, such learning does not require the Iranian lawmaker to facilitate a shift in corporate governance structure from its current model to that of the Anglo-American. That is undesirable and unnecessary, though privatization programs are pursued. Any such shift can require massive changes in cultural, socio-economic, political and legal elements, which are very unlikely to occur and which can be inefficient. Comparative research has also shown that none of the models are ideal and the choice for a country is only one of cultural, socio-economic, and political. Also, the fact that the minority protection mechanisms in the English model rely on equity principles which are unknown to the Iranian laws does not thwart the very learning. The gist of these mechanisms is to prevent majority rights being instrumentally abused against minority shareholders and such idea is common to the Iranian laws which use only a different method; i. e. 'no abuse of right' principle; of doing the same thing. In addition to these, such learning relies on elements that are shared between the two systems; i. e. the fact that majority/minority conflict occurs in corporations that are dominated by one or two shareholders and that both systems commonly need to address such conflict. As a result, the reviewed English company law mechanisms which are largely specific to

small companies where dominating shareholders are present can be inspirational to the Iranian company law as to addressing the issue of abuse of rights by majority shareholders in Iranian corporations. They identify actual examples of abuse of rights by majority shareholders and define circumstances under which such abuse can occur. They provide a range of suitable remedies for protection of minority rights in such circumstances and allow the courts to tailor such remedies so as to make them fit with the circumstances of each case whereby to make considered balance between majority rule and minority rights in each given case. They are not, at the same time, exhaustive which means they allow new examples of abuse which the future unfolds to be covered by the existing mechanisms.

Iranian company law is deficient as to the protection of minority shareholders. In summary, it allows directors' faults, however serious, to be ratified by majority shareholders. While excluding a wrongdoer director from voting at shareholder meeting, it only concerns fault that involves self-dealing. It permits shareholders to take corporate actions against negligent directors while failing to avoid ratification of the very cause of action by majority shareholders. Moreover, it fails to prevent informal discriminations that can occur against minority shareholders in corporations and further falls short of capability to avoid unfair exclusion of directors who either hold minority shareholding or represent such shareholdings. Lastly, it fails to offer personal remedies in the form of winding up or buy out orders which can be used by wronged minorities in circumstances where the company is unfairly conducted against minority interests. These deficiencies can be remedied, using the experience of the English company law on minority protection. Inspired by the derivative mechanism, company law can help minority shareholders to avoid ratification of some of more serious faults of directors by majority shareholders. The winding up and unfairly prejudicial

remedies can also be inspirational to the Iranian lawmaker as to providing suitable personal remedies for minority shareholders in certain circumstances. The latter remedy can further be used to allow the lawmaker to define the existing 'no abuse of right' principle in the light of company law and particularly as relevant to solve majority/minority conflicts. Any such definition can generally cover abuse of rights by majority shareholders and faults of directors and can further address the informal discrimination and exclusion from management problems.

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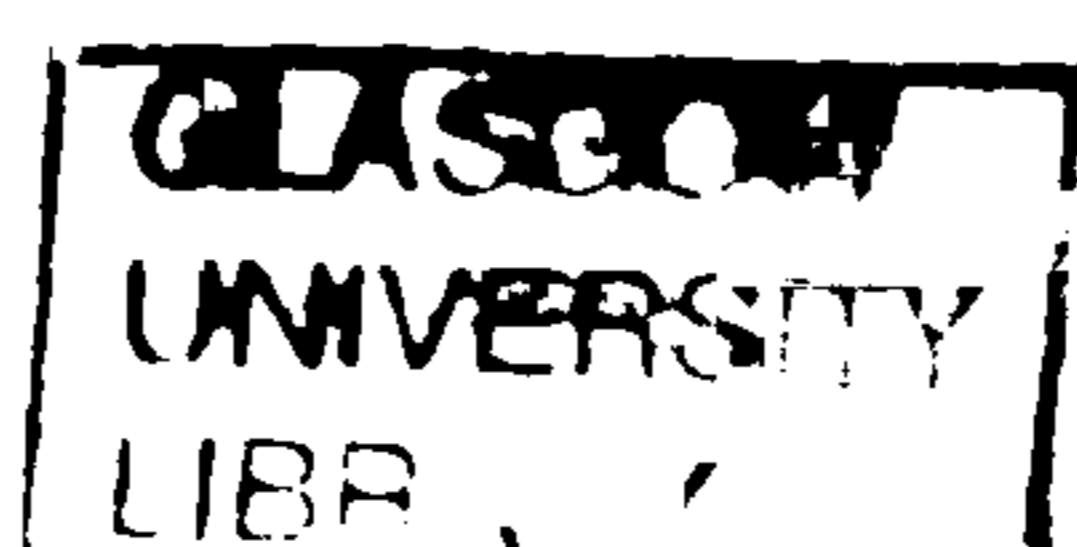
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