The Living Corporate Contract, Hypothetical Bargaining and Minority Shareholder Remedies under English and South African Law

Charl Herman

LLM International Tax Law Student[*]

Abstract

The statutory contract – also known as the corporate contract - under the United Kingdom Companies Act 2006, is the foundation upon which the corporate relationship between the minority shareholders *vis-à-vis* the controllers of the company is governed. However, the statutory contract is unable to provide minority shareholders *vis-à-vis* the controllers of the company, with appropriate remedies in order to protect their underlying interests. This is because it fails to include the legitimate expectations and/or equitable considerations between the two parties, i.e., the minority shareholders and the controllers of the company. In this context, this article refers to the statutory contract as "the living corporate contract" whereby the relationship of the minority shareholders *vis-à-vis* the controllers of the company, is infused with the element of fairness. This is evident, for example, in the problem of tunnelling, where the Companies Act 2006 does not adequately recognise and/or include within its ambit, the detrimental conduct that may be undertaken by majority shareholders in procuring an illicit benefit, at the expense of the company. Therefore, the Companies Act 2006 is in need of urgent reform, in order to more effectively prevent the controlling shareholder from avoiding the underlying obligations under the living corporate contract.

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[*] Charl obtained his LLB (with Distinction) from the University of the Witwatersrand (South Africa, Johannesburg). The author would like to thank Dr Stephen Copp for his comments and guidance in respect of this journal article. The law is stated as at 9 June 2018.

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Corporate law, Corporate remedies, Tunnelling, Living Corporate Contract, equitable considerations

I. Introduction

The central purpose of this article is to re-evaluate the nature of the company's constitution – the statutory contract[1] - under the United Kingdom (UK) Companies Act 2006 (Companies Act),[2] and the remedies provided for breach of minority shareholder 'interests'[3] thereunder. The statutory contract is espoused under section 17 of Companies Act, which contains the company's constitution, that is the company's articles[4] and any resolutions and agreements to which Chapter 3 applies.[5] Moreover, section 33 of the Companies Act seeks to bind the company and the shareholders to the company's constitution, by way of imposing statutory covenants as between the company and each shareholder.

This article will argue that, due to the formalistic and structural nature of the statutory contract - in essence the company's constitution[6] - jurisprudence with respect to minority shareholders' interests and/or remedies has subsequently developed in recent years. This in turn has led to an informal relationship emerging between the minority shareholder(s) *vis-à-vis* the controller(s) of the company. In this context, there exists a 'correlative right'[7] between them, insofar as 'legitimate expectations'[8] and/or 'equitable considerations'[9] arise *inter se*, whereby the exercise of majority power (held by the controllers of the company) *vis-à-vis* the minority shareholder(s), creates a legal obligation to not be in breach of such informal

[1] Alan Dignam and John Lowry, *Company Law* (9th edn, Oxford University Press 2016) 149 (the authors explicitly state that the company's constitution, as consisting of the articles of association, forms part of the statutory contract); see also Stephen Griffin, 'Companies Act 2006 s. 33 – altering the contractual effect of the articles of association?' (2010) 284 Company Law Newsletter 1, 3 (the author states that s 33 of the United Kingdom Companies Act envisages that of a statutory contract); see also Steyn LJ in *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCC 471 (held, the articles of association are of a 'special nature' connoting that of a statutory contract). See also (n 12) below

[2] Companies Act 2006

[3] Derek French, Stephen Mayson and Christopher Ryan, *Mayson, French and Ryan on Company Law* (33rd edn, Oxford University Press 2016) 579 (the word 'interests' encapsulates, at the very least, the members' membership to the company. In this context see *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26; see also *Re a Company (No 004477 of 1986)* [1986] BCLC 376, 379 (as per Hoffmann J (as he then was), the word 'interests' is also recognised as being wider than 'rights'). However, the word 'interests' tends to be associated with the statutory remedy under section 994 of the Companies Act – the unfair prejudice remedy

[4] Companies Act 2006, s 17(a); see also s 18 of the Companies Act which contains the provisions dealing with the company's articles of association (the company's articles of association prescribe the regulations of the company, and thus, is of central importance to the statutory contract under the Companies Act)

[5] Companies Act 2006, s 17(b) (Chapter 3 of the Companies Act deals with resolutions and agreements affecting the company's constitution – see s 29 of the Companies Act)

[6] In this context, see s 33 of the Companies Act

[7] *O'Neil v Phillips* [1999] 1 WLR 1092 (HL) 6 (as per Lord Hoffmann)

[8] ibid (as per Lord Hoffman, who stated that, legitimate expectations are a label for the correlative right 'to which the relationship between members may give rise')

[9] *Ebrahimi v Westbourne Galleries Ltd* [1973] 2 All ER 492 (Lord Wilberforce provides three elements which in essence equate to the 'equitable considerations' category)

'fundamental understandings'[10] under the statutory contract. In this respect, this article makes the thesis that, the use of the words 'legitimate expectations' and/or 'equitable considerations' equally seek to achieve a 'fundamental understanding'[11] of fairness between the controller(s) of the company *vis-à-vis* the minority shareholder(s) – by recognising the underlying purport of these concepts.

Moreover, it is argued that the relationship between the minority shareholder(s) *vis-à-vis* the controller(s) of the company – as found in the statutory contract – is best understood in accordance with the economic and contractarian concept of the 'corporate contract',[12] which for purposes of this article, is called the 'living corporate contract'. This notion of the living corporate contract extends the theoretical underpinnings of the 'corporate contract', by recognising the 'living' 'legitimate expectations'[13] and/or 'equitable considerations'[14] that exist between the minority shareholder(s) *vis-à-vis* the controller(s) of the company. Furthermore, underlying this thesis, it is argued that, the courts are in theory engaging in a form of 'hypothetical bargaining'[15] – for the purpose of completing the living corporate contract - in circumstances where the courts are requested to protect the interests of the company and/or minority shareholder(s) *vis-à-vis* the controllers of the company. This form of hypothetical bargaining undertaken by the courts is underpinned by the legitimate expectations and/or equitable considerations that exists between the minority shareholder(s) *vis-à-vis* the controller(s) of the company under the living corporate contract. In this sense, it is by way of the living corporate contract – being the essence upon which the company is formed – that

[10] *Re Saul D Harrison and Sons plc* [1995] 1 BCLC 15, 19; see also generally *O'Neil v Phillips* (n 7)
[11] *Re Saul D Harrison and Sons plc* [1995] 1 BCLC 15, 19; see also generally *O'Neil v Phillips* (n 7)
[12] Frank H. Easterbrook and David R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 18-9; see also David Kershaw, *Company Law in Context* (2nd edn, Oxford University Press 2012) 85 (Kershaw is of the view that the company's constitution forms a corporate contract, which is evidenced by s 33 of the Companies Act; for the view that the articles of association constitute a 'contract', *Re Saul D Harrison and Sons plc* (n 10) 31 (as per Niel LJ T). However, for a differing view on the nature of the company's constitution, see Paul L. Davies and Sarah Worthington, *Gower: Principles of Modern Company Law* (10th edn, Sweet and Maxwell 2016) 63 (the authors are of the view that the company's constitution is a contract subject to public scrutiny in the company law sense, however, such does not connote a contract in a private contractual sense); see also John Birds and others, *Boyle and Birds' Company Law* (9th edn, Jordan Publishing Limited 2014) 141 (the authors are of the view that, s 33 of the Companies Act envisages a contract that is of a 'special kind', being one that is of statutory import)
[13] *O'Neil v Phillips* (n 7) (as per Lord Hoffman, who stated that, legitimate expectations are a label for the correlative right 'to which the relationship between members may give rise')
[14] *Ebrahimi v Westbourne Galleries Ltd* (n 9) (Lord Wilberforce provides three elements which are in essence equate to the 'equitable considerations' category)
[15] Brian R. Cheffins, *Company Law: Theory, Structure and Operation* (rev edn, Oxford University Press 2008) 264-307 (Cheffins provides an illuminating account of the hypothetical bargaining model); see also Christopher Riley, 'Contracting Out of Company Law: Section 459 of the Companies Act and the Role of the Courts' (1992) 55 Modern Law Review 782, 796-7 (the author recognises that, a separate judicial paradigm is being undertaken by the courts, which is veiled by the hypothetical bargaining model)

provides the 'legitimate expectations'[16] and/or 'equitable considerations'[17] of the minority shareholders *vis-à-vis* the controllers of the company. This corporate relationship may, then, be enforced through statutorily prescribed minority shareholder remedies, in circumstances where the living corporate contract has been breached by the controllers of the company.

This article will, in addition, propose a potential area of reform, by considering South African corporate law, the Companies Act 2008 (**RSA Companies Act**). It will be argued that the UK Companies Act does not adequately prevent controlling shareholders from expropriating minority shareholders' interests by means of 'tunnelling'.[18] In this context, it fails to recognise and include within its statutory protections the pervasive controlling shareholder agency problem,[19] whereby majority shareholders undertake detrimental conduct which severely affects the interests of the minority shareholders, and therefore breaches the living corporate contract.

In undertaking the above, this article will, first, critically evaluate the theoretical underpinnings of the living corporate contract in the context of economic, incomplete contract and hypothetical bargaining theory. Second, the living corporate contract will be critically evaluated in the context of a long-standing and seemingly impenetrable rule of company law, which seeks to entrench majority rule over minority shareholder interests. Third, a critical evaluation in respect of minority shareholder remedies as espoused under the Companies Act will be undertaken, by linking such with the theoretical underpinnings of the living corporate contract. Fourth, this paper will, then, provide a comparative common law perspective of the derivative minority shareholder remedy, by considering the RSA Companies Act, and thereby propose reform of the Companies Act, in order to prevent tunnelling by controlling shareholders.

[16] *O'Neil v Phillips* (n 7) (as per Lord Hoffman, who stated that, legitimate expectations are a label for the correlative right 'to which the relationship between members may give rise')
[17] *Ebrahimi v Westbourne Galleries Ltd* (n 9) (Lord Wilberforce provides three elements which in essence equate to the 'equitable considerations' category)
[18] Maleka Femida Cassim, 'When Companies are Harmed by Their Own Directors: The Defects in the Statutory Derivative Action and the Cures' (Part 1) (2013) 25 South African Mercantile Law Journal 168, 179 (the author explains that, tunnelling is a mechanism whereby controllers of the company expropriate value from a company in respect of shareholding schemes and co-ordination of business activities)
[19] Kershaw (n 12) 646

II. Efficient corporate contracting, incomplete contracts and hypothetical bargaining

The theoretical underpinnings of the living corporate contract are based upon two underlying foundational concepts. First, having regard to the nature of the corporate entity (involving the concept of separation of ownership and control),[20] such consists of a contractual-linkage – or nexus of contracts[21] - between the shareholders, the board and directors of the company, wherein the terms of their relationship is set out under the living corporate contract.[22] Second, in accordance with the tenets of agency theory, contracting is one of the mechanisms used to control the self-interest of directors (the agents), who are recognised as being susceptible to not giving effect to shareholders' (the principals) interests.[23]

Having regard to the above, the living corporate contract (as being a contract underpinned by contractual-linkage and agency theory) recognises that considerations of economic efficiency are of particular importance to the contracting parties when undertaking incorporation (which includes the shareholders, the board and directors of the company).[24] This is so, in that the contracting parties, as economic agents within the market-economy, will tend to pool resources towards their most efficient use as consequence of the voluntary exchange *inter se*, thus resulting in the creation of an *efficient corporate contract*.[25] Moreover, in accordance with economic efficiency considerations, the contracting parties' preferences will be maximised under the living corporate contract – as a result of the freedom to contract in the market economy[26] - although 'externalities'[27] may have to be considered in order to reach a Pareto-optimal outcome.[28]

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[20] See generally Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (rev edn, Transaction Publishers 1999)

[21] See also Michael Jensen and William Meckling, 'Theory of the Firm: managerial behaviour, agency costs and ownership structure' (1976) 3 Journal of Financial Economics 305, 311 (the authors are of the view that the firm is a legal fiction, which consists of a 'nexus of contracts' that gives effect to the corporate relationships therein). For an opposing view on the nexus of contracts theory, see Clare M. S. McGlynn, 'The constitution of the company: mandatory statutory provisions v private agreements' (1994) 10 Company Lawyer 301, 306

[22] Iain Macneil, 'Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) Journal of Corporate Law Studies 107, 109; see also Jensen and Meckling (n 21) 311

[23] Macneil (n 22) 110; see also Jensen and Meckling (n 21) 308-9 (the authors provide an illuminating account of agency theory in the context of the relationships existent in the corporate entity)

[24] Macneil (n 22)

[25] ibid

[26] See also generally Anthony Kronman and Richard Posner (eds), *The Economics of Contract Law* (Boston, Little Brown and Co. 1979)

[27] Macneil (n 22) 111 (Macneil states that externalities result in failed pricing mechanisms, which thus have the effect of the 'side-effects' thereof being passed onto third parties)

[28] ibid

The recognition of the contracting parties that they will undertake *efficient contracting* in the market-economy leads to the resultant effect that, when contracting parties undertake contracting on an efficient economic premise, such will lead to incomplete contracting.[29] This arises when the 'performance of the actual terms of the agreement would leave gains from trade unrealised given the information available to the parties at the time performance takes place'.[30] Incomplete contracting occurs due to high transaction costs involved in the negotiation of detailed provisions in the living corporate contract; such is underscored by the limitations of the contracting parties' cognitive abilities – the problem of bounded rationality[31] - and informational asymmetry of the contracting parties *inter se*.[32] In addition, and giving rise to an incident of incomplete contracting, disputes within the corporate entity will arise when bounded rationality is linked with the self-interested behaviour of agents in the corporate entity (whereby monitoring costs are incurred),[33] including costs associated with collective decision-making and risk-bearing.[34]

In order to remedy the problem of incomplete contracting, the model of 'hypothetical bargaining' is employed for the purpose of 'filling gaps'[35] in the living corporate contract by way of implying 'default rules'[36] therein. Cheffins holds the view that hypothetical bargaining

[29] Robert Goddard, 'Enforcing the Hypothetical Bargain: Sections 459-461 of the Companies Act 1985' (1999) 20 Company Lawyer 66, 68-70; Iain Macneil, 'Contracts: Adjustment of Long-Term Economic Relations under Classical Neoclassical, and Relational Contract Law' (1978) 72 Northwestern University Law Review 854, 865 (Macneil provides that, with respect to long-term contracts, it is the recognition of the existence of gaps and processes in the contract, which is provided for, for the purpose of dealing with inevitable change in the contractual relationship)

[30] Bengt Holmstrom and Jean Tirole, 'The theory of the firm' in Richard Schmalensee and Robert Willig (eds), *Handbook of Industrial Economics* (Elsevier 1989) 61; see also Macneil (n 22) 112; see Andrew Keay and Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors' 32 Melbourne University Law Review 141, 153-4

[31] Goddard (n 29) 68-70; see also Oliver E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 Journal of Law and Economics 233, 241 and 245-6 (Williamson recognises in particular, with reference to long-term contracts, that the problem of bounded rationality renders contracts incomplete)

[32] Holmstrom and Tirole (n 30); see also Gregory Scott Crespi, 'Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm' (2002) 55 Southern Methodist University Law Review 141, 141; see also Keay and Zhang (n 30) 154-5

[33] Henry Hansmann, 'Ownership of the Firm' (1988) 4 Journal of Law, Economics and Organization 267, 277-8

[34] Stephen Copp, 'Company Law and alternative dispute resolution: an economic analysis' (2002) 23 Company Lawyer 361, 373 and 374 (Copp argues that bounded rationality and self-interested behaviour of agents provides a linkage for the purpose of incomplete contractual analysis, however, the author warns against applying such without the necessary circumspection); Hansmann (n 33) (states that, in respect of collective decision-making, the heterogenous interests of the contracting parties has the effect of leading to higher transactions costs, whereas in the case of homogenous interests, transaction costs remain low)

[35] Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules (1989) Yale Law Journal 87, 91 (Ayres and Gertner use the phrase 'filling gaps' to connote the use of default rules to complete the living corporate contract)

[36] Riley (n 15) 787 (Riley provides that default terms will be implied in the contracting parties' agreement where it is silent with respect to certain terms)

'involves thinking about what rational transactors would contract for if they had perfect information, did not face transaction costs, and could be fully confident that the *agreements reached*[37] would be performed as arranged'.[38] Moreover, in accordance with the holdings in *Ebrahimi v Westbourne Galleries Ltd*,[39] Cheffins is of the view that, in applying the 'individualized hypothetical bargaining model',[40] the courts will ascertain the 'expectations and understandings'[41] of the contracting parties, in order to resolve a dispute in question.[42]

III. Breaking the shackles of the Rule in *Foss v Harbottle*

It has been argued in this article that the living corporate contract is the contractual-linkage which governs the commercial relationship between the shareholders, the board and directors.[43] However, the nature of the contractual-linkage in the living corporate contract – as embodying the rights, obligations and interests of the contracting parties – must be considered in light of the leading case of *Foss v Harbottle*.[44] 'The Rule'[45] in *Foss v Harbottle*, according to Lord Wedderburn, encapsulates two notions based on the law relating to the company[46] and partnership principles.[47] In respect of the former, only the company may bring an action where an alleged wrong had been done to the company (the proper plaintiff principle).[48] Moreover,

[37] Cheffins (n 15) 264 (Cheffins refers to the *past tense* when explaining the function and operation of the hypothetical bargaining model)
[38] ibid 264 (Cheffins provides for two forms of hypothetical bargaining, that is, generalized and individual hypothetical bargaining. The former is concerned with hypothetical bargaining premised on the 'category of company participant', whereas in respect of the latter, the focus is on the 'individual', as in theoretically stepping into her shoes under hypothetical bargaining conditions, see 291)
[39] *Ebrahimi v Westbourne Galleries Ltd* (n 9)
[40] Cheffins (n 15) 294 (Cheffins states that, the conduct of the individual contracting parties provides insightful guidance to the analytical process, thus underscoring the author's preference for the use of the individualized version of the hypothetical bargaining model)
[41] Cheffins (n 15) 292-3 (quote as per the holdings of Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd* (n 9))
[42] ibid 293
[43] Jensen and Meckling (n 21); see also Cheffins (n 15) 31 (the author provides an illuminating economic exposition of nexus of contracts theory)
[44] *Foss v Harbottle* [1843] 2 Hare 461
[45] Kenneth W. Wedderburn, 'Shareholder's Rights and the Rule in *Foss v. Harbottle*' (1957) Cambridge Law Journal 194 (Lord Wedderburn provides an illuminating account of the 'Rule' in Foss v Harbottle, and for the purpose of this article the word 'Rule' will imply the material principle discerned from the case); in the context of the Rule, see also Sarah Worthington, *Sealy and Worthington's Text, Cases, and Materials in Company Law* (11th edn, Oxford University Press 2016) 669; see also Davies and Worthington (n 12) 595. For a differing view on Lord Wedderburn's orthodoxy, see Colin Baxter, 'The True Spirit of *Foss v. Harbottle*' (1987) 38(1) Northern Ireland Legal Quarterly 6
[46] Wedderburn (n 45) 196 (Lord Wedderburn states that the law relating to the company is naturally discerned from the foundational principles of treating a company as a separate legal person from its members)
[47] ibid 196-7 (Lord Wedderburn explains how the partnership doctrine adopted by the courts – allowing members to deal with their own squabbles – sprouted to company law)
[48] ibid 195; see also Worthington (n 45) 669

in respect of the latter, the courts will not interfere in disputes between the 'contracting parties'[49] that pertain to the internal affairs of the company (the internal management principle).[50] Nevertheless, according to Lord Wedderburn, the real nature of the Rule in *Foss v Harbottle*,[51] is best understood in the context of its position 'along the boundaries of majority rule'[52] of the company.

In responding to the rigidity of the Rule in *Foss v Harbottle*, the report of the UK Law Commission, which carried out a review of shareholder remedies with particular reference to 'the [R]ule',[53] explicitly recognised that the underlying effect of the Rule could lead to circumstances where the director(s) of the company, who may also happen to be the majority shareholder(s) of the company (controllers of the company), may have committed a wrong against the company,[54] and then, in those circumstances, the minority shareholder is practically unable to bring an action for breach of the living 'corporate contract'.[55] This is so, in that, the wrongdoer director(s) have the indirect constitutional power, by way of majority vote, to avoid litigation by 'the will of the majority of its members' (controllers of the company).[56] Consequently, then, the Companies Act introduced relief for minority shareholders, enabling them to institute a claim by way of the new statutory derivative procedure (for wrongs done to the company)[57] and/or in respect of the long-standing unfair prejudice petition (generally occurs where the majority shareholders subjugate the minority).[58] Notwithstanding, commentators are of the view that, due to the enactment of the derivative claim under the Companies Act, the Rule in *Foss v Harbottle* has either been abolished[59] or superseded by the statutory derivative procedure.[60]

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[49] The original word used by Lord Wedderburn refers to 'members' rather than contracting parties, see Wedderburn (n 45)

[50] Wedderburn (n 45) 197; for a salient discussion of the Rule in *Foss v Harbottle* see also Kathy Idensohn, 'The Fate of *Foss* under the Companies Act 71 of 2008' (2012) 24 South African Mercantile Law Journal 355, 356-7

[51] ibid

[52] ibid 198

[53] Law Commission, *Shareholders Remedies* (Cm 3769, 1997) para 1.1

[54] ibid, para 1.4

[55] See further n 66 for the exceptions under the Rule

[56] Law Commission (n 53) para 1.4

[57] Companies Act, ss 260-64; see French, Mayson and Ryan (n 3) 559

[58] Companies Act, ss 994-99; see ibid French, Mayson and Ryan 575; see also Davies and Worthington (n 12) 662. Note, the unfair prejudice petition had been previously provided for under the previous legislative framework of the UK Companies Act 1989 under s 459 thereof. Moreover, the unfair prejudice petition was first introduced by section 75 of the UK Companies Act 1980

[59] Kershaw (n 12) 669; see also Worthington (n 45) 671 (Worthington holds the view that the Rule has been abolished insofar as it relates to litigation connected to harm done to the company); see also Davies and Worthington (n 12) (the authors hold the view that, the Rule is 'almost entirely' redundant)

[60] David Kershaw, 'The rule in Foss v Harbottle is dead: long live the rule in Foss v Harbottle' (2015) (3) Journal of Business Law 274, 276 (Kershaw takes a somewhat more modest approach as compared to earlier

Nevertheless, taking into account the effect of the Rule in *Foss v Harbottle*, a minority shareholder who seeks to enforce the living corporate contract pursuant to a breach thereunder, is given the unenviable task of having to differentiate between material and non-material breaches.[61] First, where the breach pertains to 'personal rights'[62] of the shareholder which are conferred thereon *qua* member,[63] such rights will be enforceable thereunder.[64] Whereas, in the second instance (non-material breach), the shareholder will not be able to institute a claim for breach , where such falls within the bounds of the internal management rule.[65] In other words, and succinctly put: a claim for breach of the living corporate contract may be instituted by the minority shareholder, in cases where the 'exceptions'[66] to the Rule can be proved.

views, whereby he holds the view that the derivative claim under the Companies Act does not abolish the Rule, but merely supersedes it in application); Davies and Worthington (n 12) 596 (the authors are of the view that, the Rule is laid to rest to the extent that 'statute applies', and therefore the Rule will still be relevant for multiple derivative claims and claims in respect of foreign registered companies, see *Abouraya v Sigmund* [2014] EWHC 277 (Ch) and *Novatrust Ltd v Kea Investments* [2014] EWHC 4061 respectively). However, see *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) [11]-[13] (the Court held that, only in exceptional circumstances, will shareholders be permitted to bring a claim for a wrong done to the company. This decision seems to support the Rule – even if only indirectly); see the differing view in *Bamford v. Harvey* [2012] EWHC 2858 (Ch) [29] (the Court held that, the Companies Act and its underlying import were of particular importance in guiding the Court in respect of how it charters the statutory derivative claim *vis-à-vis* the common law). It is important to note that, the derivative claim under the exception to the Rule in *Foss v Harbottle* – fraud on the minority – suggests that the courts are flexible in recognising the claim. In this context see*, Estmanco (Kilner House) Ltd v. GLC* [1982] 1 WLR 2; see also commentary on the *Estmanco (Kilner House) Ltd v. GLC* in French, Mayson and Ryan (n 3) 405

[61] *Burland v Earle* [1902] AC 83, 93 (PC) (it is a fundamental principle that, the Court will not interfere with the internal management of the company, particularly in circumstances where it has no jurisdiction to do so). Having regard to this context, non-material breaches (tending to the internal management of the company) would be those that do not affect the integrity of the statutory contract, whereas, in respect of material breaches (as per the Rule), such would negatively affect the integrity of the statutory contract

[62] Wedderburn (n 45) 210 (Lord Wedderburn provides for an array of personal rights that would be enforceable under the articles of association which include, amongst others, rights to transfer shares and to vote; and, personal rights to protect preferential rights)

[63] ibid. See also Brenda Hannigan, *Company Law* (4th edn, Oxford University Press 2016) 113. In respect of rights enforced by the shareholder as member see *Hickman v Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch 881, 900; see also *Beattie v Beattie* [1938] Ch 708, 721-722

[64] Wedderburn (n 45) 210

[65] *Taunton v Royal Insurance Co* [1864] 2 H and M 135, 140; see also Wedderburn (n 45) 215; see also Hannigan (n 63)

[66] *Edwards v Halliwell* [1950] 2 ALL ER 1064 (Jenkins LJ held that, the following exceptions under the Rule may be found in cases of: a wholly *ultra vires* act; fraud on the minority; and, matters sanctioned by special majority, noting also that an action might be brought where the personal and individual rights of each member had been invaded, as the Rule had no application where the individual members were suing in their own right to protect their own individual rights as members.); see also Worthington (n 45) 670; see also Wedderburn (n 45) (Lord Wedderburn is of the view that the holding of Jenkins LJ in *Edwards v Halliwell* suggests that the so called 'exceptions' to the Rule are not exceptions at all. Lord Wedderburn further states that only in respect of 'fraud' may such involve an exception in the true sense). For a matter that concerned a litigant's indirect circumvention of the Rule that was subsequently dismissed by the court as constituting reflective loss, see *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 222-3. See also Baxter (n 45) 11 (the author provides an illuminating account of the *Foss v Harbottle* exceptions, particularly in the context of acts which are ultra vires and/or consist of fraud on the minority)

IV. Minority shareholder remedies: the UK Companies Act and informal understandings under the corporate contract

It has been argued so far that the instances where the minority shareholder can enforce its 'interests'[67] under the living corporate contract are narrowly defined to the extent that they do not conflict with the Rule and/or majoritarian constitutional considerations of the company.[68] The Companies Act, however, has widened the scope for a minority shareholder to hold other contracting parties (controllers of the company and/or directors) accountable to the living corporate contract, either, by way of the statutory derivative claim (whereby the cause of action vests in the company)[69] and/or the unfair prejudice petition. Moreover, in order to ascertain the full extent to which minority shareholder protection may be enforced under the living corporate contract, regard will be given to the 'just and equitable remedy'[70] under section 122(1)(g) of the Insolvency Act 1986.[71]

In respect of the statutory derivative claim under section 260(3) of the Companies Act, a minority shareholder may institute a derivative claim (which vests in the company) to the court 'in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'.[72] Importantly, section 260(3) envisages both wrongful *antecedent*[73] and *future*[74] conduct of a director.[75] One of the significant innovations of the statutory derivative claim, is the introduction of the 'two-stage procedure',[76] whereby the decision of litigation - which was previously held by the board and/or the majority of shareholders under the Rule - is now firmly

[67] See n 3 (all citations in footnote 3 or pinpointing a specific reference?)
[68] Davies and Worthington (n 12) 658 (the authors refer to the 'patchy' nature of shareholder protection, in particular with reference to the effects of majority rule); see also Wedderburn (n 45)
[69] Companies Act, s 260(1)(a) (it is important to keep in mind that the derivative claim is that which is vested in the company and not the shareholder)
[70] Birds and others (n 12) 703 (the just and equitable remedy is seen as one that provides a remedy for the minority shareholder)
[71] Insolvency Act 1986. See also Mayson, French and Ryan (n 3) 591-2 (it is important to note that the just and equitable remedy is one that falls under the category of winding-up of the company under the Insolvency Act 1986)
[72] Companies Act, s 260(3); Davis and Worthington (n 12) 599 (the authors hold the view that, the Companies Act only contemplates the statutory derivative claim arising in circumstances where the director breaches his or her duty).
[73] ibid (Companies Act, in particular, set out under s 170-177 of the Companies Act; see Kershaw (n 12) 609; see also s 260(3) of the Companies Act (the word 'actual' relates to conduct already committed)
[74] Companies Act, s 260(3) (the word 'proposed' relates to future conduct)
[75] Kershaw (n 12) 609
[76] *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) [78]-[79] (Lewison J provides an account of the steps the claimant must undertake when invoking the two-stage procedure under the derivative claim)

entrenched within the judicial competency of the courts – once a claim is brought.[77] However, Davis and Worthington are of the view that, the statutory derivative claim follows a 'three-stage' process, nevertheless, the effect is the same.[78]

Therefore, if the minority shareholder can show a *prima facie* case in respect of the claim instituted (first stage),[79] then the court will consider a range of factors under section 263(2) of the Companies Act (second stage),[80] which most notably includes, 'a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim'.[81] If the proposed litigation passes the second stage, then the court *must* take into account all the factors under section 263(3) of the Companies Act before granting permission (third stage).[82] It is important to discern from the underlying statutory scheme that, the statutory derivative claim directly solves the problem identified by the Law Commission, that is the issue of directors (who were also major shareholders) not being held accountable for wrongs committed against the company.[83]

Importantly, the statutory derivative claim removes the litigation decision originally held by the majority (controllers of the company) and bestows such under the juridical competence of the courts.[84] Moreover, in respect of the three-stage procedure of the statutory derivative claim, the courts are given a *judicial discretion*[85] in the Companies Act to consider a *wide-range* of

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[77] Mahmoud Almadani, 'Derivative actions: does the Companies Act 2006 offer a way forward?' (2009) 30(5) Company Lawyer 131, 135

[78] Davies and Worthington (n 12) 601 (the derivative claim involves a three-stage procedure which includes; the making of a *prima facie* case; considering three situations whereby such must be denied; and, the factors that the court must take into account in order to decide whether to proceed with the claim). For a supportive view with respect to the three-stage process, see also Almadani (n 77) 135

[79] The circumstances which may give rise to bypassing the first stage, see *Franbar Holdings v Patel* [2008] EWHC 1534 (Ch) (here the court held that the first stage was passed when the defendants admitted the case was of a *prima facie* nature); see also *Stimpson v Southern Landlords Association* [2009] EWHC 1556 (Ch) (the first stage is bypassed when the court is prepared to hear the first and second stages together)

[80] Davies and Worthington (n 12) 602 (the other factors that the courts will consider relate to a cause of action that *has* or is *yet* to arise, and such was either authorised before and/or ratified since it occurred; in this context see s 263(2)(b) and (c) respectively of the Companies Act)

[81] Companies Act; Davies and Worthington (n 12) 602 (the authors here provide an account of the additional mandatory ground of refusal in cases where the cause of action would be likely authorised and/or ratified by the company, see s 263(b) and (c) of the Companies Act respectively)

[82] Davies and Worthington (n 12) (the authors state that, the statutory derivative claim requires the courts to consider all factors under section 260(3) due to the words used in the statute referring to 'in particular'. Moreover, the factors listed therein are non-exhaustive, see s 263(3) and 268(2) of the Companies Act)

[83] Law Commission (n 53) para 1.4 (in accordance with the Law Commission report, the chief purpose thereof was to deal with the issue of director accountability in circumstances where the director(s) were also major shareholders)

[84] See Almadani (n 77) 135 (the author explains that, due to the bestowal of the litigation decision on the courts, such has created certain safeguards, particularly in respect of speculative unsubstantiated claims of minority shareholders)

[85] Davis and Worthington (n 12) 602 (the authors are of the view, that in the end, the courts are given a discretion to determine whether to grant the derivative claim, particularly when assessing the extent to which the

'non-exhaustive'[86] factors that will be applicable when the dispute is instituted before the court. Consequently, the courts will, then, 'complete'[87] the living corporate contract – as between the company (insofar as the derivative claim vests in the company) and directors, in accordance with *statutorily informed* hypothetical bargaining, as informed by the factors under section 263(3) of the Companies Act.[88]

Moving on, and from a theoretical perspective, the just and equitable remedy and unfair prejudice petition, both seek to solve the mischief of 'the controlling shareholder agency problem'.[89] In this respect, the controllers of the company (majority shareholders who are agents of the company) will use their power of majority rule to benefit themselves – thus extracting controlling shareholder agency costs[90] - under circumstances that are detrimental to the 'interests'[91] of the minority shareholders (the principals).[92] In accordance with the common law, the controlling shareholder agency problem thus resulted in the interests of the minority shareholders being ignored and/or unprotected by way of majority rule[93] - subject to certain exceptions.[94] It is through this lens that the just and equitable remedy and unfair prejudice petition will be evaluated.

Taking into account the above, the just and equitable remedy under section 122(g) of the Insolvency Act, is recognised as being one of the pathways in which a minority shareholder may find legal recourse against the controlling shareholder agency problem.[95] Under this section, a court will grant an order for winding-up the particular company in question, if it 'just

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claim would provide a significant financial contribution and factors questioning the viability of litigation). For a view where the courts have held that, litigation may be pursued in circumstances where potential financial gain is significant, see *Stainer v Lee* [2010] EWHC 1539 (Ch)

[86] Davis and Worthington (n 12) 602 (the authors explicitly state that, the factors that the court must consider in the third stage are non-exhaustive); to ascertain factors applicable in the statute, see Companies Act, s 263(3)

[87] Riley (n 15) 785 (Riley states that, the courts will interpret the 'corporate contract' in the context of judicial construction, veiled in the context of a hypothetical bargaining); see also Cheffins (n 15)

[88] ibid, Riley (n 15). Companies Act (of particular importance is s 263(3)(b) insofar as such dovetails with directors' duties under section 172 of the Companies Act, and is therefore, contingent thereon)

[89] Kershaw (n 12) 646

[90] ibid

[91] *Re a Company* (n 3) (as per Hoffmann J, the word 'interests' is also recognised as being wider than 'rights'.)

[92] Kershaw (n 12) 646

[93] *Shuttleworth v Cox Bros Ltd* [1926] All Rep 498, 502 (in this case the court recognised the principle of majority rule over minority shareholder interests, insofar as it allowed the amendment of the constitution, notwithstanding the bar against amendment antecedent thereto); see also *Allen v Gold Reefs of West Africa Ltd* [1900-03] All ER Rep 746 (in the case, the court tempered the principle of majority rule with that of whether the power exercised at the general meeting is in fact exercised 'bona fide for the benefit of the company' – such was nonetheless easily circumvented); see also *Sidebottom v Kershaw, Leese and Company Ltd* [1920] 1 Ch 154, 162 (CA) (the court upholding the jurisprudence as espoused in *Allen v Gold Reefs of West Africa* as aforementioned); see also Kershaw (n 12) 651, 672

[94] Refer to n 66 (all contents in footnote 66 or pinpointing one source?)

[95] Kershaw (n 12) 672-73

and equitable'[96] to do so. It is noted by Chesterman that, generally, minority shareholders sought an order for the winding-up of the company, so that:

> He can stand beside the barrel of gunpowder with a lighted match in his hands, so to speak, demanding that he get what he wants - which in most cases is simply a good price for his shares - or else everyone, including himself, perishes swiftly and dramatically.[97]

In *Ebrahimi v Westbourne Galleries Ltd*,[98] a case involving a winding-up petition pursuant to a director being removed from the company, Lord Wilberforce held that, in circumstances where a 'closely-held'[99] company is in fact a '*quasi-partnership*',[100] then the 'exercise of legal rights'[101] must be subject to 'equitable considerations'.[102] These 'equitable considerations'[103] impose constraints on the majority – where the company is a *quasi-partnership* - in order to ensure that there is compliance with the *special personal relationship* and/or agreement or understanding between the minority and controllers of the company.[104]

Therefore, the courts are given a *wide judicial discretion*[105]- by way of equitable considerations - to determine the exercise of legal rights under the living corporate contract.

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[96] Insolvency Act, s 122(1)(g)

[97] Michael R Chesterman, 'The Just and Equitable Winding-up of the Small Private Companies' (1973) 36 Modern Law Review 129, 130. A potential ground for operation of the winding-up order is the case of an individual who is in *de facto* control of the company, undertakes conduct to treat it as its own. In this context see the commentary of French, Mayson and Ryan (n 3) 591

[98] *Ebrahimi v Westbourne Galleries Ltd* (n 9)

[99] Amelia Schultz, 'Finding the Right Remedy in Minority Shareholder Oppression Law: A Transnational Analysis of Solutions in Closely Held Corporations' (2017) 26 Transnational Law and Contemporary Problems 499, 500 (Schultz provides that closely held companies are those with a small membership, usually consisting of family, friends and/or close business associates. Moreover, the shares therein are not open to the open market)

[100] *Ebrahimi v Westbourne Galleries Ltd* (n 9) 500 (Lord Wilberforce refers to *quasi-partnerships* as being in substance *partnerships*, notwithstanding the ostensible legal form the company); see also *Strahan v Wilcox* [2006] EWCA Civ 13 [18]-[19] (Arden LJ held that, a company may become a *quasi-partnership* after the formation thereof, and more importantly, refers to the criteria of Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd* as to when a *quasi-partnership* is born)

[101] *Ebrahimi v Westbourne Galleries Ltd* (n 9) 493; see also Chesterman (n 97) 140 (according to the author, the exercise of legal rights connotes 'the rights which arise out of the articles'. Furthermore, the author argues that, the exercise of legal rights pertains to three typical elements; an association or a personal relationship; an agreement or understanding; and, where a contracting participant is removed from management)

[102] *Ebrahimi v Westbourne Galleries Ltd* (n 9) 493

[103] ibid

[104] ibid 492 (Lord Wilberforce provides three elements which in essence equate to the 'equitable considerations' category); see also Chesterman (n 97) 140 (for a supporting view, according to the author, the exercise of legal rights pertains to three typical elements of 'equitable considerations' (my emphasis) which includes; an association or a personal relationship; an agreement or understanding; and, where a contracting participant is removed from management); see also Kershaw (n 12) 666-67

[105] *Ebrahimi v Westbourne Galleries Ltd* (n 9) 496 (Lord Wilberforce explicitly states that, the words 'just and equitable' must not be strictly confined to that of an *Ejusdem Generis* nature, but such maintains its general purposive meaning); see also Dignam and Lowry (n 1) 204 (the authors recognize the remedy confers on the courts a wide discretion to make an order that is just and equitable)

According to Chesterman, 'no agreement or understanding was ever proved'[106] between the litigants in *Ebrahimi v Westbourne Galleries Ltd*, which, therefore, it is submitted, strengthens the case for the view that, the court will ascertain the minority shareholders' interest[107] by completing the corporate contract[108] in the context of hypothetical bargaining, as informed by 'equitable considerations'[109] – even in circumstances when no express and/or oral agreement is proved to be in existence. This undertaking by the courts, to complete the living corporate contract by way of winding-up the company (informed by the notion of equitable considerations argued above), is expressly directed by section 125(2) of the Insolvency Act.[110]

The unfair prejudice remedy set out in section 994 of the Companies Act is most commonly invoked by the minority shareholder in circumstances where the majority shareholders (recall the controlling shareholder agency problem) have undertaken conduct or proposed conduct which is prejudicial to the interests of the minority.[111] The conduct complained of – relating to the affairs of the company[112] - must be both unfair *and* prejudicial.[113] Generally, the order sought by the minority shareholder in such circumstances is an order directing the majority to purchase all the shares of the minority shareholder 'at a price which reflects their proportion of the company's value'.[114]

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[106] Chesterman (n 97) 143

[107] ibid (Chesterman provides a powerful view that the court in *Ebrahimi v Westbourne Galleries Ltd* ignored the overt acts of the majority shareholding director which resisted and/or rejected the finding of an agreement or understanding between himself and the petitioning director. Clearly, the court was fixated on the petitioning director and his ostensible understanding of the alleged relationship that existed between himself and the majority holding director – even if such was misplaced)

[108] Cheffins (n 15) (as understood in the context of the purpose of the hypothetical bargaining model)

[109] *Ebrahimi v Westbourne Galleries Ltd* (n 9) 500 (such include an association formed on a personal relationship; an agreement or understanding for expectations of participation in the management of the business; and restriction on transfer of members' interest)

[110] Section 125(2) provides that if the court "is of opinion – (a) that the petitioners are entitled to relief either by winding up the company or by some other means, and (b) that in the absence of any other remedy it would be just and equitable that the company should be wound up" the court "*shall*" (author's emphasis) make a winding-up order, but subject to the important qualification that "this does not apply if … some other remedy is available to the petitioners and … they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy"

[111] Companies Act, s 994(1)(a); see also French, Mayson and Ryan (n 3) 575; see also Kershaw (n 12) 680; see also Worthington (n 45) 720

[112] *Re Saul D Harrison and Sons plc* (n 10) (as per Niel LJ T remarks that, the conduct must relate to the affairs of the company); see *Scottish Co-operative Wholesale Society Ltd v Meyer and Another* [1958] 3 All ER 66, 75 (as per Lord Morton of Henryton, held that, a restrictive interpretation in respect of the words 'affairs of the company' should not be adopted); see also *Re City Branch Group Ltd* [2005] 1 WLR 3505 (CA) [8] (as per Sir Martin Nourse, the words 'affairs of the company' must be interpreted liberally)

[113] For examples of unfairly prejudicial conduct see *Re Via Servis Ltd Skala v Via Sevis Ltd and another* [2014] EWHC 3069 (Ch) [74] (exclusion from management); see *Re London School of Electronics Ltd* [1985] BCLC 273, 281-2 (diversion of a business opportunity); see *Grace v Biagioli* [2006] 2 BCLC 70, 95 (not paying dividends)

[114] French, Mayson and Ryan (n 3) 575-76; see also Kershaw (n 12) 680

The concept of 'interests',[115] however, has particular significance with respect to the contracting parties under the corporate contract, whereby in *Re a Company*, Hoffmann J (as he then was) held that, the 'interests' of members include so called 'legitimate expectations'.[116] In *Re Saul D Harrison & Sons plc*, Hoffmann LJ (as he then was) held that, the articles of association (forming part of the corporate contract), create a 'personal relationship'[117] between the minority shareholder *vis-à-vis* the controllers of the company, and such gives rise to a 'legitimate expectation' – or correlative right[118] - whereby the exercise of power by the majority will be in accordance with such 'fundamental understanding'[119] and/or 'personal relationship'[120] *inter se*.

However, in *O'Neil v Phillips*,[121] Lord Hoffmann tempered the wording of his formulation from legitimate expectations to 'equitable considerations'.[122] According to Kershaw, Lord Hoffmann's legitimate expectations formulation does not have the same meaning as 'equitable considerations' held in *Ebrahimi v Westbourne Galleries Ltd*,[123] and therefore, should not be confused.[124] Nevertheless, the thesis in this article is defended, in that, with respect to an unfair prejudice petition, the courts will ascertain the parties' 'fundamental understandings'[125] under the living corporate contract, by engaging in hypothetical bargaining, as informed by the 'legitimate expectations'[126] of the minority shareholders *vis-a-vis* controllers of the company, in order to complete the living corporate contract. Even though Lord Hoffmann in *O'Neil v Phillips* had sought to clearly differentiate 'legitimate expectations' from 'equitable considerations', it argued in this article that, when looking at the underlying substance – rather

[115] *Re a Company* (n 3) 379 (as per Hoffmann J, the word 'interests' is also recognised as being wider than 'rights'.)
[116] ibid 379 (as per Hoffmann J, such includes interests exercised in the capacity as a member of the company); see also *Re Saul D Harrison and Sons plc* (n 10)
[117] *Re Saul D Harrison and Sons plc* (n 10) 19
[118] *O'Neil v Phillips* (n 7) (Lord Hoffmann held that legitimate expectations is a label for the correlative right 'to which the relationship between members may give rise')
[119] ibid
[120] *Re Saul D Harrison and Sons plc* (n 10) 19
[121] *O'Neil v Phillips* (n 7)
[122] ibid (as per Lord Hoffmann who was of the view that, by adopting the wording equitable considerations, such did not carry the public law connotations associated with legitimate expectations); see also Davis and Worthington (n 12) 665 (the authors are of the view that equitable considerations is the new language adopted in *O'Neil v Phillips* by Lord Hoffmann); see also Worthington (n 45) 772 (the author is of the view that, irrespective of the reservations placed on the term, legitimate expectations, by Lord Hoffman in *O'Neil v Phillips*, the term is still widely established and no other term has been proffered as being a better option)
[123] Kershaw (n 12) 689 (the author argues that Lord Hoffmann's legitimate expectation formulation distorts the equitable considerations rationale in *Ebrahimi v Westbourne Galleries Ltd* insofar as the latter only seeks to remedy informal understandings in the context of a *quasi-partnership*)
[124] ibid
[125] *Re Saul D Harrison and Sons plc* (n 10) 19
[126] *Re a Company* (n 3) 379 (as per Hoffmann J)

than the express terms - of Lord Hoffmann's views in *Re Saul D Harrison & Sons plc* and *O'Neill v Phillips*; the living corporate contract straddles the limits between the 'fundamental understandings'[127] of the 'legitimate expectations' and/or 'equitable considerations'[128] thereunder, whereby its underlying purport is one that is underpinned by fairness insofar as the Courts shall apply such 'judicially and the content which it is given by the courts must be based upon rational principles'.[129] In essence, the 'legitimate expectations' and/or 'equitable considerations' observed under the living corporate contract, is one that is fundamentally guided by the underlying principle of 'fairness', which finds its very existence in the underlying substance of 'legitimate expectations' and/or 'equitable considerations'.[130] In this respect, Lord Hoffmann held that, fairness is:

> a notion which can be applied to all kinds of activities, its content will depend upon the context in which it is being used. Conduct which is perfectly fair between competing businessmen may not be fair between members of a family. In some sports it may require, at best, observance of the rules, in others ("it's not cricket") it may be unfair in some circumstances to take advantage of them. All is said to be fair in love and war. So the context and background are very important.[131]

V. Proposed reform: South African law and the controlling shareholder problem of tunnelling

It will be recalled that under the Companies Act statutory derivative claim a minority shareholder may institute a claim (which vests in the company) when a cause of action arose

[127] *Re Saul D Harrison and Sons plc* (n 10) 19
[128] In this context, see the underlying purport of both legitimate expectations and equitable considerations. *Ebrahimi v Westbourne Galleries Ltd* (n 9) 492 (Lord Wilberforce provides three elements which in essence equate to the 'equitable considerations' category); see also Chesterman (n 97) 140 (for a supporting view, according to the author, the exercise of legal rights pertains to three typical elements of 'equitable considerations' [emphasis added] which includes; an association or a personal relationship; an agreement or understanding; and, where a contracting participant is removed from management); see also Kershaw (n 12) 666-67. *O'Neil v Phillips* (n 7) (as per Lord Hoffmann who was of the view that, by adopting the wording equitable considerations, such did not carry the public law connotations associated with legitimate expectations); see also Davis and Worthington (n 12) 665 (the authors are of the view that equitable considerations is the new language adopted in *O'Neil v Phillips* by Lord Hoffmann); see also Worthington (n 45) 772 (the author is of the view that, irrespective of the reservations placed on the term, legitimate expectations, by Lord Hoffman in *O'Neil v Phillips*, the term is still widely established and no other term has been proffered as being a better option)
[129] *O'Neil v Phillips* (n 7) 5
[130] See further n 128
[131] *O'Neil v Phillips* (n 7) 5

as a result of the *directors*' wrongs.[132] However, under South African law, section 165 of the RSA Companies Act provides that a court may 'grant leave'[133] to the minority shareholder in order to institute a 'derivative action'[134] for the purpose of protecting 'the legal interests of the company',[135] if such an action *would*, *inter alia*, be in the best interests of the company'.[136]

Having regard to this, an important feature of the RSA Companies Act – in recognising the controlling shareholder agency problem identified above – is when instituting a derivative action against the 'controllers of a company'[137] (majority shareholders), the derivative action is 'indirectly' presumed as being in the best interests of the company (taking into account its overall statutory effect).[138] The underlying policy rationale of this statutory scheme is the recognition that majority shareholders are not always actively involved in the business of the company (particularly as in the capacity of a director in a *quasi-partnership*), however, the

[132] Companies Act, s 260(3).
[133] RSA Companies Act, s 165(2)(d)
[134] ibid, s 165
[135] ibid, s 165(2)
[136] ibid, s 165(5)(b)(iii); other factors to be considered, see s 165(2) (the service of demand (by the minority shareholder) on the company to institute legal proceedings to protect its interests; see also s 165(4) (the company must have failed to take any steps); see also 165(5)(b)(i) (good faith requirement); see also s 165(5)(b)(ii) (materiality requirement); see *TWK Agriculture Ltd v NCT Forestry Co-Operative Ltd* 2006 (6) SA 20 (N) (the South African courts recognise that, the derivative action is undertaken for the purpose of protecting the interests of the company and accordingly vests therein); see also *Da Silva v CH Chemicals* 2008 (6) SA 620 (SCA) (the Supreme Court of Appeal of South Africa held that the granting of leave to institute a derivative action must be in the best interests of the company. Moreover, this requirement will overlap with the element of good faith); see also Cassim 'Part 1' (n 18) 178 (the author explains that, the RSA Companies Act generally views a derivative action as being 'not' in the best interests of the company, except in circumstances where the minority shareholder can induce evidence that such *is* in the best interests of the company); see also Maleka Femida Cassim, 'The Statutory Derivative Action Under the Companies Act of 2008: The Role of Good Faith (2013) 130 South African Law Journal 495, 501 (Cassim provides a commentary of the five factors under the RSA Companies Act that the courts will consider in order to grant leave to institute the derivative action); see also Farouk HI Cassim (ed), *The Law of Business Structures* (2nd edn, Juta and Co Ltd 2013) 423-29 (for a general overview of the derivative action from a South African law perspective); see also Dennis Davis and Walter Geach (eds), *Companies and Other Business Structures* (3rd edn, Oxford University Press: Southern Africa 2013) 295-99 (for a general overview of the derivative action from a South African law perspective)
[137] RSA Companies Act, s 2(2)(a)(ii) (the concept of control is defined therein and therefore captures within its scope the underlying import and/or effect of the 'controllers of the company'. Generally, controllers of the company, directly or indirectly exercise the majority voting rights in the company. This, therefore, accords with and/or is within the scope of section 2(2)(a)(ii) of the RSA Companies Act)
[138] The use of the word 'indirect' seeks to bring to light the underlying effect and/or purport of the statutory scheme under the RSA Companies Act; see also Cassim, 'Part 1' (n 18) 178 (the author explains the scenario whereby the RSA Companies Act views the imposition of seeking leave for purposes of the derivative action, as 'not' being recognised in the best interests of the company (rebuttable presumption). The minority shareholder will have provided evidence to rebut the presumption that such *is* in the best interests of the company. The rebuttable presumption *does not* apply where the controllers of the company prevent the minority shareholders from bringing the derivative action in circumstances where it can be shown that such *would* be in the best interests of the company); see also Maleka Femida Cassim, 'When Companies are Harmed by Their Own Directors: The Defects in the Statutory Derivative Action and the Cures' (Part 2) 25 South African Mercantile Law Journal 301, 301 (Cassim is of the view that, the presumption operating as a protection for directors' duty-breaking conduct (not in best interest to pursue the derivative action), should be given less weight by the courts)

majority shareholders may be able to manipulate the board and/or directors to their will (reinforcing the classic agency problem).[139]

Therefore, this 'indirect' statutory effect under the RSA Companies Act serves to safeguard against 'tunnelling', which occurs when a dominant shareholder – who controls an intricate web of shareholdings in public companies – co-ordinates the business of the company by manipulating the board, in order to procure a number of contracts and inter and/or intra-group transactions therefrom,[140] for the sole purpose of seeking to tunnel financial resources and/or assets to its intricate corporate portfolios.[141] According to Cassim, these intra-group transactions – by way of tunnelling – may:

> … be used to expropriate the minority shareholders of the company, by transferring or siphoning off or 'tunnelling' resources out of the company to the controlling shareholder. Tunnelling could even entail the payment of grossly inflated salaries and compensation to the majority shareholders. Dominant shareholders may thus opportunistically divert corporate value or wealth to themselves.[142]

Although, it is acknowledged that, in the context of UK public companies, there are generally widely dispersed shareholdings,[143] it is submitted that, the mechanism of tunnelling reveals a significant statutory weakness in the Companies Act, which could be opportunistically exploited by dominant shareholders. Clearly, the statutory derivative claim under section 260(3) of the Companies Act, only directly captures within its ambit a cause of action arising from the conduct by the *director*,[144] and *not* the controlling shareholder (particularly where the controlling shareholders seek to manipulate the board). Therefore, a potential area for statutory reform, would be to amend 260(3) of the Companies Act, to include a cause of action arising out of 'tunnelling' conduct by the *controlling shareholder*,[145] which would, then, 'catch' those controlling shareholders under the statutory derivative claim.

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[139] Cassim, 'Part 1' (n 18)
[140] ibid 179
[141] ibid; see also Kershaw (n 12) 703-704 (the author identifies this problem in respect of listed companies)
[142] Cassim 'Part 1' (n 18) 179
[143] Brian R. Cheffins, 'Minority shareholders and Corporate Governance' (2000) 21(2) Company Lawyer 41; see also the Office for National Statistics, 'Ownership of UK Quoted shares: 2016' <https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016> accessed 27 June 2018 (according to the Office for National Statistics, in 2016 UK quoted shares are owned by 53.9% of the world (outside the UK), whereas UK individuals own 12.3% of the quoted shares in the UK. UK Unit trust own 9.5% of the quoted shares, financial institution owns 8.1% and insurance companies own 4.9%).
[144] Companies Act, s 260(3) and (5)
[145] ibid, s 260(3) (see wording for context). Another important question arises in this regard, that is, whether the controlling shareholder may be considered as a 'shadow director' under the Companies Act. For purposes of scope and brevity, this question is not considered here

Moreover, the introduction of an 'indirect' presumption into the statutory framework of the Companies Act in favour of the minority shareholder(s), will tip the scales in favour of minority shareholder(s) interests under the living corporate contract – even if only for presumptive purposes.[146] These remedies will ensure that, minority shareholders have a directly applicable path to procuring relief from controlling shareholders, without having to undergo alternative litigation strategies (see below).

Under the Companies Act it is possible that corporate remedies which are statutorily situated within the context of the statutory derivative claim may be granted under the unfair prejudice remedy.[147] Theoretically, because of the failure under section 260(3) of the Companies Act to include and/or recognise the issue of 'tunnelling' within its ambit, a minority shareholder could petition under section 994 (unfair prejudice) instead to procure corporate relief,[148] particularly where such cause of action has 'indirectly wronged' the minority shareholder.[149] However, there may be a conflict with respect to the principles of reflective loss in that no shareholder(s) may sue company Z, where such losses merely reflect the losses sustained in company X (shareholders' interest), in which case, company X is the proper plaintiff to sue company Z.[150] Nevertheless, it is submitted that, taking into account the current statutory deficiency under the Companies Act, a minority shareholder may institute a claim for tunnelling under the unfair

[146] In this context, take note of the position under the Companies Act where the minority shareholder must first show a *prima facie* case before bringing the statutory derivative claim; see the circumstances which may give rise to bypassing the first stage of the statutory derivative claim under the Companies Act, see *Franbar Holdings v Patel* [2008] EWHC 1534 (Ch) (here the court held that the first stage was passed when the defendants admitted the case was of a *prima facie* nature); see also *Stimpson v Southern Landlords Association* [2009] EWHC 1556 (Ch) (the first stage is bypassed when the court is prepared to hear the first and second stages together)

[147] See the words used in the Report of the Jenkins Committee, which intimated that minorities are 'indirectly wronged' when a wrong is done to the company, in instances where litigation is prevented by the majority, see Report of the Company Law Committee, Cmnd 1749 (1962) (Jenkins Committee) para 206; see *Anderson v Hogg* 2002 SLT 354 IH (where relief was granted to the company); see also *Clark v Cutland* [2004] 1 WLR 783 CA (unauthorised money payments were ordered back to the company in the context of a derivative action instituted initially by petition); see also the important case of *Bhullar v Bhullar* [2004] 2 BCLC 241 (the court ordered relief to the company and not in accordance with the order sought under the petition). In *Re a Company* (No. 5287 of 1985) [1986] 1 WLR 281 and *Re Stewarts (Brixton) Ltd* [1985] BCLC 4 (here the courts accepted that the availability of the statutory derivative claim is not a bar to an unfair prejudice petition). However, for an extensive discussion of the issue see the persuasive judgement of the Court of Final Appeal of Hong Kong in *Kung v Kou* [2004] 7 HKCFAR 579 (here the court held in the negative that the unfair prejudice petition could not be used to outflank the Rule in *Foss v Harbottle*). Davies and Worthington (n 12) support Kung v Kou and conclude that the unfair prejudice petition is normally confined to relief for harm personal to the minority shareholder. See Davies and Worthington (n 12) 678

[148] *Anderson v Hogg* (n 147), *Clark v Cutland* (n 147) and *Bhullar v Bhullar* (n 147) (see cases for instances where the courts have been able to grant relief to the company under the premise of an unfair prejudice petition)

[149] Jenkins Committee (n 147); see also Davies and Worthington (n 12) 674

[150] *Prudential Assurance Co Ltd v Newman Industries* (n 66) 222-3; see also *Johnson v Gore Wood and Co* [2002] 2 AC 1; see also *Stein v Blake* [1998] 1 All ER 724 (the court dismissed the claim of the shareholder, insofar as the loss was merely reflective – the loss caused to the shareholder was merely reflective of the companies' loss)

prejudice petition, where such loss does not reflect the losses of the company.[151] Given the complexity of the issues that arise, however, it is submitted that the reforms submitted above are the preferable solution.

VI. Conclusion

It has been argued in this paper that the corporate contract[152] is the fundamental embodiment of the interests,[153] legitimate expectations[154] and/or equitable considerations[155] of the contracting participants in the company. It is submitted that, when considering the underlying purpose of the minority shareholder remedies above, the central objective that is sought to be achieved, is to provide legal meaning to the relationships and interests existent under the corporate contract, particularly in cases where the minority shareholder and/or the company seeks relief *vis-à-vis* the controllers of the company.

In giving effect to the above, the courts will evaluate and complete the living corporate contract under hypothetical bargaining,[156] either by *statutorily informed* considerations, or in accordance with the legitimate expectations and/or equitable considerations arising thereunder. An area of reform identified and proposed is the recognition of the problem pertaining to tunnelling by majority shareholders; accordingly, it is submitted that, section 260(3) of the Companies Act be amended. In a globalised business community, it is unacceptable for controlling shareholders to subvert minority shareholders' interest by way of tunnelling - thus warranting urgent reform.

[151] *R P Howard Ltd v Woodman Matthews and Co* [1983] BCLC 17; see also Dignam and Lowry (n 1) 181 (here the authors cite the case of *Atlasview Ltd v Brightview Ltd* [2004] EWHC 1056 (Ch), whereby the court dismissed the argument that claims for reflective loss fell outside the scope of section 994 petitions under the Companies Act)
[152] See n 12
[153] See n 3
[154] See n 8 and n 122
[155] See n 14, n 102-104 and n 109
[156] See n 15, n 38 and n 40

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