1 The rule in *Foss v. Harbottle*

**Introduction**

This chapter is concerned with the rule in *Foss v. Harbottle*. The chapter explores the historical origins and subsequent evolution of a rule whose principal effect is to bar minority shareholders’ actions. The treatment of minority actions by exception to the rule, or lying beyond its scope, is the subject-matter of Chapter 2. Chapter 3 is concerned with a proposed statutory derivative action. This is intended to reform defects in the common law shareholder’s derivative action.

Inevitably, as part of the process of exploring the conceptual thinking on which the rule in *Foss v. Harbottle* rests, as well as the judicial policies it expresses, this chapter will begin to open up some of the themes that will be explored more fully in Chapters 2 and 3. Chapter 1 also explores the slow process of reforming the rule and the factors which appear to have inhibited both the judiciary and the Department of Trade and Industry in undertaking that task of reform. The particular difficulties that beset the use of the derivative action against directors and other wrongdoers in public listed companies are also considered in Chapter 1.

Relying on certain judicial decisions and dicta early in the last century, some academic writers have put forward a seemingly attractive solution to the problems posed by the rule in *Foss v. Harbottle*. This takes the form of invoking the provisions of the membership contract contained in what is now section 14 of the Companies Act 1985. The question this theory raises is how far it can be reconciled, if at all, with the general body of case law associated with the rule in *Foss v. Harbottle*.

This chapter concludes with a review of some reflections found in the writing of corporate law theorists on the significance of shareholder

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1 (1843) 2 Hare 461.
2 E.g. ‘fraud on a minority’ and ‘wrongdoer control’. Cross-references in the footnotes indicate where further examination occurs.
3 This is an important issue that goes to the heart of the matter in determining the role of shareholders’ actions as a mode of civil redress in policing corporate abuse. This issue is further explored in Chapters 2 and 3.
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litigation in the general system of corporate governance. In Chapter 2, the shareholders’ action will be examined in the context of American and European law.

The origins of the English rule in Foss v. Harbottle

The origin of what is now known in English law as the rule in Foss v. Harbottle can be traced to some early-nineteenth-century decisions in the law of partnership. In the previous century, it had been established that the Chancellor would not interfere in the internal disputes of a partnership ‘except with a view to a dissolution’. Since harmony between partners is not to be had by decree, equity would not act in vain. In the early nineteenth century, however, the Chancellors relented from their previous refusal to intervene except with a view to dissolution. The old rule was restated in a form better adapted to the needs of the increasing number of unincorporated joint stock companies. Now it was only in the case of ‘matters of internal regulation’ that the Chancellor would refuse to act except with a view to dissolution.

In one of the earliest of these cases, Carlen v. Drury, the Chancellor declined to interfere because the articles of ‘partnership’ provided a very effective internal remedy for mismanagement. Under these articles the general meeting had annually to appoint a committee of twelve, which had the power to report to a subsequent general meeting called by them on any misbehaviour by the managers. The plaintiff members had made no attempt to seek redress in this way, but Lord Eldon made it clear that the ‘refusal or neglect of the committee to act’ in a case of delinquency ‘clearly made out’ might raise a case ‘for prompt and immediate interference’. It should be noted that as yet no mention is made of the principle of majority rule. Lord Eldon simply declined to intervene ‘before the parties have tried that jurisdiction which the articles themselves have provided’.

4 The English theoretical literature in respect of the unfair prejudice petition is examined in Chapter 4.
6 This rule, and the Foss v. Harbottle rule which grew out of it, were entirely creations of the Chancellor. The Chancellor had acquired almost exclusive jurisdiction over internal disputes in partnerships and companies. In the case of companies, this jurisdiction was originally founded upon the trust created by the deed of settlement and, at a later date, upon the remedies sought and the fiduciary duties of the directors.
7 (1812) V & B 154. See also Waters v. Taylor (1807) 15 Ves 10; Ellison v. Bignold (1821) 2 Jac & W 503 at 511.
8 (1812) V & B 154 at 159.
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Although the extent of the majority’s power to ratify has not yet been explored, the majority were already conceded a right to jurisdiction over any ‘internal’ dispute.

It is not a matter of chance that, while the Chancellor applied a general rule of non-intervention to every type of partnership, this rule took the particular form described above only in the case of joint stock companies. In such companies, with a large and fluctuating membership, ownership was already considerably divorced from management. Shares were in practice freely transferable and an internal procedure for remediing grievances was frequently provided. In *Carlen v. Drury* itself, though the parties were termed ‘partners in a joint concern’, the articles allowed as many as 1,600 persons to become partners, and 300 of them brought the action. The social and economic character of such an undertaking was clearly very different from that of an ordinary ‘private’ partnership. In the form in which the old rule was still applied to such partnerships it bears a far more tenuous resemblance to the *Foss v. Harbottle* rule as it later developed. In a ‘private’ partnership there was never any question of an aggrieved partner first seeking a remedy within the partnership even if he were in a minority. The Chancellors simply refused to intervene in ‘partnership squabbles’ or ‘mere passing improprieties’. However, by the early nineteenth century, the Chancellor would grant relief without insisting upon a dissolution where to do so would be of advantage only to the wrongdoer.  

A major advance in the law in regard to minority shareholders was marked by the decision in *Foss v. Harbottle* which transformed the old partnership rule into one of the leading principles of modern company law. Though the case concerned a statutory company created by private Act, the decision came just before Gladstone’s Act of 1844 extended the right to incorporate to ordinary trading companies by simply registering their deed of settlement. The courts had now to apply a quasi-partnership rule in a corporate setting.

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9 It was not until many years later that the courts recognised the essential legal difference between a partnership and an unincorporated company. See James LJ in *Re Agricultural Insurance Co.* (1870) 5 Ch App 725.  
10 See, for example, *Marshall v. Colman* (1820) 2 J & W 266.  
11 *Smith v. Jones* (1841) 4 Beav 503.  
13 See (1843) 2 Hare 461 at 494–5. See further *Moseley v. Atton* (1847) 1 Ph 790; and *Bailey v. Birkenhead Railway* (1850) 12 Beav 433 at 441.
In his judgment in *Foss v. Harbottle*, Wigram VC followed the older cases on unincorporated companies by insisting that the minority must show that they had exhausted any possibility of redress within the internal forum. Some notion of majority rule had been implicit in the earlier cases, but Wigram VC was the first to state plainly that the court will not intervene where a majority of the shareholders may lawfully ratify irregular conduct. This is a somewhat circular argument. On the other hand, his judgment implies that where it is futile to hope for action by the general meeting a suit may nevertheless be brought by the minority even for matters which might in law be ratified by the majority. On this last point, the rule was to become even more unfavourable to the minority. It was later established that the *Foss v. Harbottle* rule barred a minority action whenever the alleged misconduct was in law capable of ratification, whether or not an independent majority would ever be given a real opportunity to consider the matter.15

Wigram VC’s judgment is also notable for his discovery of an entirely new principle to support that of majority rule. For in the corporate character of the company he found a second ground for restricting minority actions. Since an incorporated company was the ‘proper plaintiff’ in any action concerning its rights or its constitution, it would only be very exceptionally in the case of grave abuse that a minority might be allowed to sue in their own name by joining the company as defendant. This principle, that the company itself was the proper plaintiff in proceedings concerning its rights, was closely linked with the discretion exercised by the courts of equity over the use of the representative form of action. It was to have a considerable influence upon the later Victorian judges in adopting an increasingly restrictive attitude to minority actions for breach of the articles or breach of duty by directors.

In the decade following *Foss v. Harbottle*, the scope of the exceptions to the rule was only vaguely indicated. The task of defining the exact extent of the exceptions to the rule was to be the work of later generations of judges. On the other hand, the more obvious implications of Wigram VC’s judgment were soon to be drawn. Where, as in *Mozeley v. Alston*, the majority were alleged to be of the same opinion as the complaining minority, there was ‘obviously nothing to prevent the company from filing a bill in its corporate character’.16 Conversely, where the general meeting

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14 See (1843) 2 Hare 461 at 494–5. See further *Mozeley v. Alston* (1847) 1 Ph 790; and *Bailey v. Birkenhead Railway* (1850) 12 Beav 435 at 441.
15 See, for example, *MacDougall v. Gardner* (1875) 1 ChD 13 at 25. However, a wider view was still being taken by Jessel MR in *Russell v. Wakefield Waterworks* (1875) LR 20 Eq 474 at 482.
16 (1847) 1 Ph 790 at 800. See also *Exeter & Crediton Railway Co. v. Butler* (1847) 5 Rail Ca 211; and *Edwards v. Shrewsbury Railway* (1848) 2 De G & S 537.
The rule in *Foss v. Harbottle* had already sanctioned the conduct complained of by the minority, it only remained to decide whether the majority were legally entitled to ratify that particular kind of misconduct; the court might address itself to this matter at once and would not insist on a prior application to the body of the shareholders.\(^{17}\) This was the first step in a gradual process by which the English courts ceased to require that the minority’s complaint be referred first to the general meeting. In other respects, however, the English rule was to become more, not less, exacting.

**Judicial analysis of the rule**

In some cases in the late nineteenth century and in the following century, the courts attempted to do more than apply the rule or limit its application by defining exceptions to it. It has been seen, in the historical account of its gradual evolution given above, that the genesis of *Foss v. Harbottle* was an equitable rule of partnership law modified to meet the needs of joint stock companies. It has been said by an Australian judge that a modern registered company ‘is a hybrid growth’. It is ‘a partnership which has been invested with the character of a corporation, and the rules which are applicable are partly referable to both characters’.\(^{18}\) This ‘hybrid growth’ is reflected in the hybrid character of the *Foss v. Harbottle* rule itself. It consists of two complementary ‘arguments’ or ‘grounds’. From the first\(^ {19}\) the courts stressed the close link between these two interrelated principles: (1) the right of the majority to bar a minority action whenever they might lawfully ratify alleged misconduct; the fact that misconduct was of a kind that was ratifiable was also a bar; and (2) the normally exclusive right of the company to sue upon a corporate cause of action.

The numerous judicial *dicta*\(^ {20}\) combining these two ‘arguments’ for the *Foss v. Harbottle* rule in a single statement of principle strongly suggest their interdependence. What is not clear is whether the connection between them is one of logic, or whether it is simply an association of ideas hallowed by repetition. It is only to be explained by the ‘hybrid’ origins of both company law and the rule in *Foss v. Harbottle*. In the leading case of *Edwards v. Halliwell*,\(^ {21}\) Jenkins LJ made an attempt to elucidate the precise relationship between the ‘majority rule’ and the ‘proper plaintiff’ aspects

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\(^ {17}\) Lord *v. Copper Miners* (1848) 2 Ph 740.

\(^ {18}\) Australian Coal & Shale Employers’ Federation *v. Smith* (1938) 38 SR (NWS) 48 at 53.

\(^ {19}\) See *Foss v. Harbottle* (1843) 2 Hare 461 at 491–7.

\(^ {20}\) See, for example, *Foss v. Harbottle* (1843) 2 Hare 461 at 491, 492 and 494–5; *Mozeley v. Alton* (1847) 1 Ph 790 at 800; *Burland v. Earle* [1902] AC 83 at 93; and *Pavlides v. Jensen* [1956] 7 Ch 565 at 579.

\(^ {21}\) [1950] 2 All ER 1064 at 1066.
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of the rule. He contended that the will of the majority, *vis-à-vis* the minority, is to be identified with that of the company. Consequently, to say that the company is *prima facie* the proper plaintiff in actions concerning its affairs is only another way of saying that the majority, within the limits of their power to ratify, have the sole right to determine whether or not a dispute shall be brought before the courts.

The weakness of this otherwise attractive explanation is that, in the cases of breaches of duty by directors, it is not enough for the minority to show that the majority could not lawfully ratify what has been done. In order to bring themselves within the fraud on a minority exception, categorised by Jenkins LJ as the only true exception to the rule, it must be further shown that the alleged wrongdoers are in control of the company. Here then the notion of the company as ‘the proper plaintiff’ has acquired a force of its own quite independent of the majority’s power to ratify. It will be seen in the following chapter that as this point the *Foss v. Harbottle* rule is most open to criticism as being unjustifiably restrictive.

**Judicial policies justifying the rule**

Whatever the relationship between the ‘partnership’ and ‘corporate’ aspects of the *Foss v. Harbottle* rule may be at the level of conceptual analysis, as practical policy arguments in favour of the rule they are clearly not self-evident. In the latter part of the nineteenth century, some judges attempted to explain the real policies that the rule was intended to serve. In *Gray v. Lewis*, James LJ justified the principle that any ‘body corporate’ is the proper plaintiff in proceedings to recover its property by pointing to the obvious danger of a multiplicity of shareholders’ suits in the absence of such a rule as *Foss v. Harbottle*. Every member would be able to sue any director, officer or shareholder alleged to have enriched themselves at the company’s ‘expense’. There might be as many bills in equity as there are shareholders multiplied into the number of defendants. This situation would be aggravated where suits were discontinued at will, or dismissed with costs against plaintiff shareholders with the plaintiff shareholders unable to meet those costs.

23 See, for example, *Pavlides v. Jensen* [1956] 1 Ch 565 at 575.
24 See Chapter 2, p. 27 below.
25 (1873) 8 Ch App 1035 at 1051.
26 See *La Compagnie de Mayville v. Whitely* [1896] 1 Ch 788 at 807; *Mozley v. Altoun* (1847) 1 Ph 790 at 799; and *Lord v. Copper Miners* (1848) 2 Ph 740.
cope with this problem by exercising its powers to stay and consolidate actions.²⁷

Another argument, and one at first sight much stronger, in support of the rule is advanced by Mellish LJ in MacDougall v. Gardiner.²⁸ If ‘something has been done irregularly, which the majority are entitled to do regularly, or if something is done illegally which the majority of the company are entitled to do legally, there can be no use having litigation about it the ultimate end of which is that a meeting is called and them ultimately the majority gets its wishes’. Doubtless it is futile to allow the minority to sue where the majority have the retrospective power, by ratifying what has been done, to nullify any decision that a court may give in favour of the minority. Granted the majority’s power to ratify all but the gravest forms of abuse, this is certainly a much more compelling argument than the supposed danger of a ‘multiplicity of actions’.

There are still, however, two obvious flaws in this defence of Foss v. Harbottle. First of all (as has been seen already), it fails to take account of the fact that it is not sufficient in every case to show that the misconduct then alleged is incapable of ratification. Where the minority rely upon the ‘fraud on a minority exception to the rule’ in bringing a derivative action, it is not sufficient to show a serious non-ratifiable breach of directors’ duties; they must further prove that the wrongdoers still legally control the company. As will be seen in the next chapter,²⁹ it is this additional hurdle that is the aspect of the Foss v. Harbottle rule that is most open to criticism.

The second flaw is Mellish LJ’s defence of Foss v. Harbottle in that the distinction he implies, between the forms of misconduct which are ratifiable and those which are not, has never been governed by entirely consistent or clearly discernible principles. It will be seen in Chapter 2 that nothing shows this better than the rather haphazard development of circumstances, whether true exceptions or not, where shareholders’ actions are permitted.

The minority shareholder as an ‘unfavoured litigant’

Professor Sealy draws a contrast with other types of litigant, for example those seeking judicial review. The latter receive, on the question of locus standi, a more favourable judicial acceptance than does the minority shareholder: ‘Time and again he is sent away with no answer, as often as

²⁸ (1875) 1 ChD 13 at 25. See also ibid., p. 22 per James LJ.
²⁹ See Chapter 2, p. 27 below. ³⁰ See Chapter 2, pp. 51–8 below.
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not with a rebuke for troubling the court.31 This discounts the minority shareholders’ undeniable statutory and contractual status as a member who may have invested thousands or even millions. These factors are not enough in themselves to determine his standing to sue in company law and indeed for most purposes they are irrelevant.32

Professor Sealy draws attention to a number of sources of difficulty and confusion in the case law which reinforce the generally negative judicial attitude. He points to the muddled jurisprudence on the ‘proper plaintiff’ principle. There is a rather confused analysis, where a particular type of wrongdoing occurs, between what is a wrong to the company and what is a wrong to the individual.33 In the past there has been no consistency as to what stage in the legal proceedings the Foss v. Harbottle issue should be raised and on what evidential basis the issue of locus standi should be resolved. Usually, it has been dealt with in limine, but in some cases the plaintiff was allowed a full hearing before the Foss v. Harbottle issue was resolved, even if it resulted in the minority shareholder losing.34 Certainly, in the case of the derivative action a stricter approach is now taken. The Court of Appeal35 has insisted that the locus standi point must be raised at any interlocutory stage without submission of evidence. This approach is directly linked with the characterisation of the Foss v. Harbottle rule as a purely procedural matter. As such, a less rigorous approach to providing a fully reasoned basis for a decision may result than would be the case if a principle or rule of substantive law were at issue.36 On any careful analysis, the Foss v. Harbottle rule is (like any other rule determining locus standi) a mixture of substance and procedure.37

Further confusion can arise where the court decides to resolve the Foss v. Harbottle point by referring the matter to the shareholders in general meeting. It may not be clear whether the majority are to resolve whether or not the company should litigate, or whether they are being asked to ratify the wrongdoing that has occurred. In either case the shareholders in a large public company are unlikely to have the information to make a proper judgment of their own interests or those of the company.

32 Ibid. The issue of enforcing the membership contract is examined below at p. 13.
33 See further Chapter 2 below.
34 See, for example, North West Transportation Co. Ltd v. Beatty (1887) LR 12 App Cas 589 (PC); and Hogg v. Cramphorn Ltd [1967] Ch 254. See Chapter 2 below.
The reform of civil procedure in recent years may enable the courts to provide better answers to some of these problems. In the next chapter, it will be seen that the procedural reform of the derivative action (first introduced in 1994 as Order 15, rule 12A)\(^{38}\) has brought some clarity, compared with the earlier state of procedural confusion. In one leading case in the Court of Appeal,\(^ {39}\) the process of discovery of documents and the state of the pleadings were described as a 'shambles'. To take one improvement, for example, applications for indemnity orders can now be heard at the stage of the application for leave under rule 12A and its successors.

As the Law Commission’s Consultation Paper on shareholder remedies\(^ {40}\) indicates, the courts’ case management powers\(^ {41}\) may prove of some assistance in both ‘derivative’ and ‘personal’ shareholder suits. However, in Chapter 2 it will be contended that these new case management powers will still not allow the admission of evidence (when the application to bring a derivative suit first comes before the court) about the \textit{prima facie} case against those who have wronged the company. This initial stage will still be confined to arguing the issue of \textit{locus standi} on the basis only of allegations in the pleadings. It will be seen that, in the case of public listed companies, the element of ‘wrongdoer control’ will still create serious problems for the plaintiff. It would seem that Professor Sealy’s proposal for a ‘compromise procedure’\(^ {42}\) is not available either in the common law derivative suit\(^ {43}\) or in the Law Commission’s proposal for statutory reform.\(^ {44}\)

It is generally considered that the two most significant barriers to successful shareholders’ proceedings (especially in the case of derivative suits) are: (a) the difficulty of obtaining, in advance of litigation, adequate evidence to support alleged wrongdoing (even where this is strongly suspected); and (b) the difficulty posed by the great expense of such civil litigation (without any hope of direct personal benefit). In its Report on shareholder remedies,\(^ {45}\) the Law Commission rejected a proposal for ‘pre-action discovery’ of documents.\(^ {46}\) Similarly, no change

\(^{38}\) See now the Civil Procedure Rules 1998, Schedule 1.
\(^{41}\) See the Civil Procedure Rules 1998, Part 3.
\(^{43}\) See Chapter 2 below.
\(^{44}\) See Chapter 3 below.
was made by the Law Commission to existing arrangements for the funding of shareholders’ litigation. However, it will be seen that subsequent developments have opened up entirely new possibilities in the guise of ‘conditional fee agreements’. It still remains a matter of speculation as to what impact such agreements will have in shareholders’ proceedings, whether derivative or personal.

The movement for reform

A dozen years ago, Professor Sealy predicted that, even if Parliament provided a statutory remedy, the ‘courts would reinvent just as effective way of saying “go away”’. He later observed that there is an almost palpable judicial resistance in the UK to any move which would allow the individual shareholder any greater access to the courts, and, whatever the legislator may do, this in the long term may continue to be the most potent force against change. This has proved a remarkably accurate prediction. The Law Commission’s report on shareholder remedies in 1998, under the chairmanship of a distinguished Chancery judge, retained as much as possible of the rule in *Foss v. Harbottle* consistent with creating a statutory derivative action. The other actions by exception to that rule are left unchanged. No change is made to ‘substantive’ company law and due reverence is paid to the ‘proper plaintiff principle’ (and other aspects of the *Foss v. Harbottle* doctrine) in shaping the structure of the proposed new statutory procedure. Much existing *Foss v. Harbottle* jurisprudence finds its niche, in a suitably recast form, in the Law Commission’s reformed procedure. It will be seen in Chapter 3 that the Law Commission’s notion of ‘strict judicial control’ is considerably more constraining than equivalent Commonwealth legislation.

does not confer on shareholders a corporate right to ‘internal’ company documents. See *Conroy v. Petronius Clothing Co. Ltd* [1978] 1 WLR 72. The position is different in other common law jurisdictions. See the discussion of section 319 of the Australian Corporations Law by Diana Faber, ‘Reform of Shareholders’ Remedies’ in *Developments in European Company Law* (Kluwer Law, 1998), vol. 1, p. 119 at p. 127.

47 See Consultation Paper, para. 6.104.
48 See Chapters 2 and 3 below.
50 Ibid., p. 16.
51 See Report, paras. 6.1–6.6. See also paras. 6.80–6.93.
52 E.g. the role of the independent organ (ibid., para. 6.88), the majority’s power to ratify or resolve that no action be taken by the company (ibid., para. 6.87) and the court’s power to adjourn proceedings to enable the company to call a meeting (ibid., para. 6.100).
53 See Chapter 3 at p. 88.