



UiTM LAW REVIEW

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UNIVERSITI TEKNOLOGI MARA (UiTM)

An Introduction

Universiti Teknologi MARA (formerly known as MARA Institute of Technology) is Malaysia's largest institution of higher learning. It had its beginnings in 1956 as Dewan Latihan RIDA, a training centre under the supervision of the Rural Industrial Development Authority (RIDA).

Nine years later Majlis Amanah Rakyat (MARA) Act, 1965 provided for a change of name from Dewan Latihan RIDA to Maktab MARA (MARA College). The Act also defined a new role for the MARA College -- to train Bumiputras (literally it means "the sons of the soil" - ie the indigenous people) to be professionals and semi-professionals in order to enable them to become equal partners with other ethnic groups (ie the former migrants, especially the Chinese and Indians) in the commercial and industrial enterprises of the nation.

In 1967 Maktab MARA was renamed Institut Teknologi MARA (ITM) (or MARA Institute of Technology). In August 1999, the Institute was upgraded to university status and named Universiti Teknologi MARA (UiTM).

As part of the government's affirmative action policies, UiTM provides education and training in a wide range of sciences, technology, business management and professional courses to 56,408 full-time students in 2000. Another 3,156 have enrolled for off-campus courses. In addition, there are 7,725 students in distance-learning and flexible-learning programmes.

The main campus stands on a 150-hectare piece of land on a picturesque hilly area of Shah Alam, the state capital of Selangor Darul Ehsan, about 24 kilometres from the city of Kuala Lumpur.

The Universiti has also established branch campuses in the various states of the Federation: Sabah (1973), Sarawak (1973), Perlis (1974), Terengganu (1975), Johor (1984), Melaka (1984), Pahang (1985), Perak (1985), Kelantan (1985), Penang (1996), Kedah (1997) and Negeri Sembilan (1999).

The Universiti currently offers 184 programmes conducted by 18 Faculties. These programmes range from post-graduate to pre-diploma or certificate levels. More than half of these are undergraduate and post-graduate programmes, while diploma programmes account for an additional 39%. Some of the post-graduate programmes are undertaken in the form of twinning programmes, through collaboration with universities based overseas.

The following 18 Faculties currently run programmes in the University:

Accountancy; Administration and Law; Applied Science; Architecture Planning & Surveying; Art & Design; Business & Management; Civil Engineering; Education; Electrical Engineering; Hotel & Tourism Management; Information Technology & Quantitative Science; Mass Communication; Mechanical Engineering; Office Management & Technology; Performing Arts; Science; Sport Science & Recreation.

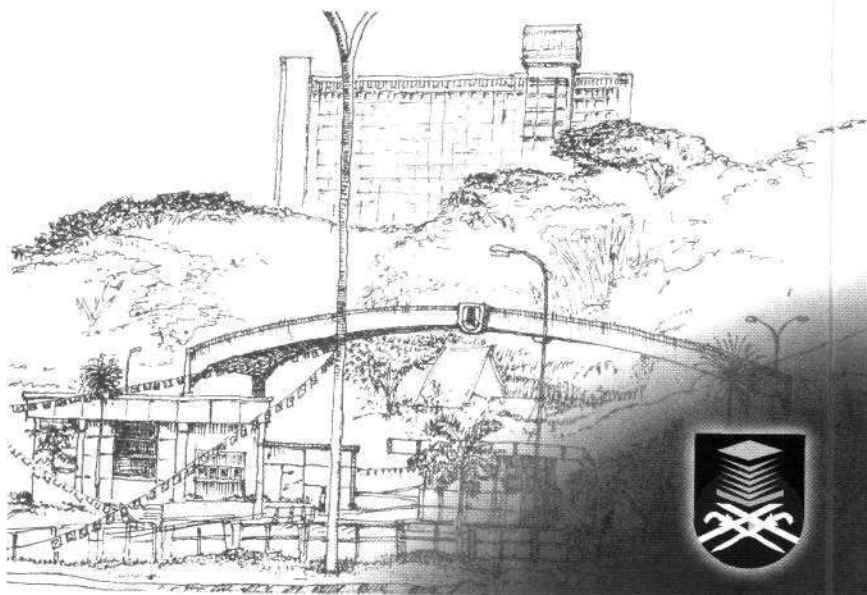
In addition to faculties there are 17 'academic centres' to cater various academic, business, technological and religious needs of the campus community. They are Extension Education Centre (PPL); Language Centre; Centre for Preparatory Education; Resource Centre for Teaching and Learning; Total Quality in UiTM (CTQE); Department of Academic Quality Assurance & Evaluation; Computer Aided Design Engineering Manufacturing (CADEM); Malaysian Centre for Transport Studies (MACTRANS); Text Preparation Bureau; Bureau of Research & Consultancy; Malaysian Entrepreneurship Development Centre (MEDEC); Islamic Education Centre; Centre for Integrated Islamic Services; Business & Technology Transfer Centre.

THE FACULTY OF ADMINISTRATION AND LAW, UiTM

The Faculty of Administration and Law (formerly known as the School of Administration and Law) was founded in 1968. It began as a centre offering British external programmes, the LLB (London - External) and the Chartered Institute of Secretaries (now Institute of Chartered Secretaries and Administrators). The only internal programme offered then was the Diploma in Public Administration and Local Government (DPALG). In 1978 the LLB (London - External) programme was terminated and replaced by the current internal LLB programme. The LLB is a three-year academic degree course based on the structure of the undergraduate law programmes normally offered in the British universities. Unlike most of the British LLB programmes, however, the LLB at the Faculty is conducted on a semester system. In 1982 the Faculty introduced a one-year LLB (Hons) programme towards which graduates of the LLB could advance their studies. The LLB (Hons) is a professional and practice-oriented programme that provides training to students for their career in the legal practice as Advocates and Solicitors. The delivery of the curriculum for this course adopts the method and strategy of simulated or experiential learning. Because of the unique experience it provides to students in their legal training this course has acquired wide recognition and acceptance among the Malaysian public.

The Faculty of Administration and Law enjoys strong connections with the legal profession, particularly the Malaysian Bar, and the industry. It takes pride in continually developing pioneering options in its degree programmes, both at the academic and professional levels. In 1995 the Faculty introduced the degree of Bachelor in Corporate Administration (Hons) to train young and bright Malaysians to hold office as Company Secretaries. In the pipe-line are some new courses - Bachelor of Law and Management (Hons), Bachelor of Administrative Science (Hons), Masters of Law and Executive Masters in Administrative Science.

The Faculty currently comprises some 70 academic staff from both the disciplines of law and administration. It has about 600 students reading for the LLB and LLB (Hons) and 500 students reading for the Diploma in Public Administration and Bachelor in Corporate Administration (Hons). The Faculty admits about 200 students each year.



Main Entrance to Shah Alam Campus

EDITORIAL NOTES

This law journal had a long period of gestation in the Faculty. There were several attempts in the past, by individuals or the faculty collectively, to bring about its parturition. It is no easy task to initiate an academic journal, regardless of the discipline it represents. It demands a high degree of commitment in time, energy and attention. It calls for an intense love of labour for scholarship among a critical mass of the faculty members, either in the editorial board or as article contributors. But, at long last, this journal has arrived.

Many factors led to this successful launch. The recent elevation of this institution to university status created its own impetus. Our strong law programme and its capable teachers demanded, and will benefit from, this specialist forum for academic debate and analysis. There is support within the legal profession and among our many distinguished alumni for such a journal, too. We are delighted by the synergy and collaborative goodwill the notion of a journal has evoked. So, we were able to marshal much expertise and experience to bring out this inaugural issue of the Journal.

Academic faculty at UiTM are part of the worldwide network of academia. We must participate in discussions and debates over issues that are not only of direct academic and professional concern but also of importance to the general public. A journal such as this facilitates reflective and disciplined participation. In doing so, it helps the Faculty, and the University, to undertake its noble role in serving the general community.

A learned journal is one of the major measures by which the weight and prestige of an institution are judged. It reflects the institution's maturity and ability to manage and conduct its specialist discipline. It reflects a confidence among its faculty to offer themselves to be evaluated in the open market place of ideas, and it serves notice of the faculty's readiness to serve the community at large. This Journal, in no small measure, marks the coming of age of the Faculty.

The Journal functions also as a meeting point for law teachers and practitioners who share a common interest in various areas of law. It provides them a source of information on the current and topical issues in their specialised areas. It creates a forum for the exchange of ideas and for engaging in discourse over sometimes intricate and often vexed legal issues. Much is gained by the legal fraternity, as well as the legal system, through such engagements and encounters.

Law teachers, as members of the broader academic community, are aware that it is no longer tenable for them to function solely within their traditional ivory towers, isolated from the reality of the world outside. For career and professional advancement, and for taking their rightful role in the community, no academic can confine

herself to her classroom or departmental audience. She must reach for a wider audience. The recognition (or lack of it) that she gains from her peers, both within and without the discipline, will speak for her standing and credibility in the community, both scholarly and otherwise. This Journal will serve as one channel for the Faculty members to reach that wider audience.

There are relatively few academic legal journals in this country. Most existing legal publications cater for the professional needs of legal practitioners. One ramification of this is that there are few discourses on theoretical and abstract legal issues. Yet these issues are important for the fuller appreciation and development of the law and the legal system, by the legislature, the reform bodies and the courts. This Journal will try to answer this need and stimulate discussions on issues that are of interest and relevance to the academic and broader communities.

The labour and skill required for this Journal to thrive will challenge the staff of the institution and the supporters of this initiative among the profession and the wider community. We hope the Journal sails well in fair winds.

Our wish is that Malaysia's legal profession, its legal academic circle and the many students and practitioners of law in this country and elsewhere will benefit from this forum for analysis and reform. We hope this Journal makes an important contribution to debate on vital legal matters in our society. We hope, too, that our quest for self-expression and critical reflection among the members of the legal academia will be assisted by this Journal. It is with great pleasure and some satisfaction at the completion of this worthy task that we complete this inaugural Editorial.

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RATIFICATION OF DIRECTORS' BREACHES OF DUTY: PROBLEMS, PERSPECTIVES AND SCOPE FOR REFORM

by S.T.LINGAM*

Introduction

The ability of the company to avoid transactions made by directors in breach of their duties as well as its ability to make the wrongdoing directors personally liable to it for such breach may be hindered where there has been a "ratification" of such breach. This article seeks to highlight the problems associated with the present legal position regarding ratification of a director's breach of duty and to suggest possible reforms taking into account developments in other common law jurisdictions.

What is ratification?

Ratification has been variously described as "adoption", "affirmation", "confirmation", and "approval".¹ Ratification may take the form of a prior approval by the company² or the *ex post facto* acceptance³ by it of a transaction which was outside the authority of the director concerned. It is generally accepted that members in general meeting may ratify acts of directors. Upon a valid ratification, the acts of the director will bind the company and the wrong doing director is absolved from any liability to the company for its breach. According to Gower,⁴

"It is a normal principle of the law relating to fiduciaries that those to whom the duties are owed may release those who owe the duties from their legal obligations and may do so either prospectively or retrospectively provided that full disclosure of the relevant fact is made to them in advance of the decision. Consequently, it has

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1 See: R J C Partridge, "Ratification and the release of directors from personal liability" (1987) CLJ 122 and the cases cited in footnotes 2-5 thereof.

2 See: *New Zealand Netherlands Society "Orange" Inc v King's* (1973) 2 ALL ER 1222; *Multinational Gas and Petrochemical Co v Multinational gas and Petrochemical Services Ltd* [1983] Ch 258; *Winthrop Investments Ltd v Wims Ltd* [1975] 2 NSWLR 666.

3 e.g. *Hogg v Cramphorn Ltd* [1967] Ch 254; *Re Cape Breton* (1885) 29 Ch D 795; *Bamford v Bamford* (1970) Ch 212; *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

4 L C B Gower, *Gower's Principles of Modern Company Law* (Sweet and Maxwell London 1997) 644-645.

long been recognised that an ordinary majority of the shareholders in general meeting may release the directors from many of their fiduciary duties, provided that at least the company is a going concern".

Further, "Ratification has a twin effect. It operates so as to make binding on the company a transaction which might otherwise be impeachable as having been entered in breach of fiduciary duty and so as to release the directors from liability to the company for breach of duty."⁵

However, the law on ratification is not as clear and settled as it ought to be and leaves a number of issues unsettled. Numerous articles have been written in this area which has variously been described as, "an uncleared minefield"⁶ "singularly muddled",⁷ "murky"⁸ and, "a concept that has outlived its usefulness".⁹

A proper appreciation of the concept of ratification, the surrounding difficulties and an attempt to unravel those difficulties is necessary for a more comprehensive discussion of the pitfalls that may frustrate the company or a minority shareholder in the attempt to curb self-dealing by directors or cure its ill effects. Though at times one is inclined to feel that ratification is indeed "a concept that has outlived its usefulness",¹⁰ the better view seems to be that, "the doctrine of ratification is necessary, in the context of modern commercial life".¹¹

Problems of Ratification

A. The power to ratify

Ratification in the corporate context has its origins in the law of fiduciary obligations and trusts. Professor Finn states the general rule thus: "Where a fiduciary has a personal interest in a decision he intends taking in his representative capacity he can, as a general rule, immunise himself both from the conflict rule and from the fiduciary duty by making a full disclosure of his interest to his beneficiaries and by obtaining their consent to his decision notwithstanding his personal interest".¹²

It is also established law that directors are fiduciaries in relation to the company. Thus, breaches of duties by the directors are said to be capable of ratification by

5 Ibid at 645

6 Fridman, "Ratification of Directors Breaches" (1992) 10 C & SLJ 252.

7 Cranston, "Limiting Directors Liability: Ratification, Exemption and Indemnification" (1992) JBL 197 at 199.

8 Karen Yeung, "Disentangling the Tagged Skein: The Ratification of Directors' Actions" (1992) 2 ALJ 343.

9 Fridman, above n 6.

10 Ibid at 267.

11 R Baxt, "Judges in their own cause: The ratification of Directors' Breaches of Duty" (1978) 5 MULR 16.

12 P D Finn, *Fiduciary Obligations* (the Law Book Company Sydney 1977) 51 and also cited in Saul Fridman, "Ratification of Directors Breaches" (1992) C & SLJ 252 at 253.

the fully informed beneficiary, viz, the company. However, the concept of ratification has been applied in the context of the modern day corporation without sufficient consideration having been given to a number of issues, such as who may ratify, what breaches may be ratified, and what is the effect of such ratification (1) upon the transaction, (2) upon the liability of the directors and (3) upon minority shareholders in the light of the rule in *Foss v Harbottle*?¹³

B. Who may ratify?

The commonly accepted view is that breaches of duties by directors may be ratified by the company in general meeting. Palmer¹⁴ states that in general, full disclosure by the shareholders in general meeting would relieve the directors from liability. Gore Browne¹⁵ states, "the most important way in which a director may be relieved from liability for breach of duty is ratification by ordinary resolution of the general meeting, or by the approval of all members having voting rights at a general meeting..."

Gower also accepts this view. According to him, "It is a normal principle of the law relating to fiduciaries that those to whom the duties are owed may release those who owe the duties from their legal obligation and may do so either prospectively or retrospectively, provided that full disclosure of the relevant fact is made to them in advance of the decision. Consequently, it has long been recognised that an ordinary majority of the shareholders in general meeting may release the directors from many of their fiduciary duties, provided at least that the company is a going concern".¹⁶ Numerous cases may be cited in support of this generally accepted view.¹⁷

The board of directors, too, have sometimes been held to be capable of ratifying the acts of individual directors.¹⁸ However, the cases may be distinguished on their particular facts and consent of the board is usually inadequate.¹⁹

Assuming that principles of equity may be applied in the context of the modern day corporation and that breaches by the directors as fiduciaries may be ratified by

13 (1843) 2 Hare 461.

14 Sir Francis Palmer, *Palmer's Company Law*, (vol.2 Sweet & Maxwell, London) 8134 at para 8.539.

15 Boyle and Sykes (ed), *Gore Browne on Companies*, (Vol. 2 44th edn Jordans Bristol) para 27.21.

16 L C B Gower, *Gower's Principles of Modern Company Law* (Sweet & Maxwell London 1997) 644-645. See also: R R Pennington, *Company law* (Butterworths London 1995) 745.

17 *Eg. Bamford v Bamford* [1970] Ch 212; *Hogg v Cramphorn* [1967] Ch 254; *Irvine v Union Bank of Australia* (1877) 2 App. Cas 366; *Grant v United Kingdom Swithback Rly* (1880) 40 Ch. D 135; *North-West Transportation Ltd v Beatty* (1887) 12 App Cas 589; *Pavlidis v Jensen* (1956) Ch 565; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666.

18 See: *Peso Silver Mines Ltd v Cropper* (1966) 58 DLR (2d) 1; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1.

19 See: H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporation Law* (Butterworths Sydney 1997) 386.

the beneficiary, difficulties arise in identifying the beneficiary for the purposes of ratification.

That the directors are fiduciaries *vis a vis* the corporation is now beyond question. That the corporation is a separate legal person is equally beyond question. Therefore if ratification is to be applicable in the corporate context, only the corporation itself may ratify.

Who then is the corporation for the purpose of ratification? Any suggestion that either the board of directors or the majority of the shareholders in general meeting could automatically be regarded as the corporation itself would fly in the face of *Salomon's case*.²⁰

Despite this, as has been seen, case law has proceeded on the basis that the majority of the shareholders in general meeting are competent to ratify directors' breaches of duty. Though this is out of line with the concept of corporate personality, one has to concede that such an approach is most practical. The corporation, being an artificial entity, has neither a body nor mind of its own. It has to be personified either through the corporators acting as a collective body via the general meeting or the board of directors.

Practical though this approach may be, it is not without further criticism. In the case of ratification by a majority at a general meeting, such ratification may be procured through the votes of the wrongdoing director acting in his capacity as a shareholder.²¹ Thus, a wrongdoing director who himself has a majority shareholding in the company, or is able to garner the support of the majority of the shareholders through his influence or through the proxy machinery, would remain unaccountable to the company for his breach. In the case of ratification by the board of directors, the likely bias is obvious. The board may well be composed of his friends and cronies and, as one writer observes,²²

"Indeed, if one of the underlying reasons for strict fiduciary obligations is to ensure that those who control corporate assets and enterprise do not succumb to the temptations that inevitably arise, then it is hard to justify on policy grounds a rule which allows directors effectively to act as judges in their own cause".

C. What breaches may be ratified?

Assuming that the power to ratify may reside in the general meeting, or, possibly, in the board of directors, the next pertinent question is whether all forms of breaches

20 *Salomon v Salomon & Co Ltd* [1897] AC 22

21 *North-West Transportation Ltd v Beatty, Bamford v Bamford, Winthrop Investments Ltd v Winns Ltd* cited in footnote 17 above.; See also: R. Baxi, "Judges in their own cause: The Ratification of the Directors Acts: An Anglo-American Comparison" (1978) 41 MLR 161.

22 Saul Fridman, "Ratification of Directors' Breaches" (1992) C & SLJ 252 at 266.

of fiduciary duty are capable of being ratified. Here, too, case law does not provide a clear answer.

Where directors have acted for an improper purpose, the courts have generally accepted that the general meeting may ratify the breach. The bulk of case law in this area involves the issue of shares for an improper purpose, in particular, the forestalling of a takeover bid. The courts have been consistent in their stand that such issues may be ratified by the company in general meeting.²³ However, where there is fraud or oppression, courts would intervene.²⁴ As pointed out by Professor Baxt,²⁵ difficulties arise where the majority in voting to ratify the breach also had the improper purpose in mind and did not, therefore, vote for the purposes of the company. This matter gets further complicated when the directors themselves use their votes in their capacity as shareholders to ratify the issue of shares.

In *Ngurli v McCann*²⁶ it was established that resolutions of shareholders in general meeting would not be effective if the purpose of the majority of the meeting was otherwise than for the purposes of the company as a whole.

Mahony J.A. in *Winthrop's case*²⁷ stated that it has not yet been settled whether, if the purposes of the majority was the same as that of the directors (i.e. the defeating of a takeover bid), that will be an improper purpose of that majority which would make the resolutions ineffective.

Professor Baxt²⁸ suggests that it would be better in such cases to require an independent group of shareholders to ratify the transaction.

In relation to self-dealing situations involving directors contracting with the company, the classic decision, which has not yet been expressly overruled is that of *North-West Transportation Ltd v Beatty*.²⁹ That case held that such dealings may "be affirmed or adopted by the company, provided that such affirmation or adoption is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards the shareholders who oppose it".³⁰

Thus, a director involved in such a self-dealing may have the matter ratified by exercising his right to vote his own shares at the general meeting, so long as he

23 *Hogg v Cramphorn Ltd.* (1966) 3 WLR. 1995; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Bamford v Bamford* [1970] Ch 212.

24 See: *Clemens v Clemens & Others* (1976) 2 ALL ER 268 and comments of Buckley J in *Hogg v Cramphorn*, *ibid.*

25 "Judges in Their Own Cause", n 21 above.

26 (1953) 90 C.L.R. 425.

27 Above, n 21.

28 Above, n 25.

29 (1887) 12 App cas 589.

30 *Ibid.* Per Sir Richard Baggalays at 595.

acts honestly and makes disclosure to the company of his interest in the relevant contract.

In cases where the director concerned himself has an absolute majority, or is able, by his influence within the company, to obtain a majority vote in his favour, it is almost certain that abuses will continue.

Many jurisdictions provide for articles which prevent interested directors from voting to ratify such contracts at a meeting of the board of directors (in cases where ratification by the board is allowed). It is rather incongruent that case law allows a director to vote in his capacity as a shareholder whereas articles can negative his vote in his capacity as a director.³¹

A viable alternative would be the US position which requires ratification by an independent majority of shareholders and a consideration of the fairness of the price paid by the corporation.

In relation to self-dealing situations involving the usurpation of corporate opportunities, the issue of ratification also raises difficulties. The two most often cited cases to highlight the problem are that of *Cook v Deeks*³² and *Regal (Hastings) Ltd v Gulliver*.³³

In the former case, three out of four directors (who were also the only shareholders) diverted a corporate opportunity to a company which they had formed. Subsequently, they called a general meeting at which they ratified their action using their majority votes. The court held that the ratification was not valid.

On the other hand, in the latter case, the directors had bought shares in a subsidiary in circumstances where the company itself could not afford to take up those shares. The court, while holding that the directors had breached their duty to the company, also held that it was a breach that was ratifiable by the company in general meeting.³⁴

It is not an easy task to reconcile the cases. Both can be regarded as cases involving the expropriation of corporate assets or opportunities. Why, in *Cook v Deeks* was ratification not allowed whereas in *Regal (Hastings)* it was? Was it because the cases can be distinguished on the basis that in fact only the former involved a misappropriation of corporate assets while the latter involved merely the making of an incidental profit? Or was it because in the former case the directors had

31 R Baxt, "Judges in their own Cause: The ratification of Directors' Breaches of Duty" above n 21 at p 43.

32 [1916] 1 A.C 554.

33 [1942] 1 ALL ER 378.

34 See also: *Furs Ltd v Tomkies* (1936) 54 CLR 583.

profited at the expense of the company whereas in the latter case there had been no harm to the company at all? Could it also be said that the cases can be distinguished on the basis that in *Cook v Deeks* the directors had acted fraudulently whereas in *Regal* they had acted bona fide in the interests of the company. A clear answer to this is yet to be found.

D. The effect of ratification

A further problem relating to ratification is the question of its real effect. It is often presumed that upon ratification, the transaction concerned is binding upon the company and directors are absolved from liability to the company for their breach of duty. Further, as a result of the rule in *Foss v Harbottle*,³⁵ ratification by the majority prevents the minority shareholder from instituting a derivative action, except in cases falling within its recognised exceptions. Thus, where there is fraud or oppression, the minority may bring a derivative action. But in those situations where it is unclear whether these elements are present but the wrongdoing directors have used their own votes to ratify the breach, the position of the minority shareholder's standing to institute an action needs to be reconsidered.

(a) Release from liability

Assuming that the general meeting is competent to ratify the acts/transactions done by the directors on behalf of the company, a generally accepted consequence of such ratification, as we have seen above, is that the act/transaction now becomes binding upon the company. The company and third party will then be able to sue each other to enforce it. However, it is also often thought that such ratification results in the absolving of the directors of their personal liability to the company for breach of duty to the company.³⁶

Closer scrutiny of the concept of ratification, however, indicates that one ought to be hesitant in concluding that any ratification by the general meeting (or for that matter the board of directors) would automatically result in the release of the directors from liability. Partridge³⁷ argues that such conclusion is incorrect and that any purported release of the directors from liability ought not to be valid on ground of lack of consideration. Such release is also not supported by estoppel, nor is it a consequence of the corporate constitution.³⁸ The importance of the distinction between a prospective release of a director from his duty to the company and a subsequent release, by ratification, of an accrued right against the wrongdoing director is also highlighted. While mere accord is sufficient for a prospective release

35 (1843) 2 Hare 461.

36 See *Regal (Hasting) Ltd v Gulliver*, above n 33; *Prudential Assurance Co. Ltd v Newman Industries Ltd* (No. 2) [1982] Ch 204 at 220.

37 R J C Partridge, "Ratification and the release of directors from personal liability" (1987) CLJ 122.

38 Ibid at 126-135.

from such duty, a subsequent release requires both accord and satisfaction. Hence a subsequent release by ratification cannot be effective to prevent a company from suing the director concerned for the loss arising from the breach.

The U K has to a certain extent recognised that the mere ratification by a company in general meeting does not of itself release a director from liability. In the context of *ultra vires* transactions it has now been statutorily provided under s 35 of the Companies Act 1985 that a company may ratify an *ultra vires* transaction by a special resolution. However, such resolution would not automatically have the effect of releasing the directors from liability to the company. In order to release the directors from such liability to the company, a separate special resolution to that effect has to be passed.

Statutory amendments ought to be introduced to require separate resolutions in order to release directors from liability to the company in respect of breaches which have resulted in actionable claims against them by the company. A decision by the company to relieve a director from such liability should be effected by special resolution.

(b) Ratification and the right to institute a derivative action

At common law, it was generally accepted that ratification by the majority, or even the possibility of ratification by the majority, has the effect of depriving a shareholder of his right to institute a derivative action.³⁹

The justification for denying the minority shareholder the right to institute a derivative action in the case of ratifiable breaches was that the courts would be likely to give effect to the voice of the majority and the minority shareholder's suit would be futile. The majority's voice was equated with that of the company itself. Decisions of the company were matters of internal regulation to be taken by the appropriate organ of the company authorised to do so under the articles of association. It was not the business of the court to question the wisdom of corporate decisions properly taken. Thus, the minority would have no *locus standi* to initiate a derivative action (unless it fell within the relevant exceptions to the rule in *Foss v Harbottle*).

A couple of matters need greater consideration:

- (1) Whether actual or intended ratification ought to deny the minority shareholder standing to sue (i.e. to initiate a derivative action) in all cases of a ratifiable breach.

39 See Wedderburn: "Shareholders' right and the Rule in *Foss v Harbottle*" (1957) CLJ 194; *Edwards v Halliwell* [1950] 2 All ER 1066; *McDougall v Gardiner* (No.2) (1875) 1 Ch D 13.

- (2) Whether statutory intervention is necessary or desirable to enable a minority shareholder to institute an action on behalf of the company in situations where he lacks *locus standi* to initiate a derivative action.

On the first issue, a preliminary objection to denying a disgruntled minority shareholder a right to sue on behalf of the company is whether a majority of the members of the company can in fact ratify the acts of the agents of the company *viz* the directors. This has been discussed earlier.⁴⁰

As we seen, the *Salomon* principle would dictate that only the corporation is capable of ratifying any act done on its behalf. Despite this, for practical purpose the will of the majority is best accepted as the will of the company for validating the transactions done on its behalf and perhaps also for forgiving the wrongdoing directors.

But should such ratification, or the possibility of such ratification, deny the minority shareholder of access to the courts to protect the company in situations which may otherwise justify intervention by the courts (aside from the exceptions to the *Foss v Harbottle* rule)? While it has long been thought that it is not the business of the court to manage the affairs of the company and that such matters are best left to the shareholders and directors,⁴¹ it has been observed that, "whether this approach is a wholly adequate basis for judicial policy in the area of modern company law is open to doubt".⁴²

Such a rule certainly denies the minority shareholder the opportunity to have the merits of his case given due consideration by the courts.

There have been cases where, despite the fact that the breaches concerned were ratifiable, minority shareholders have been allowed to sue. A notable example is *Alexander v Automatic Telephone Co*⁴³ where the breach by the directors arose as a result of their decision to make a call on shares payable on allotment by all the subscribers except three directors who had the largest shareholding. The remaining two directors who had been parties to that decision initiated an action against the directors and the company for a declaration that all the shareholders were bound to pay on the call. Despite the fact that the directors had acted bona fide, and the breach was one that could possibly have been ratified by the majority in general meeting, the court of appeal granted the relief claimed. Lindley M R observed that this case was not one of mere internal management which could be left to the shareholders to settle among themselves. Wedderburn⁴⁴ considered that if such

40 See page 4, above.

41 See *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* (1927) 2 KB 9.

42 K W Wedderburn: "Shareholders' right and the rule in *Foss v Harbottle*" (1957) CLJ 194 at 194.

43 (1900) 2 Ch. 56 and referred to in Wedderburn's article at n 42 above.

44 Above n 42

cases were to be followed they indicate that "real" exceptions to the rule in *Foss v Harbottle* do exist.

*Hogg v Cramphorn*⁴⁵ and *Bamford v Bamford*⁴⁶ can also be regarded as examples of such cases, though it must be pointed out that the issue of the rule in *Foss v Harbottle* was not brought up in either of those cases to challenge the standing of the plaintiffs. This may indicate that a strict application of the rule is not favoured by the courts.⁴⁷ It has been argued⁴⁸ that the Australian case of *Residues Treatment & Trading Co Ltd v Southern Resources Ltd*⁴⁹ is a further indication of this trend. That case also involved the allotment of shares by directors in order to frustrate an impending takeover. The plaintiff's claim had been struck out by the court below on the basis that they lacked *locus standi* to initiate the action. On appeal, the Full Court of the Supreme Court of South Australia surmounted the hurdle posed by the rule in *Foss v Harbottle* by concluding that the breach of fiduciary duty on the part of the directors would have the effect of diminishing the voting power of their shares. They had a personal right not to have it so diminished. It then fell within the "personal rights" exception to the *Foss v Harbottle* rule, thereby providing the plaintiffs with the necessary *locus standi*.

This unsatisfactory position is criticised heavily by Welling,⁵⁰ who condemns as misconceived the idea/concept that a majority of shareholders or board of directors can extinguish a corporate right to an action to remedy a breach of duty and the idea that ratification by the majority of shareholders or board of directors can extinguish the right of the individual shareholder to initiate an action.

There is a need to have greater clarity in the law concerning the effect of ratification or the possibility of ratification upon the right of the individual shareholder to institute an action on behalf of the company. The present position is inadequate to curb wrongdoing directors from using either their majority shareholding in the company or their position to influence the majority to secure a ratification of a ratifiable breach. In particular, self-dealing directors may take advantage of the paralysing effect of ratification or the possibility of such ratification on the right of the minority shareholder to institute an action to protect the company. Unless courts are, indeed, willing to adopt a more liberal attitude and give greater leeway in favour of a minority shareholder attempting to protect the company, there is a need to consider further statutory reforms. This brings us to the second issue, which it appears must be answered in the affirmative.

45 [1966] 3 All ER 420.

46 [1968] 2 All ER 655.

47 See Karen Yeung, "Disentangling the Tangled Skein: The Ratification of Directors actions" (1992) 66 ALJ 343.

48 Ibid at p 347-348.

49 (1988) 6 ACLC 1160.

50 B Welling, *Corporate Law in Canada: The Governing Principles* (Butterworths Toronto 1991) 428.

Canada has seen fit to introduce dynamic statutory reforms in relation to shareholder remedies as a whole, following the recommendations of the Dickerson Committee.⁵¹ The main remedies are the oppression remedy, Appraisal Rights, and the Statutory Derivative action. Of particular relevance to the present discussion is the statutory derivative action, which replaces the rule in *Foss v Harbottle*.⁵² Other than providing for the complainant⁵³ to apply to the court for leave to bring or defend an action on behalf of the corporation, it specifically provides that an action by a minority shareholder shall not be stayed or diminished merely because the breach of duty in question is capable of ratification or has been ratified by the shareholders.⁵⁴ The fact of ratification is to be regarded merely as evidence to be taken into account by the court in making an order. The Dickerson Committee also suggested a criteria for assessing the evidential value of a ratification. It said, "If, for example, the alleged misconduct was ratified by majority shareholders who were also the directors whose conduct was attacked, evidence of shareholder ratification would carry little or no weight. If, however, the alleged misconduct was ratified by a majority of disinterested shareholders after full disclosure of the facts, that evidence would carry much more weight indicating that the majority of disinterested shareholders condoned the act or dismissed it as a mere error of business judgment".⁵⁵

Such a provision would eliminate what has been described as "the major absurdity of the *Foss v Harbottle* rule".⁵⁶ It would have the advantage of having the case of the minority shareholder heard on its merits without denying the majority shareholders the court's consideration of the fact of ratification.

Would this open the company and/or its officers to the floodgates of litigation or otherwise encourage futile litigation, a matter which is considered to be one of the reasons for the rule in *Foss v Harbottle*? I think not. Given that shareholders are generally averse to litigation, coupled with the fact that such litigation must be at their own cost and time (unless the court deems it appropriate to give an order for costs against the company), it is unlikely that minority shareholders will become "litigation happy" unless their case is a meritorious one. Further, the statutory derivative action has failed to make a dramatic impact because of the availability of the "oppression" remedy.⁵⁷

51 R W Dickerson, J L Howard and L Getz, *Proposals for a new Business Corporations Law for Canada* (the Dickerson Report) 1971.

52 Above n 13.

53 Define in s 238.

54 Section 242 (1).

55 Dickerson Report 1971, above n 51, para. 487 and cited in Jill Poole and Pauline Robert, *Shareholder Remedies-Corporate Wrongs and the Derivative Action*, (1999) J.B.L. 99 at 110.

56 Gower, *Modern Company Law* (3rd ed) 86, referred to in Saul Fridman, "Ratification of Directors Breaches" (1992) C & S.L.J. 252 at 272.

57 See Brian R Cheffins and J M Dine, "Shareholder Remedies: Lessons from Canada" (1992) 13 Co. Law 89 at 94.

In Australia, the Corporations Law permits a member to make an application to the court for an order, *inter alia*, authorising the member to institute proceedings on behalf of the company.⁵⁸ This is permitted, *inter alia*, in situations where oppression, unfair prejudice, and unfair discrimination has occurred. Previously, though such statutory derivative action may be ordered, there was no provision which expressly touched the effect of ratification of the breach of duty, on the right of the member to such an order. Thus, despite the availability of such statutory derivative action, aggrieved shareholders would still have been stymied by proof of corporate approval of a director's breach of duty.⁵⁹

However, this situation has been altered by the Corporate Law Economic Reform Program Act 1999⁶⁰ which has introduced many amendments to the Corporations Law. Section 239⁶¹ of the Corporations Law now contains a provision to the effect that ratification would not preclude the standing of a shareholder in a derivative action. It would merely be a factor to be taken into consideration in deciding on an order. The section further stipulates a test to evaluate the standing of a ratifying resolution. It requires the court to have regard to, "(a) how well informed about the conduct the members were when deciding whether to ratify or approve the conduct; and (b) whether the members who ratified or approved the conduct were acting for proper purposes".⁶²

This new provision is to be welcomed. However, in addition to the two matters which the court is to have regard to, it would be an improvement also to require the court to have regard to the extent to which the wrongdoing directors had used their influence as directors or their own votes as shareholders to secure the ratification. It could perhaps be argued that this point may already be subsumed under requirement (b) above, as members may not be acting for proper purposes if they were influenced by the directors or if the directors themselves voted as shareholders. But, as has been suggested by Professor Baxt,⁶³ ratification is best done by a disinterested majority of shareholders. If ratification is to be permitted and the fact of ratification is to be only of evidentiary value, then the "independentness" or otherwise, of the ratification ought to be given due consideration.

In the United Kingdom, s 459 of the English Companies Act 1985 provides for a remedy to a member in cases where the company's affairs are being or have been conducted in a manner unfairly prejudicial to the members. Section 461 further

58 See in particular s 260 (2) (g).

59 Saul Fridman, "Ratification of Breach of Directors Duties" above n 52.

60 Following from the recommendations of the CSLRC, Enforcement of the Duties of Directors and officers of a Company by means of a Statutory Derivative Action, Report No 12 (1990) and the CASAC, Report on a Statutory Derivative Action (1993).

61 as amended by the CLERP Act 1999.

62 Section 239 (2); cited in Jill Poole and Pauline Roberts, "Shareholder remedies-Corporate wrongs and the Derivative Action", above n 55 at 109.

63 Above n 31.

provides that the court, upon being satisfied that the members petition is well founded, may make, *inter alia*, an order authorising civil proceedings to be brought in the name and on behalf of the company. However, it does not contain any express provision as to the effect of any ratification of the breach in question upon the right of the shareholder to institute such derivative action.

In 1995 the Law Commission was requested "to carry out a review of shareholder remedies with particular reference to:- the rule in *Foss v Harbottle* (1843) 2 Hare 461 and its exceptions; sections 459-461 of the Companies Act 1985; and the enforcement of the rights of shareholders under the articles of association and to make recommendations".⁶⁴ Pursuant to the said terms of reference, a Consultation Paper⁶⁵ was published in 1996. Subsequently a Report was published in 1997.⁶⁶ The Report recommended, *inter alia*, the introduction of a statutory derivative action to replace the present derivative action. (The merits or otherwise of the proposed derivative action and procedure are not pursued here).

In so far as the issue of ratification is concerned, the report acknowledges the complexity by stating, "There is danger that our desire to simplify the derivative action could be undermined by the complexities which arise where it is claimed that the relevant breach of duty has been, (or, may be) ratified".⁶⁷

What is rather disturbing is that the Report concluded that a shareholder should not be granted leave to proceed by way of the statutory derivative action where ratification has occurred. Thus, a major obstacle to the derivative action which other jurisdictions, like Canada and now, Australia, have found fit to eliminate, remains a pitfall for the shareholder in the U K. In cases where no ratification has taken place, a shareholder will still be able to proceed. But what if the company, subsequently, ratifies the breach in question? The action will, in all likelihood, be struck out.⁶⁸

The English position is therefore not as dynamic and modern as it could be. The recommendations preserve the conservative *Foss v Harbottle* rule, protecting the company from "unnecessary shareholder interference".⁶⁹ The Law Commission also seems to have considered that enlarging the circumstances in which individual shareholders can bring derivative actions would result in an increase of legal proceedings. However, this may be an unfounded fear as Canadian experi-

64 Law Commission, *Shareholders' Remedies*, Consultation Paper No. 142, (July 1996 London HMSO) para 1.2.

65 Ibid.

66 Law Commission Report, *Shareholders Remedies*, Law Com. No 246 (Cm.3769 October 1997 London HMSO), see also: Jill Poole and Pauline Roberts, "Shareholder Remedies - Corporate Wrongs and the Derivative Action", above n 55.

67 para 6.81; also cited in Poole and Roberts, "Corporate Wrongs and the Derivative Action" *ibid*.

68 Poole and Roberts, *ibid* at 109.

69 Consultation paper, above n 63 at para 4.11.

ence indicates that there have been relatively few derivative actions in public companies.⁷⁰ It has also been argued that, "these shareholders are unlikely to take the risk of pursuing an action since there is no guarantee of securing an indemnity against costs and any remedy will be for the company with only indirect benefits for the shareholders".⁷¹

In Singapore, s 216⁷² is the approximate equivalent of the Australian s 232⁷³ and the English s 459.⁷⁴ That section provides a remedy to a shareholder in cases of oppression, disregard, prejudice and unfair discrimination. Where the petitioner has established his case, the court may make certain orders as provided in s 216(2). Although the section states generally that the court may make any order it thinks fit, s 216 (2) (c) specifically provides that the court may "authorise civil proceedings to be brought on the name of or on behalf of the company by such persons as the court may direct". Thus, a statutory derivative action in the context of oppression, disregard, prejudice and unfair discrimination is available to a shareholder. However, that section does not touch the issue of the effect of ratification.

In 1993, Singapore introduced amendments to its Companies Act 1967.⁷⁵ *Inter alia*, the amendments provide for a statutory derivative action. A new s 216A and s 216B were introduced, along the lines of the Canadian Business Corporations Act. In particular, s 216B(1) provides that:

-"An application made or an action brought or intervened in under section 216A shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the company has been or may be approved by the members of the company, but evidence of approval by the members may be taken into account in making an order under section 216A".

Thus, like the Canadian and the new Australian position, the fact of ratification or possibility of ratification will have evidentiary value but will not be a bar to a derivative action. Sadly, however, these provisions⁷⁶ only apply to non listed companies.⁷⁷ "The reason for leaving out listed companies was the fear that unscrupulous people would make frivolous applications to harass listed companies and thereby attempt to manipulate the share price".⁷⁸ Section 216A does not preclude

70 See Poole and Roberts, etc, above n 55.

71 Ibid, citing B R Cheffins, "Reforming the Derivative Action: The Canadian Experience and British Prospects" (1997) CILR 227 at 259-260.

72 Companies Act 1967.

73 Corporations Law.

74 Companies Act 1985.

75 Via Companies (Amendment) Act 1993.

76 Sections 216A and 216B.

77 Section 216A(1), which defines a company to mean, "a company other than a company that is listed on the Stock Exchange in Singapore".

78 Walter Woon, *Company Law*, (FT Law and Tax Asia Pacific, Singapore 1997) at 343, footnote 131.

common law derivative actions. In the case of listed companies, only the common law procedure is allowed.⁷⁹

As stated above, the Canadian experience did not result in a substantial surge of derivative actions following their virtual abolition of the *Foss v Harbottle* rule. Even if there is likely to be some increase in litigation, it would seem to me that there is a greater need to check abuse in public listed companies which have at their disposal vast amounts of public money. The procedure for the statutory derivative action requires that the court must be satisfied that the complainant is acting in good faith and it must *prima facie* be in the interests of the company that the action should be brought.⁸⁰

Therefore, the fear that frivolous applications would be made appears more imaginary than real. In Malaysia, s 181(1) of the Companies Act 1965⁸¹ provides for a remedy in cases of oppression, disregard, prejudice and unfair discrimination. Section 181(2) provides that the court, upon being satisfied that the applicant has established his case under s 181(1), may make "such order as it thinks fit" but, in particular, stipulates several orders in s 181(2) (a) - (e). None of those orders is a statutory derivative action, unless the general provision stated above can be interpreted to encompass every possibility including the derivative action. The Malaysian legislation in this regard is sorely in need of revision. It is suggested that changes along the lines of the Canadian position ought to be adopted in Malaysia.

In conclusion, it may be stated that the law on ratification is still in a muddled state. Difficulties exist, in particular, with regard to who may ratify, what breaches may be ratified, and the effect of any such ratification (or proposed ratification) upon:

1. The act or transaction in question *vis a vis* the third party,
2. The liability of directors/agents to the company for a breach of their duties, and
3. The right of the shareholder to institute a derivative action on behalf of the company.

There is a need to control the extent to which directors may use their voting power as shareholders to ratify transactions in which they have an interest. In this respect it has been suggested above that ratification should be made by an independent majority of shareholders, taking into account also the fairness of the price paid by the corporation, as is the position in the U.S.

79 Ibid.

80 S.216A(3)(b) and (c).

81 Which is approximately equivalent to the Singapore s 216.

In relation to release of directors from liability for breach, it is suggested that the better approach would be to require a separate special resolution to that effect, as is required under the English Companies Act 1985 in relation to *ultra vires* transactions.

It is further concluded that neither a ratification nor the possibility of it should be a bar to a minority shareholder who wishes to institute a derivative action. In this respect the Canadian model, which has already been adopted in Singapore to a large extent, may be the best alternative. It is further suggested that provisions be made stipulating a test for the standing of a ratification along the lines of s 239 of the Corporations Law as amended by the CLERP Act 1999⁸² and also taking into account the independentness of the ratification.⁸³

82 discussed above at p 15.

83 discussed above at p 16.