

Legal Issues Arising from Minority Shareholders' Remedies in Malaysia and United Kingdom

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ABSTRACT

The rules surrounding the standing, pleadings and proof of corporate litigation are notoriously convoluted. Towering over the area stands the legacy of the rule in Foss v. Harbottle which forms a major precedent in this area of law in Malaysia. The shareholders whether he has majority, substantial or minority interest is really concerned with the issue of managerial accountability and with the enforcement of a corporate right. However, there are many persisting setbacks and limitations surrounding the rule in Foss v. Harbottle. The article will make an attempt to highlight the legal issues arising from the provisions governing the shareholders remedies in Malaysia and compare with the legal position in United Kingdom incorporating the latest effort by the UK Law Commission Consultative Paper No 142 on Shareholder remedies. Finally the paper will also proposed the possibility of introducing a statutory derivative action in Malaysia and the legal ramifications arising from such proposal.

ABSTRAK

Kaedah berkaitan tentang hak menuntut, pliding dan beban pembuktian tuntutan korporat memang terbukti kompleks dan menimbulkan persoalan-persoalan yang belum dapat diselesaikan. Prinsip yang telah ditetapkan dalam kes Foss v. Harbottle merupakan teras pengikat utama bagi cabang undang-undang ini di Malaysia. Salah satu kepentingan yang perlu dikekalkan sama ada seseorang pemegang syer itu mempunyai kepentingan majoriti atau minoriti adalah isu berkaitan tanggungjawab pengurusan serta penguatkuasaan hak dari segi undang-undang korporat. Dalam konteks ini, terdapat beberapa had dan halangan yang berbangkit dari kes Foss v. Harbottle. Artikel ini akan membincang dan mengenalpasti beberapa isu undang-undang dari peruntukan yang mengawalselia remedi pemegang syer di Malaysia. Selain dari itu suatu kajian perbandingan akan dilihat dengan kedudukan terkini di United Kingdom terutama usaha terkini yang sedang dilaksanakan oleh Suruhanjaya Undang-undang di UK berdasarkan kertas kerja Rundingan No 142 bagi remedi Pemegang syer. Akhir sekali artikel ini juga akan mengkaji usaha dan cadangan untuk memperkenalkan tindakan derivatif dari segi statut di Malaysia dan implikasi yang berbangkit dari cadangan tersebut.

INTRODUCTION

One of the pillars of company law is the principle of majority rule. Both at the level of the board of directors and the company in general meeting, company decisions are generally decided by a simple majority vote. But while the concept

of majority rule is fundamental, it carries with it the potential for abuse power. There are major issues relating to the position of minority shareholders in pursuing the cause of action against a company particularly when the offence or liability alleged, arises from a breach of duty by the directors. As far as breaches for negligent statements and offences on insider trading are concerned, Malaysian law provides civil remedies to allow the injured party to bring a cause of action against the offender or to allow the regulator to act on behalf of the injured party. This can be seen through the provisions in the Security Industry Act 1983 and the Security Commission Act 1993.

However, for liabilities arising from breaches of the fiduciary duties of directors, shareholders are unable to bring a cause of action directly against the offender because the wrong is committed against the company. In Malaysia, the general principle, as in common law, is that directors owe their duty to the company and not to shareholders individually. Thus, shareholders can only challenge the breach if they can either, establish that there is fraud on the minority, or establish that the conduct amounts to an unfair prejudicial act oppressive to the shareholders. Thus, the only effective means to seek a remedy is based on a derivative action against the company.

Alternatives for the minority shareholders in pursuing a cause of action through the derivative action available in Malaysia and their limitations form the crux of the discussion and analysis in this section. This article will consider the legal issues arising when the course of action is based on breach of director's duties. Furthermore the article will also discuss the justification for introducing a statutory derivative action that will enhance and preserve shareholders rights to institute proceedings against the company.

SECTION 181 OF THE MALAYSIAN COMPANIES ACT 1965 AND THE EXCEPTION TO THE *FOSS V. HARBOTTLE* RULE

One of the problems raised in relation to the right to bring a cause of action against the directors or the company is that related to the proper plaintiff rule. By virtue of the case of *Salomon v. Salomon & Co.*¹ applicable in Malaysia, a company has separate legal identify and thus, the power to litigate for compensation for any wrongful act committed against the company lies with the company.² This is a major setback, in that it deprives the shareholders and

¹ [1987] AC 22.

² This is known as the rule in *Foss v. Harbottle* (1843) 2 Hre 261, ER 189. This rule is also known as the internal management rule which was expressed by Lord Davey in *Burland v. Earle* [1902] AC 83 at page 93 as "an elementary principle of law and that the court will not interfere with the internal management of companies acting within their powers and in fact no jurisdiction to do so".

creditors of a valid cause of complaint where the director or the company controllers have acted in breach of their duties, whether fiduciary or otherwise.

For the shareholders, in the case of director's breach of duty, they may not be able to commence an action on behalf of the company as they may lack the power to control the board by exercising their power through the general meeting.³ Therefore, the only course of action available to them is to remove the directors.⁴ The law provides two means to enable the shareholders and creditors to preserve their interests. Firstly, by way of an application to the court for relief under section 181 of the Companies Act 1965. In relation to this issue one of the remedies provided by the Act in the case of oppression is to order for the winding-up of the company as stipulated under section 218(7) of the Company Act 1965. Secondly, by application of the exceptions to the rule in *Foss v. Harbottle*.

SECTION 181 OF THE MALAYSIAN COMPANIES ACT 1965

Prior to 1965, investors have to resort to common law doctrines to check abuse of powers by directors or majority shareholders. However, with the enactment of section 181, in response to the inadequacies of the common law,⁵ the 1965 Companies Act provides relief against oppressive conduct, conduct in disregard

³ See also *Automatic Self Cleansing Filter Syndicate v. Cunningham* [1906] 2 Ch 34 and *Shaw v. Shaw* [1935] 2 KB 113. See also Article 73 of Table A Companies Act 1965 which specifies that the power exercised by directors is subjected to power regulated in the general meeting.

⁴ See Companies Act 1965, Table A, Art 69. See also section 128 in relation to removal of directors of a public company. In Malaysia the power to remove a director from the office lies with the company based on a special notice and an ordinary resolution passed at a general meeting. This right is given to the company irrespective of any overriding provisions in the article and memorandum of association. See also section 128(1)-(2).

⁵ Section 181 of the Malaysian Companies Act 1965 was enacted against the background of dissatisfaction with section 210 of the English Companies Act. Under the common law provision, in order to succeed an applicant had not only to show that the conduct was oppressive but also that to wind up the company would be unfairly prejudicial to some part of the members including the applicant but otherwise the facts would justify the winding up of company on just and equitable ground. This issue than was discussed by the Jenkins Committee (Cmnd 1749 (1962) paras 199-212) arrived at two conclusion. This include firstly, that the term oppressive was too strong a word to be applicable in all cases and secondly the word does not accord the underlying intention of section 210 as originally framed namely to provide a remedy in cases of unfairly prejudicial conduct. It was then proposed that section 210 to be amended to make clear that the remedy was available to cover cases of unfairly prejudicial conduct as originally intended and not just oppressive conduct. Consequently, the result now is that section 210 of the English Companies Act 1948 was subsequently replaced by section 75 of the Companies Act 1980 which in turn was replaced by section 459 of the English Companies Act 1985. At present section 459 (1) of the UK Companies Act provides that a member of a company may apply to the court by petition for an order on the ground that the company's affairs are being conducted in a manner which is unfairly prejudicial to the interest of the members generally or some parts of that any actual proposed act or commission of the company including an act or commission on its behalf is or would be so prejudicial.

of interests and discriminatory or prejudicial conduct. Section 181 of the Malaysian Companies Act generally corresponds with section 210 of the United Kingdom Companies Act 1948. However, there are some major differences in wording and scope. In *Re Thai Kong Swamill Sdn Bhd & Ors v. Ling Beng Sung*,⁶ the Privy Council, comprising of Lord Wilberforce, Viscount Dilhorne, Lord Salmon, Lord Fraser of Tulleybelton and Sir Garfield Barwick, made a comparative analysis between section 181 of the Malaysian Companies Act and section 210 of the United Kingdom Companies Act. The major difference between the two provisions is that section 181 has added “disregard of the interests of the members and oppression” as a ground of relief making explicit what was inherent in section 210. It also introduces a new ground in sub section 1(b) and sets out the kind of relief which may be granted and provide a specific type of relief, that of winding-up of the company. On the other hand, section 201 is differently constructed. The court is required to find facts that would justify the making up of a winding-up order under the “just and equitable” grounds provision in the act and also, to justify that winding-up the company would not unfairly prejudice the “oppressed minority”. On the other hand, the Malaysian section requires a finding of “oppression” or “disregard” and then leaves a wide discretion to the court to decide the appropriate relief, including that of winding-up the company. That option ranks equally with the others, so it is incorrect to say that the primary remedy is winding-up.

Thus, as pointed out by the Federal Court, the major difference between the two provisions is that “while section 181 specifically provides for the winding-up of the company if the circumstances of a particular case warrant, such a relief would be wholly inappropriate to an application under section 210 of the English Companies Act 1948.”⁷ Thus, it may be concluded that the differences in the statutory pattern of section 181 and 210 of the English Companies Act are the direct result of doubt on the part of the Malaysian legislature with regard to the effectiveness of the latter section as an ideal model to construct a provision dealing with oppressive conduct. Hence, Section 181 is differently constructed and broader in scope than section 210 of the English Companies Act.

As mentioned in the *Re Kong Thai Sawmill* case, to be able to achieve relief under section 181, the petitioner must ensure that it falls within the two

⁶ [1978] 2 MLJ 227.

⁷ *Re Khong Thai Swamill (Miri) Sdn. Bhd, Lim Beng Sung v. Kong Thai Sawmill (Miri)* [1976] 1 MLJ 59. Further in *Tuan Haji Ishak bin Ismail v. Leong Hup Holdings Bhd and Others* [1996] 1 MLJ 661, a similar comparative analysis was made by the Court of Appeal comprising of Justice Mahadev Shanker, Siti Norma Yaakob JJCA and Abdul Malek J stating that both section are similar except that section 210(1) did not contain any reference to unfairly prejudicial conduct by controllers or oppressive exercise of director’s powers in disregard of member’s interest and had no equivalent to section 181(b) that is unfair discrimination or prejudicial acts.

limbs of subsection 181 namely to be able to complain of oppression or unfair discrimination or being otherwise prejudiced. Lord Wilberforce, speaking for the Privy Council, stated that relief cannot be sought under section 181 merely because facts are established which would found a minority shareholders's action, the section requires "oppression" or "disregard". The mere fact that one or more of those managing the company possess a majority of the voting power and in reliance of the power, make policy or executive decisions, with which the complainant does not agree, is not sufficient. Those who take interests in companies limited by shares have to accept majority rule. It is only when the majority rule passes over into rule oppressive of the minority, or in disregard of their interests, that the section can be invoked.

This is one of the major problems pertaining to section 181, since there are no definite guideline or criteria as to what amounts to "oppression". Furthermore, there are no statutory definition of the term "oppression" in the act. Subsequently, Malaysian cases have referred to common law guidance⁸ resulting in various interpretations. In *Re Harmer*,⁹ "oppression" was defined to include "burdensome, harsh and wrongful". It was said that the word should be given a meaning according to its common use and understanding in the English language.¹⁰ In *Kumagai Gumi Co Ltd v. Zenecon – Kumagai Sdn. Bhd. & Ors*,¹¹ Annuar J. referred to the decision in *Re Tivoli Freeholds Ltd*¹² where Menhennitt J laid down certain criterias to constitute "oppression" when he said, "there must be something adverse or detrimental to the members financial interest as shareholders and that some members have suffered in a pecuniary sense in their capacity of members". Thus, it can be deduced from the cases that the scope of what amounts to 'oppression' can be construed subjectively since there is no definite or precise test.

This was supported in *Owen Sim Liang Khui v. Piasau Jaya Sdn. Bhd & Anor*.¹³ When it was pointed out that the dictum given by Lord Wilberforce in

⁸ However because of the differences in wording of the comparable sections namely section 181 and 210 the Privy Council in *Re Kong Thai Sawmill* had cautioned against relying on the English precedents in Malaysia. Lord Wilberforce said that it is important that courts applying section 181 should do so in according to its terms and its purpose and should not regard themselves as necessarily bound by United Kingdom decisions which are base in upon a different section and in some case restrictive. This reservation was also expressed in *Tuan Haji Ishak v. Leong Hup Holdings Bhd.* [1996] 1 MLJ 661 and other appeals.

⁹ [1958] 3 ALL ER 689.

¹⁰ per Roxburgh J in the first instance in *Re HR Harmer Ltd*. This dicta was referred to in *Owen Sim Liang Khui v. Piasau Jaya Sdn. Bhd. & Anor*. [1996] 1 MLJ 113.

¹¹ [1994] 2 MLJ 789.

¹² [1972] VR 445.

¹³ [1996] 1 MLJ 113. This case has referred to a number of common law case in its judgement and among others are *Scottish Co-operative Wholesale Society Ltd. v. Meyer* [1959] AC 324 and *Re Harmer Ltd* [1958] 3 All ER.

Re Thai_Kong Sawmill merely constituted guidelines and not on flexible propositions in law. Question as to whether there was oppression, disregard or unfair discrimination must be determined based on the facts of each particular case. The problem was also expressed in *Jaya Medical Consultants Sdn. Bhd. v. Island & Peninsular*¹⁴ where it was held that “it is quite impossible to lay down categories of conduct considered to be oppressive, each case has to be examined in the light of it’s own particular facts”. Thus, it can be said there is no definite test to determine what constitutes oppression under section 181 and the court must look at the alleged acts of oppression as whole and not in isolation.

In addition, Malaysian courts have long ignored the “unfairness” ground provided by section 181 (1) (b) and focused more on the “oppression” ground in paragraph (a) of the same section.¹⁵ Even in *Re Thai Kong Saw Mill (Miri) Sdn. Bhd.*, the court failed to appreciate the potential of “unfairness”, although the court did point out that Malaysia has two limbs instead of the one in the United Kingdom Act. This creates another major problem, since ‘oppression’ is more difficult to establish than ‘unfairness’. It was not until 1993 that Siti Norma Yaakob J in *Jaya Medical Consultants Sdn. Bhd. v. Islands & Peninsular Bhd.*¹⁶ pointed out the distinction between oppression and unfairness.

Furthermore, another issue where relief can be granted under section 181 is related to the question of parties’ locus standi. The question of what constitutes sufficient locus standi for different classes of person to invoke section of the act has been raised in a few cases. Section 181 itself lists those who are entitled to invoke it in seeking appropriate relief from oppression in the courts. The section begins with the term “member” or “debenture holder”. This would mean that a member or debenture holder may also obtain a remedy, if the conduct complained of is contrary to the interests of one or member of the debenture holders. However, there is no definition in the Act for both terms.¹⁷ Thus, the section provides relief to shareholders and creditors, but in the majority of cases that come under this section, the applicant will mostly likely be a shareholder.

¹⁴ [1994] 1 MLJ 520.

¹⁵ There are not many common law cases which succeeded in relying on oppression in England. Among them are *Re HR Harmer Ltd.* [1958] 3 ALL ER 689 and *Scottish Corporative Wholesale Society v. Meyer* (1959) AC 324. Similarly in Malaysia, some of the case that has succeeded to use this ground are *Re Coliseum Stand Car Service Ltd.* [1972] 1 MLJ 109 and *Ng Chee Keong v. Ng Teong Kiat Highlands Plantations Ltd.* [1980] 1 MLJ 445.

¹⁶ [1994] 1 MLJ 520.

¹⁷ However section 16 of the Companies Act 1965 defines the word “member of the company” as to include the subscribers to the memorandum who has been damaged to have agreed to become members of the company and upon the incorporation of the company shall be entered as members in its register of members. The general position of locus standi with regards to the parties has been explained by the Court of Appeal in *Owen Sin Liang Khui v. Piasau Jaya Sdn. Bhd. & Anor* [1999] 1 MLJ 113 where only one that comes under section 16(6) may present a petition under section 181 namely those who can establish that his name is registered under the company register of members.

As far as the position of creditors is concerned, Malaysian cases illustrate that there are many instances in which the act complained of will constitute oppression. Examples range from cases of removal or exclusion from the board, to refusing to alter the memorandum, to irregularities in keeping accounts, loans from the funds of the company, investments contrary to the main objects of the company. In relation to breach of fiduciary duties, one of the significant issues is whether it can be said to come within the ambit of section 181.

The issue for those breaches of fiduciary duties which consist of non-disclosure and conflict of interest were considered in three cases; *Re Khong Thai Sawmill*,¹⁸ *Re Senson Auto Supplies Sdn. Bhd.*¹⁹ and *Jaya Medical Consultants v. Island & Peninsular*.²⁰ From these cases it can be seen that breach of fiduciary duty in the form of non-disclosure of a conflicting interest by the directors can only come within the ambit of oppression under section 181 of the Act, if it can be proven that the non-disclosure is deliberate. Perhaps then, the court would be inclined to accept non-disclosure as an additional background factor in the gravity of the oppression when considering the entire facts in a particular case.

THE EXCEPTIONS TO THE RULE IN *FOSS V. HARBOTTLE*
(THE COMMON LAW DERIVATIVE ACTION)

The rule in *Foss v. Harbottle* is concerned with the right of a company to sue for any wrong done to itself encompassing the policy that the wishes of the majority of the members of a company regulating its own affairs should prevail as against the locus standi of its members to sue as individuals. However, in reality the effect of the rule is to prevent to a great extent, the rights of individual and shareholders to seek relief against wrongs done to themselves or the company. The rigidity of this rule was lessened by judicially devised exceptions in favour of minority shareholders. Those actions which come within the exceptions are generally referred to as minority shareholders actions.

The courts have determined that certain categories of action fall within the exceptions and these include where the action is a personal action,²¹ when the action concerns an ultra vires or illegal transaction,²² when the action relates to transactions which require a special majority,²³ when the action relates to

¹⁸ [1976] 1 MLJ 59.

¹⁹ [1988] 1 MLJ 326.

²⁰ [1994] 1 MLJ 520.

²¹ See *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2)* [1982] Ch 204; *Stein v. Blakes* [1998] 1 ALL ER 724; and *Lim Hean Pin v. Thean Seng Co Sdn. Bhd.* [1992] 2 MLJ 10.

²² See *Burland Earle* [1902] AC 83; *Smith Croft* [1988] 1 Ch 114. See also *Paidah Genganaidu v. The Lower Perak Syndicate Sdn. Bhd.* [1974] 1 MLJ 220.

²³ See *Baillie Oriental Telephone and Electric Co. Ltd.* [1915] 1 Ch 503; and *Lim Hean Pin v. Thean Seng Co.* [1992] 2 MLJ 10.

transactions that constitute a fraud on the minority²⁴ and where justice in the case requires it.²⁵ The exceptions are substantially the product of case law. The following is a brief discussion on the exceptions to the rule in *Foss v. Harbottle*.

a. Fraud upon the minority

A shareholder is entitled to sue if the actions of the majority constitute a fraud on the minority. The English court of Appeal in *Prudential Insurance Co. Ltd. v. Newman Industrial Ltd. (No. 2)*²⁶ clearly states the exception to the rule in *Foss v. Harbottle* and justifies such exception as follows :

There is an exception to the rule where what has been done accounts to fraud and the wrongdoers are themselves in control of the company. In this case, the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholder's action on behalf of themselves and all others. The reason for this is that, if they were denied that right, then grievance could never reach the court because the wrongdoers themselves being in control, would never allow the company to sue.²⁷

In order to justify a derivative action, the plaintiff must provide prima facie proof that the defendant were in position of control within the company and had perpetrated a fraud upon the minority. What tantamounts to fraud to the minority? In *Allen v. Gold Reef of West Africa*²⁸ it was decided that the majority must use their voting power to act "bona fide for the benefit of the company as a whole."

²⁴ For example see *Burland v Earle* [1902] AC 83 and *Menier v. Hooper's Telegraph Works* (1874) 9 Ch App 35. See also the Malaysian case of *Abdul Rahim bin Aki Krubong Industrial Park (Melaka) Sdn. Bhd.* [1995] 3 MLJ 417 which had adopted the principle in *Burland v. Earle*.

²⁵ Jenkins LJ who introduced this concept suggested in *Edwards v. Halliwell* [1950] 2 ALL ER 1064 that the exception to the rule in *Foss v. Harbottle* showed that the "rule is not inflexible rule and it will be relaxed where necessary in the interest of the justice". However the suggestion of the fifth exception was rejected in *Prudential's* case where the court said that they are not convinced that this a practical case particularly if it involves a full trial even before the trial is applied. Per Cumming-Bruce, Templeman and Brightman LJJ *ibid* at pg 221. In Malaysia, the High Court case of *Tan Guan Eng v. Ng Kweng Hee* [1992] 1 MLJ 487 noted this argument in *Prudential*. Nevertheless on the strength of *Edwards Halliwell* [1950] 2 ALL ER 1064, Edgar Joseph Jr. J introduced a fifth exception in Malaysia at page 503 of the case namely an "exception to the rule in *Foss v. Harbottle* will be made "where justice of the case requires it". The High court case dicta was confirmed in and approved by the Court of Appeal in *Abdul Rahim bin Ali v. Krubong Industrial Park (Melaka) Sdn. Bhd.*

²⁶ [1892] Ch 204. In this case, the derivative action was instituted against two directors in *Newman Industries Ltd* who had used their position within the company to conceal to their own advantage certain interest which they held in the transaction between *Newman Industries* and another company.

²⁷ *Ibid.*, pg. 210 – 211.

²⁸ [1900] 1 Ch 656.

The term fraud was also defined in *Abdul Rahim bin Ali v. Krubong Industrial Park (Melaka) Sdn. Bhd.*²⁹ as a matter which has absolutely nothing to do with the actual fraud or deception at common law.

b. The act is illegal or ultra vires

At common law, where the act by a company is one which is ultra vires, the rule in *Foss v. Harbottle* does not apply. The case of *Burland v. Earle*³⁰ make it clear that the court will not interfere in the domestic affairs of a company only "if its acts are within its powers." Essentially than if it is shown that a company in any of its commission or omission has not acted within its powers, the court in appropriate cases will exercise their jurisdiction to set aside any wrong or illegality. The ultra vires exception together with the 'fraud upon minority' exception have been considered as the only true exception to the rule in *Foss v. Harbottle*. The ultra vires transaction falls outside the scope of *Foss v. Harbottle* since such acts cannot be rectified by the majority of the members. Further, ultra vires does not only confine to acts which were beyond the objects and power as set out in the memorandum but also to illegal and criminal acts of the company.

c. Where personal rights are infringed

The fourth exception enunciated by Edgar Joseph Jr. in *Tan Guen Eng & Anor. v. Ng Kweng Hee & Ors.*³¹ is that where the personal rights of the members are infringed, the rule in *Foss v. Harbottle* has no application at all. But as Justice Sharma reiterated in *David Lau Tai Beh v. Lau Ek Ching Sdn. Bhd.*³² the dividing line between personal rights and corporate rights is at times difficult to draw.

Membership rights may be derived from the statute, memorandum or article of association of the company or a distinctive separate members' agreement. An action under this exception may be instituted directly against the other members without associating the company as a joint defendant.³³

d. Special Resolution

Mismanagement of companies can also be resolved by the passing of ordinary resolution of the company in the general meeting. Nevertheless, if the statute or the article specifically provides that an act or transaction can only be approved

²⁹ [1995] 3 MLJ 417, CA.

³⁰ [1902] AC 83. See also *Sarawak Building Supplies Sdn. Bhd. v. Director of Forests & Ors.* [1991] 1 MLJ 211.

³¹ [1992] 1 MLJ 487.

³² [1972] 1 MLJ 217.

³³ See *Ling Beng Hin v. Ling Beng Sung* [1990] 1 CLJ 512.

by the consent of majority, then the exception in *Foss v. Harbottle* cannot be read to dispense these requirements.³⁴

As reiterated in *Lim Hean Pin v. Thean Seng Co. Sdn. Bhd. & Ors.*:³⁵

The rights of a member to bring an action for a declaration that an alteration if the company article is void and of no effect falls within the exception which states that the rule in *Foss v Harbottle* does not prevent an individual member from suing if the matter in respect of which he is suing is one which can validly be done or sanctioned not by a simple majority of the members of the company but only by special majority namely special resolution.

e. Where justice of the case requires it

The last exception to the rule in *Foss v Harbottle* is where the justice of the case requires, the court will make an exception to the rule. This exception was discussed as an obiter dicta by Justice Street in *Hawlesbury Development Co. Ltd. v. Landwork Finance Pty. Ltd.*³⁶ However, the Court of Appeal in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2)*³⁷ did not concur with the view on the ground that it was not a 'practical lest particularly if it involves a full-dress trial before the trial is applied.'³⁸

However, the reluctance of the English court of Appeal was not recognised by the Australian courts. In *Biala Pty. Ltd. v. Mallina Holdings Ltd. (No2)*³⁹ the Supreme court upheld the argument of the plaintiff where Justice Ipp held that the court may allow a derivative action by shareholders in circumstances where the justice of the case require.

In Malaysia, in line with Australian courts, the courts has recongnised this exception in *Abdul Rahim bin Ali v. Krubong Industrial Park (Melaka) Sdn. Bhd.*⁴⁰ The last two exceptions will be dealt with in detail since these are referred to as derivative actions in which the complaining shareholder brings an action on behalf of the company. Malaysian authorities have long adopted the exceptions to the rule in *Foss v. Harbottle* which has been subjected to judicial consideration in a number of local cases.⁴¹ Analysis of these cases

³⁴ For example transaction within the scope of section 31(1) namely on amendment of article of association, matters pertaining to reduction of capital section 64(1) and section 152(1) which requires special resolution.

³⁵ [1992] 2 MLJ 10.

³⁶ [1969] 2 NSW 782.

³⁷ [1982] Ch 204.

³⁸ [1982] Ch 204 at pg. 221. See the judgment of Justice Cumming-Bruce, Templeman and Brightman LJJ.

³⁹ (1993) 11 ACLC 1082.

⁴⁰ [1995] 3 MLJ 417 at 432.

⁴¹ For example see *Owen Sin Liang Khui v. Piasau Jaya Sdn. Bhd. Anor* [1996] 1 MLJ 113; *Hii Heng Tuong Alphonsus v. Lok Min Wah & Ors.* [1995] 4 MLJ 259; *Chooi Chee Sum v. Salehsan Tek Thye Sdn.Bhd. & Ors.* [1995] 4 MLJ 210; *Abdul Rahim bin Ali v. Krubong Industrial Park (Melaka) Sdn. Bhd. & Ors.* [1995] 3 MLJ 417; *Alor Janggus Soon Seng Trading Sdn Bhd. &*

indicates that the task of establishing the elements of the exceptions is not an easy one. For example, the exception for fraud on the minority and the exception “where justice requires it” are the most commonly pleaded exceptions in Malaysian cases. In terms of the exception for “fraud on the minority”,⁴² one of the elements that has to be proven is the element of “control”. From the decided cases, most of the derivative actions are based on allegations of “fraud upon the minority shareholders” by those who are in control of the affairs of the company. Essentially, two vital questions may arise; what acts and omissions will constitute a fraud on the minority shareholders and what is the basis for ascertaining that those who are alleged to have perpetrated fraud upon the minority shareholders are in control of the company.

Fraud in the context of an exception to the rule, does not lie in the act done or the transaction conducted by the director and company controllers, but in the use of the voting power by the majority and the directors, whether to approve or to ratify the acts or transaction in question.⁴³ Thus, the element of control of the part of wrongdoer must be proven. This is an important question, given that whether or not the wrongdoers are in control of the company may be a difficult and intricate question to determine. In order to determine whether control existed with a particular individual group of individuals, the court may be required to look beyond ownership of shares.⁴⁴ This is because control can be vested with the director or shareholders or perhaps, even an outsider, through the use of nominee directors, interlocking shareholding, agreement of the shareholders or the use of proxies. Thus, it is not easy to establish control, since who is in control of the company need not be based solely on who owns the company, but other factors have to be taken into consideration.

Ors. v. Sey Hoe Sdn Bhd. & Ors. [1995] 1 MLJ 241; *Ng Kian Chong & Ors. v. Siaw Seng Kee* [1994] 3 MLJ 691; *Re Tong Eng Sdn. Bhd. (Loh Loon Keng Petitioner)* [1994] 1 MLJ 451; *Emar Sdn Bhd (under receivership) v. Adigi Sdn. Bhd. and Anor.* [1992] 2 MLJ 734; *Lim Hean Pin v. Thean Seng Co. Sdn. Bhd. & Ors.* [1992] 2 MLJ 10; *Tan Guan Eng & Anor. v. Ng Kweng Hee & Ors.* [1992] 1 MLJ 487; *Automobile Peugeot SA v. Asia Automobile Industries Sdn. Bhd & Ors.* [1988] 3 MLJ 209; *Re Kong Thai Sawmill (Miri) Sdn. Bhd. & Ors.* [1976] 1 MLJ 59; *Paidiah Gengnaidu v. The Lower Perak Syndicate Sdn. Bhd. & Ors.* [1974] 1 MLJ 22; and *Mooney & Ors. v. Peat, Marwick Mitchell & Co. & Anor.* [1967] 1 MLJ 87.

⁴² The term “fraud on minority” does not mean fraud in the context of tort of deceit as in *Derry v. Peek* (1899) 14 App Cas 337. Fraud in the context of derivative action includes “not only fraud at common law but also fraud in the equitable sense as in the equitable concept of a fraud on a power” per Sir Robert Megarry VC in *Eastmenco (Kilner House) Ltd. v. Greater London Council* [1982] 1 WLR 2 at pg 12.

⁴³ This can be illustrated from Megarry VC in *Eastmenco (Kilner House) Ltd. v. Greater London Council* [1982] 1 WLR 2. at pag 12 when he said “the essence (of fraud on the minority) seems to be an abuse or misuse of power”. Similarly Vinelott J said in *Predential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2)* [1981] Ch 257 that “fraud” lies in the use of voting power.

⁴⁴ This was illustrated in *Ting Chong Maa v. Chor Seck Choon* [1989] 1 MLJ 477 where it was held that control includes de facto control. See also *Tan Guan Eng v. Ng Kweng Hee* [1992] 1 MLJ 487.

Furthermore, even where shareholders institute a derivative action alleging that those in control of the company have perpetrated fraud upon them, there is still a hurdle to cross before their action can reach trial. The plaintiff before proceeding with their action, must establish a prima facie case that the company is entitled to the relief claimed and that the action falls within the boundaries of the exceptions to the rule in *Foss v. Harbottle*.⁴⁵

Furthermore, they may have no right to bring a derivative action if the majority of those directors, who were independent of the wrongdoers are opposed to the action. This is illustrated in *Prudential's case*, where Vinelott J agreed that the principle which underlies the rule in *Foss v. Harbottle* is that it would be wrong to allow a minority shareholder to bring proceedings joining the company as defendant and claiming relief against other defendants on behalf of the company for an alleged wrong against the company, in circumstances where the majority of the members take the view that the proceedings are not in the interest of the company.⁴⁶ Furthermore, in *Smith v. Croft (No 2)*⁴⁷ the transaction in question was held to be ultra vires and therefore illegal. Nevertheless, Knox J ordered that the action be struck out on the grounds that the independent shareholders were opposed to the action.⁴⁸

The court has to consider the question of whether the shareholder has standing to bring the derivative action as a preliminary issue at the beginning of the trial or during the trial itself.⁴⁹ This requirement has been the subject of controversy in certain cases.⁵⁰ In *Biala Property Ltd. & Anor. v. Mallina Holdings Ltd.*⁵¹ It was held that there is no universal rule making it appropriate that the

⁴⁵ See also *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2)* [1982] Ch 204 at pg 323

⁴⁶ Ibid. However the judge concluded at page 327 that the action be permitted as he was "satisfied that there was no way in which Prudential could have ensured that the question whether proceedings should be brought by Newman would be fairly put to the shareholders or even that a full investigation would be made into all the circumstances surrounding the transaction".

⁴⁷ [1988] Ch 114.

⁴⁸ In this case the complaining shareholders had only 14% of voting rights and the defendants have 63%. The other shareholders in the company holders 21% votes and they were opposed to the litigation.

⁴⁹ In a derivative action there is every reason why the question of locus standi should be decided at the earliest opportunity. First it discourages unnecessary litigation and further if an action is stopped at an early stage it will save the company's expense and judicial time are saved.

⁵⁰ Issue in relation to locus standi was also raised by Professor Sealey in his article, Problems of standing, pleadings and proof in the corporate litigation, in B Pettet (ed), *Company Law in Change*, at page 12 where he blamed the traditional adversarial of the common law system which placed the plaintiff in a disadvantage position since the law insist that he follows the orderly sequence of pleading which requires a case to be clearly formulated from the start and does not allow discovery until the issues are well defined.

⁵¹ (1988) 6 ACLC 1138. See also *Hurley & Anor. v. BGH Nominees Pty. Ltd. & Ors.* (1982) 6 ACLR 791 where King CJ is of the opinion that the procedure suggested in the Prudential case

issue of locus standi be determined as preliminary issue. In certain circumstances, it may necessary for the courts to determine if the dispute could have been resolved by discussions with the company initially.⁵² Of course, this may lead to investigating the manner in which the majority would have viewed the problem as was held in *Smith v. Croft* (No 2).⁵³

In Malaysia, the position remained unsettled until 1995 until the Supreme Court decision in *Alor Janggos Soon Seng Trading Sdn. Bhd. v. Sey Hoe Sdn. Bhd.*⁵⁴ In that case, Jemuri Sarjan CJ referred and followed the approach of the English courts in the *Prudential* and *Smith v. Croft* cases, concluding that the investigation should be carried out during the hearing of preliminary matters, in order to determine whether the plaintiff's case comes within the exceptions to the rule in *Foss v. Harbottle*.

In addition, in Malaysian there are also some procedural aspects that have to be fulfilled before the issue of locus standi can be pleaded. A defendant has to make an application under the Rules of the High Court 1980⁵⁵ for determining the locus standi of the plaintiff as a preliminary issue or take an order to strike out the application, before the plaintiff is allowed to proceed further in the action.⁵⁶ It seems that the making of a formal application under either of these rules is not a flexible requirement, since the court should not entertain a preliminary objection to locus standi even in urgent cases such as in an application to set aside an ex parte order. This means that a defendant must make two applications, one under the rules to challenge the locus standi and the other to set aside the ex parte order.⁵⁷ Needless to say, this can be seen to be quite a cumbersome process creating an additional burden on the parties in the process of corporate litigation.

Another related issue is that concerning costs, which might act as a bar to the shareholder instituting a course of action against the company. The complainant shareholder who is bringing the derivative action on behalf of the company has to bear the cost of litigation. A shareholder suing on a derivative action is like any other ordinary litigant who has to pay his own legal fees as well as the taxed cost of the defendants in the event if he fails in the action. To make matters worse, if he succeeds, whatever amount of damages will be

could not be applied in all cases and that he felt that the procedure of determining the issue of locus standi should be determined in each individual case according to what appears to be just and convenient in the case.

⁵² See *Hew Sook Ying v. Hiw Tin Hee* [1992] 2 MLJ 189.

⁵³ [1988] 2 Ch 114.

⁵⁴ [1995] 1 MLJ 241.

⁵⁵ Rules of the High/court of Malaysia 1980, Order 33 Rule 2 and Rule 5.

⁵⁶ *Ibid* Order 18 Rule 19. See also *Smith v. Croft & Ors. (NO 2)* [1987] BCLC 206.

⁵⁷ This can be illustrated in *Alor Janggos Trading Sdn. Bhd. & Ors. v. Sey Hoe Sdn. Bhd. & Ors.* [1995] 1 MLJ 241.

awarded to the company. Therefore, the litigation would be costly and might have immense effect on the shareholder's financial position. However, the common law have advanced in resolving the problem by formulating a procedure whereby the complaining party may apply to the court by way of summons at an interlocutory stage for the company to indemnify him against the costs of the action.⁵⁸

UK LAW COMMISSION CONSULTATIVE PAPER NO 142 ON SHAREHOLDER REMEDIES

In United Kingdom, the Law Commission Consultative paper⁵⁹ has provisionally recommended a partial abrogation of the rule in *Foss v. Harbottle* and the creation of a separate and new derivative action from section 459 of the Companies Act. It emphasised that the advantage of a statutory derivative action is that it offers the possibility, in appropriate circumstances, that the cause of action may be enforced without a liquidation. In addition, the creditors would be treated equally with shareholders if wrongs to the company are remedied by relief for the company rather than its shareholders.⁶⁰ The most significant advantage is that this derivative action would enable a member to enforce any cause of action vested in the company, against any person arising from the breach or threatened breach of duty by any director, including claims against third parties as a result of such breaches.⁶¹ The papers' proposal that this would be implemented by enforcing strict judicial control at all stages⁶² was largely inspired by the Woolfe Report.⁶³

Since the reform in most respects involve question of procedures, the new derivative action will be governed by rule of courts which among others will partially replace the rule in *Foss v. Harbottle* as stated in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No 2)*.⁶⁴ The Supreme Court

⁵⁸ See *Wallesteiner v. Moir (No 2)* [1975] QB 373; *Jaybird Group v. Greenwood* [1986] BCLC 319 and *Smith v. Croft (No 1)* [1986] 2 ALLER 551.

⁵⁹ Law Commission consultation Paper No 142, *Shareholder Remedies: A Consultative paper* (London: The Stationary Office 1996). A follow-up paper was also published as a response to Paper no 142, Law Commission Consultation Paper No 246. (London: The Stationary office 1997). The second paper proposed the recommendation for the introduction of a new derivative procedure to replace the right to bring a derivative action at common law and recommendation of the Scottish Law Commission. It introduces two new sections in the Companies Act 1958 namely section 458A which deals with derivative action in England and Wales and section 458B which deals with the analogous section in Scotland.

⁶⁰ The Law Commission Consultative Paper, No 142 at para 16.4(ii).

⁶¹ *Ibid.*, para 15.2.

⁶² *Ibid.*

⁶³ The Right Lord Woolfe, *Access To Justice: Final Report*, 1996, London, HMSO, 1996.

⁶⁴ [1982] Ch 204, 210.

rule Committee has power to make rules of court for the High Court with respects to matters of procedure.⁶⁵

If a new rule making power were required for derivative actions, it might be located in a group of sections in the United Kingdom Companies Act 1985, headed 'shareholder remedies' which could also contain the unfair prejudice remedy. Other features of the reform are:

1. The applicant would unless the court gives leave to start proceeding without notice to the company be required to give the company 28 days notice of the grounds on which he wishes to bring a derivative action;
2. leave the court to continue the action would have to be sought by close of pleadings at the latest;
3. in considering whether to grant leave, the court should take into account all the circumstances;
4. leave of the court would be required for compromise or discontinuance.
5. the court would continue to be able to indemnify the applicant against some or all of his costs; and
6. the court should have power to give direction for a meeting of the company to be held.

In addition, the reform also proposed the introduction for a new remedy available to small-owner-managed companies, which are particularly badly affected by the prolixity and cost of section 459 proceedings. With this regards, the new remedy is focused on the situation where a shareholder entitled to management participation, is wrongly excluded which formed the most common allegation in unfair prejudice cases in UK. The remedy is expected to reduce the member of issues currently being raised with consequent reduction in the cost and length of proceedings.

Furthermore, to facilitate the recommendations, the new procedure would be governed by the rules of the court not merely by statutory provisions since these could be more easily amended in the light of changing circumstances.⁶⁶ This would certainly extend the ability of the shareholder with locus standi to bring a derivative action based on the breach of directors's duties.⁶⁷ On the

⁶⁵ Section 84 and section 85 of the UK Supreme Court Act 1981. Section 75 of the County Courts Act 1984 gives similar powers to the County Court Rule Committee. The Draft Court Proceeding Rules published with the Woolfe Report are intended to replace both the RSC and the CCR. See Ch 20, para 1 of the Woolf Report.

⁶⁶ Para 15.3.

⁶⁷ This would improve the present position where to challenge a breach of directors duties a shareholder must either establish that there is fraud on minority or where there is a breach of the shareholders personal right.

other hand, the Law Commission paper has been severely criticised⁶⁸ from various perspectives, particularly concerning the proposals ability to achieve it's objective and on grounds of procedural aspects. Nevertheless, the introduction of a codified statutory remedy will certainly constitute a great effort in the attempts to improve the position of the shareholder/creditor in preserving their right of action against breaches of director's duties.

PRESENT POSITION : UK MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY – COMPLETING THE STRUCTURE 2001

The field of remedies by derivative actions has been thoroughly considered by the UK Law Commission. The 1997 proposals were endorsed by the UK government including new rules restricting derivative action to actions for breach of duty by the directors and extending such actions to cover breach of directors' duties of care and skill and the putting of the derivative action on to a statutory footing.

Two other areas were raised in the 2001 report namely:

1. The extent to which decisions not to sue by the board of directors or ratification of the wrongful act by the members should bar a derivative action; and
2. the extent to which the rules on the admissibility of derivative actions should be embodied in legislative form.

In summary, the 2001 report agreed that derivative action should be put on a statutory basis. However these action should extend only to breach of duty by a director, including the duty of care and skill. Ratifications and discuss not to sue should block a derivative action if unlawful. To be lawful, such decision must be taken by a proper majority not tainted by participation in the wrong nor under the influence of the wrongdoer. The court should have discretion in allowing such action to proceed but should also be guided by whether the action is in the best interests of the company, on which question it should have regard to a proper decision of a disinterested majority of the relevant members. If other criteria are require to guide the court in these cases they should be laid down by the Companies Commission and a power should be provided to enable this.

⁶⁸ See J. Lowry, 'Reconstructing shareholders actions; a response to the Law Commission's consultation paper' (1996) 17 *Co. Law* 247; AJ Boyle, 'The new derivative action' (1996) 16 *Co. Law* 256; and C. Riley, 'The values behind the Law Commissions's consultation paper' (1996) 17 *Co. Law* 260.

THE POSITION OF PN4 COMPANIES IN MALAYSIA

As far as PN4 Companies⁶⁹ are concerned the position in Malaysia requires that these companies should provide necessary corporate information to the authorities as a form disclosure requirement in its effort to enhance shareholder remedies. These requirements are stipulated in the new KLSE revamped listing requirement, Practice Notes No 4/2001 – Criteria and obligation pursuant to paragraph 8 – 14 of the Listing Requirements (PN4). The PN4 provisions also aims to protect the interest of investors by ensuring that sufficient information disclosures are made on the progress of the restructuring plans of affected listed companies and by imposing penalties on affecting listed companies that do not meet the requisite datelines.

For delisted PN4 Companies seeking relisting on the KLSE, they must demonstrate that they are financially strong and have identified the causes that led to their past distressed financial state. The companies must also have new dominant shareholders and management. For relisting purposes, among the corporate information that are required to be disclosed includes details on assets, including new assets to be injected are of good quality and would be able to rectify their profitability, cash flow and balance sheet problems.

This disclosure is significant as to ensure an intensive monitoring and surveillance of PN4 Companies by the Securities Common since it was revealed that a variety of breaches and mismanagement was committed by the directors and senior offices of these companies.

PROSPECTS OF A STATUTORY DERIVATIVE ACTION IN MALAYSIA

The discussion above has illustrated that the common law derivative action has given rise to several problems. Although a derivative action gives a right for the injured shareholder to bring a course of action on behalf of the company against the errant directors, there are considerable setbacks and hurdles that one has to go through before one is able to initiate proceedings.

Is there any possible solution to improve the position of the shareholder? One of the proposals put forward is to create a statutory derivative action to secure for the shareholder a right a course of action against the company.

⁶⁹ PN4 Companies are affected listed companies that fail to meet the financial condition for continued trading and listing on the KLSE. In this context, the provisions of KLSE'S practice note 4/2001 (PN4) which became effective on 15 Feb 2001 are intended to ensure that affected listed companies take expeditions steps to regularise their financial conditions within the stipulate time frame.

Professor Sealy has pointed out some of the problems associated with the common law action in relation to the formal requirements for pleading and proof imposed by the courts.⁷⁰

The introduction of a codified derivative action would overcome some of the weaknesses of the common law derivative action. In Malaysia, a statutory derivative action has also been proposed by the Malaysian High Level Finance Committee on Corporate Governance.⁷¹ The committee, in discussing the prospects of introducing a statutory derivative action, seems to take a very cautious view on the issue. In discussing the possibility, reference has been made to the Corporate Law Economic Reform Programme (CLERP) of Australia,⁷² the position in Singapore⁷³ and in the United States.⁷⁴ Surprisingly, no comparative study was made of the current Law Commission proposals in the United Kingdom.

Overall, the proposed Code seems to favour the Singaporean approach.⁷⁵ It can be observed that the Code favours a policy of balancing the benefits of a statutory action against the spectre of massive litigation necessitating a cautious approach requiring further study and review.⁷⁶ Although it agrees that in the

⁷⁰ See LS Sealy, Problems of standing, pleadings and proof in corporate litigation, in B. Pettet (ed), *Company Law in change*. The issue was also dealt in another article by Sealy, 'Shareholders' remedies in the common law world' (1997) *CfLR* 172.

⁷¹ Report on Corporate Governance, *Finance Committee on Corporate Governance*, February 1999.

⁷² *Ibid.*, para 4.4-4.10 Chap 6. CLERP in Australia has highlighted the numerous problems associated with the common law derivative action. The majority uncertainty is whether ratification by some shareholders of directors' breach of duty would result in denying other shareholders the right to bring a derivative action to protect the company. CLERP has therefore proposed a statutory derivative action to overcome the inadequacies of common law and allow the shareholders and directors of the company to bring an action on behalf of the company, for a wrong done to the company if the company is unwilling or unable to do so.

⁷³ *Ibid.*, para 4. 11-4. 18. In addition to the oppression remedy, Singapore has enacted a statutory derivative action through section 216A and 16B of the Companies Act 1993 which is based on the Canadian legislation.

⁷⁴ *Ibid.*, para 4.19. This is based on the American Law Institute (ALI), *Principles of Corporate Governance*.

⁷⁵ This includes the ability of the court to decide on the desirability of allowing the complainant to control the action without analyzing the company's alleged cause of action against the wrongdoer and the court's ability at a preliminary stage to strike out frivolous and vexatious action. Further the court has the ability to impose conditions on the locus standi and to tailor the order according to the justice of the case. This may include an order giving the complainant access to company records to enable him to gather evidence for the action, a problem which often deters shareholders from bringing an action. In addition the court also will have the ability to order that the company indemnify the complainant for the cost of action. This overcomes the advantage of the common law derivative action where if the shareholder wins, the benefit will accrue to the company but if he loses, he pays the cost of all the parties. See para 4.17 of the Code.

⁷⁶ Para 4.21, Chap 6 of the Code.

long term, codifying the derivative action would increase private enforcement and reduce the need for public or regulatory interference, at the same time, the code also expresses doubt and caution by stating that the derivative action should not be looked at in isolation. Instead, a comprehensive study should be undertaken of the entire remedies available to shareholders, including section 181, remedies for irregularity in management, personal and representative action by shareholders and issues relating to access of information by shareholders.⁷⁷

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⁷⁷ *Ibid.*, part 4 of the Code which discusses on derivative action.

