CLEMENTS v. CLEMENTS BROS. LTD: ENTRENCHING CONTROL

The issue in *Clements* v. *Clements Bros. Ltd.*,[1] can be stated in general and in specific terms. The broad proposition relates to the limits on the powers of majority shareholders (that is shareholders with the majority of voting power in the company) – the principle of majority rule. The more specific matter concerns the power of directors and controllers to issue additional shares for maintaining themselves in control. The latter problem has generated considerable litigation in recent years, but the outcome is not entirely clear.

Clements Bros. Ltd. was a long established family company carrying on a successful building business. The plaintiff held forty-five percent of the shares and her aunt held the remaining fifty-five percent. The board of directors consisted of the aunt and four other directors, the plaintiff having resigned her directorship sometime earlier due to differences with the chairman. The directors proposed to increase the company's share capital from £2000 to £3650 by the creation of a further 1650 ordinary shares, ranking equally with the existing shares. 200 of the new shares were to be alloted to each director other than the aunt and the balance of 850 shares was to be acquired by the company and placed in trust for long service employees of the company. The proposed trustees were the chairman of directors and the company's solicitor and accountant.

The plaintiff was given notice of an extraordinary general meeting in which resolutions to implement the above scheme were to be proposed. She wrote back through her solicitor, protesting that she had not been consulted and expressing her concern of "a manoeuvre which, however dressed up, will take away her rights, her capital and her income without compensation."[2] In particular, the plaintiff complained that the effect of the resolutions would be to reduce her dividend income to less than half its present level; to deprive her of the power to block a special resolution (since her holding would be reduced to less than twenty-five percent of the total); and to reduce her rights of pre-emption (under the company's articles) to acquire her aunt's shares in case of transmission, thus relegating her permanently to a position of a minority shareholder. The plaintiff alleged further that the new shares were grossly underpriced and would dilute the capital value of the existing holding, causing her considerable capital loss. The resolutions were nevertheless passed, supported by the aunt and opposed by the plaintiff's representative. The plaintiff brought an action against the company and the aunt to set the resolutions aside for being oppressive. The aunt stated her belief that the directors should have a stake in the company and that long-time employees be rewarded. She relied on her right to vote as she pleased since she honestly believed it was in the interests of the company.

1 [1976] 2 All E. R. 268.
2 Ibid., 275.

The principle of majority rule raised in *Clements* has been discussed elsewhere[3] and will be mentioned here only briefly. Foster J. found the classical test, laid down in *Greenhalgh* v. *Adrene Cinemas Ltd*[4] of little assistance in intra-corporate disputes of the instant kind. In that case, Evershed M. R. suggested:[5]

> "[Y]ou may take the case of an individual hypothetical member and ask whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit."

The hypothetical "neutral" interest is non-existent when it comes to a very real dispute between warring factions of shareholders. Foster J. has illustrated this point by posing the rhetorical question:[6] "[D]id Miss Clements [the aunt] when voting for the resolutions, honestly believe that those resolutions, when passed, would be for the benefit of the plaintiff?"

This note is primarily concerned with the specific issue of the corporate power to issue shares for purposes of preserving control. It is believed that *Clements* is best discussed in these terms since Foster J. has expressly stated his disaffection with the conventional test of the limits of majority power[7]. Rather, the conclusion rests on the fact that the plaintiff was deprived of her existing right of a shareholder with more than twenty-five percent of the votes and her rights under the company's articles for the pre-emptory acquisition of the shares was greatly reduced. Though Miss Clements supported the resolutions in good faith, they were "specifically and carefully designed to ensure not only that the plaintiff can never get control of the company but to deprive her of what has been called her negative control",[8] and were, therefore, invalid.

Disputes over share allotments designed to affect control often arise in a takeover situation. Faced with a takeover, the directors may issue new shares to themselves and their supporters to prevent the bidder from ever gaining majority control. *Hogg* v. *Cramhorn*[9] is a clear authority for the proposition that such an allotment is for a collateral purpose (the primary purpose of share issue being the raising of additional capital) and is an improper, and therefore invalid, use of directors' powers to issue shares, irrespective of their subjective good faith. In *Howard Smith Ltd* v. *Ampol Petroleum Ltd*[10], the Privy Council has authoritatively stated that "it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority or creating a new majority which did not previously exist."[11] However, *Hogg's* case, and especially the English Court of Appeal in *Bamford* v. *Bamford*[12] have established that such an 'improper" share allotment can be ratified and thereby validated by a majority resolution of the shareholders. In *Bamford* Harman L. J. thought it a "commonplace of

3 (1977) 40 M.L.R. 71.
4 [1951] Ch. 286.
5 Ibid., 291.
6 Supra n. 1 at 281.
7 Ibid., 282.
8 Ibid.
9 [1961] 1 Ch. 254.
10 [1974] 1 All E.R. 1126.
11 Ibid., 1136 per Lord Wilberforce.
12 [1970] Ch. 212.

company law" that certain irregularities by the directors may be ratified by an ordinary majority of shareholders and considered a share issue of the kind discussed as falling in this category.[13] *Bamford* was recently approved and followed by the N.S.W. Court of Appeal.[14]

The extra power given to controlling shareholders in this respect is explained by the fact that the shareholders are not subject to the same fiduciary duties as directors. In particular, shareholders are not bound by a general duty to refrain from using their vote for "a collateral purpose". It appears, therefore, that the restraint over corporate power to issue shares for the purpose of affecting control operates only where the dispute is between the directors and the controlling shareholders. No such limit exists (subject to general considerations of good faith) when the dispute is between majority and minority shareholders. The power of majority shareholders to whitewash the sins of the directors in making an improper allotment of shares produces a number of unpalatable anomalies. First, since representation on the board is normally proportional to the members' voting power, it may well be asked why majority shareholders are given the power to validate an act which is forbidden to their representatives. Second, directors who plan to use the share issue method to frustrate a takeover would be well advised to act speedily, before the bidder has acquired sufficient shares to upset their voting support. In principle, it was held immaterial whether the directors had planned to render an existing majority unassailable or to destroy an existing majority by turning it into a minority.[15] But in practice the existence of a majority which supports the act becomes the crucial factor for its effectiveness. Third, a power (like the power to issue shares) which is given by the company's articles to the directors (as is invariably the case) cannot be usurped by the shareholders.[16] It follows that the only way to issue shares designed to affect voting control is for the directors to commit a breach of their fiduciary duties and to have it ratified by the members – a rather inelegant solution to say the least.

In *Clements* the company had apparently run out of registered share capital and had to *increase* it before proceeding with the scheme – a power which is reserved to the company in general meeting.[17] This, of course, was a fortuitous element. Had there been sufficient registered, but unissued, share capital, the directors could have simply issued it in the terms proposed, asking the members to ratify the act. This would have put the case squarely in the *Hogg* and *Bamford* situation.[18]

Foster J.'s decision clearly shows how important it is to approach the matter not through the abstract and vague considerations of the good faith of the majority but by examining the disadvantage caused to the minority. In particular, such a view may improve the position of the minority shareholders whose hopes of gaining control of the company by the acquisition of the necessary shares have been dashed by a well-calculated

13 Ibid., 238.

14 *Wintrop Investments* v. *Wings Ltd* [1975] 2 N.S.W.L.R. 666.

15 *Hogg* v. *Cramhorn*, supra n. 9 at 269.

16 E.g. *Automatic Self Cleansing Filter Syndicate Co. Ltd.* v. *Cuninghame* [1906] 2 Ch. 34.

17 Companies Act 1955, S. 70 (2).

18 It should be noted, however, that a private company in New Zealand must always increase its capital before a share allotment. Unlike in the United Kingdom, a private company in New Zealand must issue all its registered share capital; Companies Act 1955, ss. 356 and 361.

share allotment. A bidder who has been buying heavily on the stock exchange or through private dealings in the hope of gaining control would be paying more than market price for the shares. He stands to incur considerable loss if the bid is decisively frustrated and the value of the shares plummets. Another complaint by a minority shareholder may relate to the issue's price. If shares designed primarily to preserve control are issued for less than the current market price, they dilute the value of the existing shares and the issue should be open to objection on this ground.

The result in *Clements* is welcome. The emphasis on the particular prejudice to the minority shareholders' interest is thought to be a departure from the conventional application of the principle of majority rule. It is another example of the courts' growing preparedness to conduct a meaningful investigation of the plight of minority shareholders. It remains to be seen whether a similar approach is adopted in future cases.

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