CHALLENGING DIRECTORS' DECISIONS

DANIELS v. *DANIELS*

The procedural rule in *Foss* v. *Harbottle*[1] limits the ability of a ninority to sue the controllers or directors for wrongs to the company or infringements of the personal rights of the shareholders. The rule ıas been summarized by Lord Davey as follows:

> The Courts will not interfere with the internal management of companies acting within their powers, and in fact, have no jurisdiction to do so. Again it is clear law that in order to redress a wrong done to the company, or to recover money or damages alleged to be done to the company, the action should prima facie be brought by the company itself.[2]

There are two aspects to the Rule: "the informal management" rinciple and the "proper plaintiff" principle. As expounded in cases ıch as *MacDougall* v. *Gardiner*,[3] the substance of the "internal management" principle is that the courts will not permit a minority shareholder ɔ bring litigation concerning "internal irregularities", i.e. activities apable of ratification by ordinary resolution of the majority. In other vords, the Courts promulgate the principle of majority rule.

With respect to the second aspect of the Rule, it is generally held ıat the proper plaintiff in an action alleging a wrong to the company whether by outsiders or controllers) is the company itself.[4] Often, the otential defendants will be in control of the company, and in effect, ıey determine whether proceedings will be brought before the Court. Thus, the practical effect of the Rule is to prevent effective action gainst those who remain in voting control of the company, even if ıch persons are the wrongdoers.

As a result, certain qualifications to the majority's right to control ıe company's affairs have been accepted by the Courts.[5] A relaxation f the proper plaintiff aspect of the Rule is permitted where:

> . . . the persons against whom the relief is sought, themselves hold and control the majority of shares in the company, and will not permit an action to be brought in the name of the company. In

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[1] (1843) 2 Hare 461.
[2] *Burland* v. *Earle* [1902] A.C. 83 at 93.
[3] [1875] 1 Ch. D. 13.
[4] *Edwards* v. *Halliwell* [1950] 2 All E.R. 1064.
[5] L. C. B. Gower, *The Principles of Modern Company Law* 4th ed. (1979) 4.

that case the courts allow the shareholders complaining to bring an action in their own names. . . .

However, a limitation is imposed:

In such an action, the plaintiffs cannot have a larger right to relief than the company itself would have if it were the plaintiff, and cannot complain of acts which are valid if done with the approval of the majority of the shareholders or are capable of being confirmed by the majority.[6]

Such an action is properly described as a "derivative action".[7]

The purpose of this note is to analyse and evaluate the contribution made by *Daniels* v. *Daniels*,[8] itself a case concerning an alleged wrong to the company, in this area of law. Though the case was decided over two years ago, there has been such controversy about its significance that a review of both the case and the critical literature seems appropriate.

The Case

(a) *The Facts*

The plaintiffs, minority shareholders of a company, brought an action against the two directors (also the majority shareholders) and the company.

By the statement of claim, the plaintiffs alleged that, in Octobe[r] 1970, the company, on the instructions of the two directors, sold the company's land to one of the directors for £4,250. The substance o[f] the allegation was:

(i) the value of the land at the time of sale had been assessed a[t] its probate value, which is customarily less than the ope[n] market value;

(ii) as such, the defendants knew or ought to have known tha[t] the sale was at undervalue;

(iii) Four years after the sale, the land was sold for £120,000 (i.e a profit of £115,750).

The defendants applied to have the action struck out.

(b) *The Submissions*

For the defendants it was stated that the Rule in *Foss* v. *Harbottl[e]* precludes minority shareholders from bringing an action on behalf o[f] the company. The only relevant exception to the Rule was fraud:

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[6] *Supra* n. 2 at 93.

[7] The term "derivative action" is one commonly used in American jurisdic[-]tions to distinguish between suits brought by a shareholder as a representative o[f] himself and the other shareholders (a representative action), and those in whic[h] the shareholder, as a nominal plaintiff, sues as a representative of the compan[y] which is the true plaintiff. The action is brought against the wrongdoer and th[e] company as a nominal defendant. It is only recently that this term has bee[n] adopted in the U.K.: *Wallersteiner* v. *Moir* (*No.* 2) [1975] 1 All E.R. 849 at 85[...] *per* Lord Denning, M.R.

[8] [1978] 1 Ch. 406.

> . . . where there must be a minority who are prevented from remedying a fraud or taking any proceedings because of the protection given to the fraudulent shareholders or directors by virtue of their majority.[9]

It was contended that since no fraud was alleged, in its absence, the plaintiffs had no standing to bring an action.

In reply, Counsel for the plaintiffs asserted "the rights of a minority are not limited to cases of fraud; they extend to any breach of duty";[10] and since the plaintiffs were otherwise remediless, they were entitled to bring an action.

(c) *The Decision*

Templeman, J. held that the plaintiffs were entitled to proceed with their action.

The Judgment

(a) *Form of the action*

As noted earlier, where a wrong is done to the company, an individual shareholder, in certain circumstances, may sue on behalf of the company in a derivative action. Complexities are sometimes introduced when the facts of the case accommodate the possibility of both a derivative and a personal action. It is clear that Templeman, J. regards *Daniels* v. *Daniels* as involving a derivative action, since he refers to the defendant's actions as "a breach of duty which they owe to the company".[11] He accepts that *Alexander* v. *Automatic Telephone Co.*[12] involved both an infringement of individual rights and a breach of duty owed to the company. However, it is the latter characterization which Templeman, J. describes as "an exception going wider than fraud",[13] and relies on it to support his formulation of an exception to *Foss* v. *Harbottle*. Clearly, the "personal rights" aspect of the case is of no concern to him.

A derivative action must comply with the procedural requirement that the writ be in representative form, "on behalf of the plaintiffs and other shareholders other than the defendants". This was not done in *Daniels* v. *Daniels,* yet the action was allowed to proceed. Such a procedure is permissible because "*Wallersteiner* v. *Moir* (*No. 2*) illustrates that where no objection is taken to the absence of a representative form from the minority shareholders writ, the derivative action can proceed".[14]

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9 *Id.* 409 B.
10 *Ibid.*
11 *Id.* 414 A.
12 [1900] 2 Ch. 56.
13 *Supra* n. 8 at 411 H.
14 K. Wedderburn, "Minority Shareholders and Directors' Duties" (1978) *Mod. L.R.* 569 at 571.

(b) *Analysis of the Judgment*

Templeman, J. reviewed the authorities concerning exceptions to the Rule in *Foss* v. *Harbottle.* In his opinion, the cases which dealt with simple fraud[15] on the one hand, and gross negligence[16] on the other, did not account for those situations where "without fraud, the directors and majority shareholders are guilty of a breach of duty owed to the company, and that breach of duty not only harms the company but benefits the directors".[17] To fill this hiatus, Templeman, J. cited three cases which he regarded as illustrative of an exception to *Foss* v. *Harbottle,* which does not require the presence of fraud. These cases were *Alexander* v. *Automatic Telephone Co.,* "(a case) contemplating an exception going wider than fraud";[18] *Cook* v. *Deeks,* "(which) establishes that an action will lie where, without fraud, directors in a majority divert in their own favour business which should properly belong to the company they represent";[19] and *dicta* in *Pavlides* v. *Jensen,*[20] "(directors appropriating assets of the company)".[21]

With respect, Templeman, J.'s analysis of these cases indicates a distortion of the concept of "fraud on the minority" as recognized in this area of the law. As an exception to *Foss* v. *Harbottle* "fraud" is not confined to actual *male fides,* (as Templeman, J. implies) but also embraces its wide equitable meaning. "Fraud" refers to "an abuse of power" which need not necessarily be deceptive or dishonest. Indeed, "fraud on the minority" has been expressed as widely as "the controller's failure to act bona fide for the benefit of the company as a whole".[22]

In the light of this, the three cases are not authority for any separate exception to *Foss* v. *Harbottle.* Rather, they are examples of the established exception of "fraud on the minority" in its broad sense. *Cook* v. *Deeks* and the *dicta* in *Pavlides* v. *Jensen* are properly subsumed into the category of "expropriation of company property".[23]

No resolution by the majority can authorize a breach of the directors' duty to act *bona fide* in the interests of the company. Gower[24] points out that there may be a breach, even in the absence of conscious dishonesty if "they (the directors) have acted as they did because it was in their own interests, or that of some third party, without consider-

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15 *Atwool* v. *Merryweather* [1967] L.R. 5 Eq. 464 n; *Menier* v. *Hoopers Telegraph Works* [1874] L.R. 9 Ch. App. 350; *Mason* v. *Harris* (1879) 11 Ch. D. 97.

16 *Turquand* v. *Marshall* [1869] L.R. 4 Ch. App. 376; *Pavlides* v. *Jensen* [1956] 2 Ch. 565.

17 *Supra* n. 8 at 413.

18 *Id.* 411 H.

19 *Id.* 412-13.

20 *Supra* n. 16.

21 *Supra* n. 8 at 414 D.

22 A.B. Afterman, *Company Directors and Controllers* (1970) at 144.

23 Generally, the majority may not ratify a transaction which expropriates the company's property for the benefit of the controllers. Gower, *op. cit. supra* n. 5 at 616.

24 *Id.* at 572.

ing whether it was also in the interests of the company". In *Alexander,* the directors required applicants for shares to make payments, but issued shares to themselves without such a requirement. Although there was no actual fraud, and the directors acted "in the belief that they were doing nothing wrong",[25] the minority's action succeeded. Arguably, this case involved a breach of the duty to act *bona fide* in the wide sense described by Gower.[26]

Thus, Templeman, J.'s exception is founded on cases exemplifying that fraud on the minority is not limited to fraud in its strict sense. It would be reasonable to expect that any principle he derived from these cases would be, in substance if not form, a restatement of this law. The principle which Templeman, J. "gleaned" was:

> A minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company.[27]

With respect, Templeman, J. seems to have manipulated the authorities so as to produce a desired result. It is conceded that *Cook* v. *Deeks,* and *Alexander* were cases which involved the directors benefitting at the company's expense, but in neither case was there any reference to negligence. Further, although *Pavlides* v. *Jensen* was directly concerned with negligence, the dictum cited by Templeman, J. is completely removed from that context. Danckwerts, J. was merely reciting the established exceptions to *Foss* v. *Harbottle* as stated by Lord Davey in *Burland* v. *Earle.* Insofar as Templeman, J. implies that these cases are precedents for the view that negligence may found a minority action, he presents an analysis of these cases which is incorrect.

Does this mean that Templeman, J.'s "principle" is necessarily invalid insofar as it contemplates negligence as an exception to *Foss* v. *Harbottle*? If the answer is in the negative, then the "principle" marks an innovation to the present law, not merely a restatement of it.

An Exception for Negligence?

Although Templeman, J. held that there was a breach of duty, he did not specify which particular duty was infringed. However, the main thrust of his judgment indicates that he contemplates negligence as the foundation of a minority shareholders' action:

> . . . it would seem to me quite monstrous . . . if the confines of the

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25 *Supra* n. 12 at 65 *per* Lindley, M.R.

26 *Op. cit. supra* n. 5 at 619. Gower suggests that this is the case, but Wedderburn, (1958) *Cam. L.J.* 95 at 101 ragards the directors' conduct as being *bona fide.* The actual judgments in the case do not expressly state that the directors acted *bona fide.* The breach of duty was described as "depriving the company of the use of money which the directors ought to have paid up sooner than they did". It is submitted that this strongly suggests that the directors subordinated the company's interests to their own, thereby breaching their duty to act *bona fide.*

27 *Supra* n. 8 at 414 D.

exceptions to *Foss* v. *Harbottle* were drawn so narrowly that directors could make a profit out of their negligence.[28]

Prima facie, this runs directly counter to the decision of Danckwerts, J. in *Pavlides* v. *Jensen.* In that case the complaining minority shareholders of Company A brought an action against the directors, alleging they were guilty of negligence in the sale of a valuable asset belonging to Company A to another company at an undervalue. The plaintiffs claimed that the defendant directors who controlled the company would not permit him to sue in negligence, nor would the majority shareholder (a company in which the defendants were both directors and a majority of the board) bring the action.

Danckwerts, J. refused to grant the plaintiffs standing to complain of this breach of duty owed to the company. He read Lord Davey's *dictum*[29] as expressly confining the circumstances in which a minority shareholder can instigate a derivative action to cases where the acts complained of are fraudulent (including appropriation by a majority, of company property), or beyond the powers of the company. Thus, Danckwerts, J. refused to extend the category of "fraud on the minority" to include a breach of the duty to take reasonable care. It was expressly held that a director's negligence is open to ratification by the majority in a general meeting.[30]

Templeman, J. refused to dissent from *Pavlides* v. *Jensen,* but distinguished it on the ground that no benefit had accrued to the directors in the earlier case:

> . . . to put up with foolish directors is one thing, to put up with directors who are so foolish that they make a profit of £115,000 at the expense of the company is something entirely different.[31]

Opinion is divided as to whether this ground of distinction can be sustained. D. Prentice[32] maintains that it is a sound one, and that the directors in *Pavlides* v. *Jensen* were akin to Danckwerts, J.'s "body of rabid teetotallers who obtain a controlling interest in a brewery". On the other hand, the facts of that case do sustain the argument that the directors did gain an indirect benefit through their negligence.[33] In the present writer's view, Templeman, J. can be criticized for the imprecision of his language. Had he stated that the "benefit" must be "exclusive" or "direct", then the distinction would be clearly sustainable.

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[28] *Id.* 414 B.

[29] *Supra* n. 2 at 93.

[30] One of the prerequisites for a derivative action is that the wrong complained of cannot be ratified by a majority at a general meeting.

[31] *Supra* n. 8 at 414 C.

[32] (1979) 41 *The Conveyancer* 49.

[33] The defendant company A was a subsidiary of the holding company B, and the directors of A were also directors and the majority of the board of company B. Company A held 25% of the share capital of the purchasing company. Company A was thus sharing the benefit of the cheap price. This benefit was perhaps, indirectly shared by the defendants in their capacity as shareholders of Company A.

Inferential support can be found in Templeman, J.'s judgment for the view that the exception only applies to those who have *directly* benefitted by the breach of duty. The defendant husband argued that the financial advantage had accrued solely to his wife. Although Templeman, J. was not prepared to dismiss the suit against the husband at this preliminary stage, it appears that he would have done so, had there been clear evidence to support the husband's argument.[34] On balance, it is submitted that Templeman, J. means "direct benefit", and that a valid distinction has been drawn.

The prohibition of fraud on the minority is directed at those in control of the company. Templeman, J. did not assert as a ground of distinction that the wrongdoers in *Pavlides* were not in control of the company (a prerequisite for a derivative action). It is submitted that he was correct in not doing so.[35] Although Danckwerts, J. was unwilling to find that the directors were in control of Company A, the *ratio decidendi* of the case was that their negligence was ratifiable by the general meeting, and thus fell outside the exception to *Foss* v. *Harbottle*. Reference to the control issue was merely *obiter*.[36]

The other major obstacle to overcome was *Turquand* v. *Marshall*,[37] a case dealing, *inter alia*, with the propriety of a loan made to one of the company's directors who died insolvent. There were *dicta*[38] to suggest that the Courts will refuse standing to minority shareholders when the complaint stems from a director's "default in judgment". Templeman, J. maintained that his principle was not contrary to *Turquand* v. *Marshall* because:

> . . . in that case the powers of the directors were effectively wielded not by the director who benefitted,[39] but by the majority of independent directors who were acting *bona fide* and did not benefit.[40]

A minority shareholder cannot bring a derivative action unless the act complained of is incapable of ratification by a majority in a

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[34] B. Rider, "Amiable Lunatics and the Rule in Foss v. Harbottle" (1978) *Cam. L.J.* 270 at 286.

[35] As the sole directors and owners of the majority of shares, the defendants in *Daniels* were clearly in effective control of the company. As such, there was no need for the plaintiffs to show that both the directors and the general meeting had been invited to institute proceedings and had refused to do so.

[36] Even the correctness of Danckwerts, J.'s *dictum* is doubtful. Wedderburn, *supra* n. 26 at 94 maintains that Danckwerts, J.'s reasoning is inconsistent with the approach taken in *Menier* v. *Hoopers Telegraph Works*. There is also ample authority for lifting the corporate veil of the holding company to determine that the board of directors is in *de facto* control e.g. *Re Darby* [1911] 1 K.B. 95.

[37] *Supra* n. 6.

[38] *Id.* 386 *per* Hatherley L.C.

[39] On this analysis, *semble* an action would have been possible against the director who received the benefit. Since he died insolvent, and an action would have been futile, this issue was not discussed in the case itself.

[40] *Supra* n. 8 at 414D. Again, Templeman, J.'s imprecise language leads to ambiguity. He does not make it clear whether "acting *bona fide*" and "did not benefit" are to be regarded as separate grounds of distinction, or are cumulative. To alleviate this uncertainty, Templeman, J. should have been more exact.

general meeting. In *Daniels* Templeman, J. did not specifically state whether his principle required the plaintiff to show that the breach of duty is not ratifiable.[41] Of course, the obvious answer is that it is necessarily implied that the breach of duty was incapable of ratification, otherwise the plaintiffs would not have been given standing to continue the action. To draw such an implication is not inconsistent with *Pavlides* v. *Jensen* because a different type of negligence is involved, namely "self serving" negligence.

However, there is another alternative; a derivative suit is available although the breach may be ratified by the majority. In *Alexander* v. *Automatic Telephone Co.*, a case which Templeman, J. regards as a derivative action,[42] the Court of Appeal stated that the defendant directors would have escaped liability had they made full disclosure to, and obtained consent from the other shareholders. *Semble,* ratification of the breach of duty was possible.[43] Templeman, J. expressly relied on this case to substantiate his principle. It is open to speculation whether he accepted it *in toto*. If that is the case, then *Daniels* is inconsistent with the Court of Appeal's decision in *Burland* v. *Earle,* which regards compliance with this requirement as essential.[44]

For various reasons, the former alternative is preferred.[45] Unfortunately, Templeman, J.'s silence leaves doubt as to whether it is the one that he adopted. However, since Templeman, J. did not cite any excerpts from *Alexander* which referred to the ratification issue, it is submitted that he did not accept or even consider Lindley, M.R.'s finding on this point, and that the first alternative should be adopted (albeit by default).

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[41] Generally, the plaintiff must show that had the matter been put to the general meeting, the majority's approval would be a "fraud on the minority," i.e. it would not have been in the interests of the company as a whole. Gower, *op. cit. supra* n. 5 at 623.

[42] *Supra* n. 12. The case itself was pleaded as such (p. 63), and was accepted as being an available form of procedure by Lindley, M.R. (p. 69).

[43] *Id.* 66. *Alexander* is a puzzling case and seems to be an anomaly on the law related to *Foss* v. *Harbottle*. If ratification is possible, then under *Burland* v. *Earle, supra* n. 2, no minority suit should be possible. If there was a breach of the duty to act *bona fide* (as Gower suggests) then ratification should be impossible. On the other hand, if Wedderburn is correct, and the directors did act *bona fide,* insofar as there was a breach of the duty to act for proper purposes or the no-conflict duty, then the case law suggests that the breach is ratifiable and thus no minority action should have been possible. *Regal (Hastings) Ltd.* v. *Gulliver* [1942] 1 All E.R. 378; *Ngurli* v. *McCann* (1953) 90 C.L.R. 425.

[44] Whether *Daniels* is therefore incorrect on this issue, depends on whether cases such as *Hogg* v. *Cramphorn* [1967] Ch. 254, and *Bamford* v. *Bamford* [1969] 2 All E.R. 655, which state that a minority shareholder may sue on a director's breach of duty, notwithstanding that ratification is possible, are properly characterized as personal or derivative actions.

[45] A full discussion of this issue is beyond the scope of this note. Suffice it to say that the latter alternative raises the issue of whether the directors as wrongdoers, may nevertheless vote their own shares in their capacity of shareholders. *Mason* v. *Harris* (1879) 11 Ch. D. 97 and *semble* Danckwerts, J. in *Pavlides* v. *Jensen* [1956] 2 Ch. 254 suggest that they can. *North West Transportation Co.* v. *Beatty* (1887) 12 A.C. 589 suggests they can, subject to a restriction where the directors act fraudulently. On the other hand, *Hogg* v. *Cramphorn ibid.* is authority for the proposition that even where the directors act *bona fide,* their voting powers may be limited. It is a controversial issue.

The end result is that both *Pavlides* v. *Jensen* and *Daniels* survive concurrently. Provided that he does not benefit himself, then irrespective of the damage resulting to the company, under *Pavlides* v. *Jensen,* a negligent director will still escape a minority shareholder's derivative suit. Of course, the director must be able to secure ratification of his conduct at a general meeting. However, if the director's negligence is such that he benefits himself at the expense of the company, then on the authority of *Daniels,* he is exposed to the possibility of litigation.

Although Templeman, J. dismissed *Heyting* v. *Dupont*[46] summarily as a case where "the exceptions to the rule in *Foss* v. *Harbottle* did not come into play", there are *dicta* in the case which could have supported his decision.

From time to time the Courts have acknowledged that there may be an exception to *Foss* v. *Harbottle* based on the necessity of justice.[47] Such judicial comment is of a very generalized nature, but in *Heyting* v. *Dupont,* the Court of Appeal was more specific, and observed that a derivative action for misfeasance without alleging fraud may be available where justice requires.[48] Arguably, the type of negligence involved in *Daniels* constitutes a misfeasance falling within this category, and warrants an application of the "justice exception".

Otherwise, the case must be read as an accretion to the "fraud on the minority" exception. When it is remembered that negligence and fraud are usually totally dissimilar branches of law, to describe negligence as a form of fraud seems anomalous. Of course "fraud" bears a wide meaning in this context, but all the cases applying it involve at least an improper motive.[49] Negligence, by its very nature, does not. To suggest that self serving negligence at the expense of the company infers something akin to bad faith, seems artificial, and tends to blur the distinction between conduct which is not *bona fide* and conduct which is negligent. Moreover, the "principle" presents a curious hybrid of the duty not to allow conflict of personal interests, and the duty to exercise reasonable care. This is implicit in Templeman, J.'s assertion that profit-making negligence is within the exceptions to *Foss* v. *Harbottle*. Although the Courts have recognized that the same facts may accommodate breaches of two duties (e.g. *Ngurli* v. *McCann*), the differentiation between the duties is preserved. The amalgamation

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[46] [1964] 2 All E.R. 273.

[47] In *Foss* v. *Harbottle supra* n. 1 at 492 *per* Sir James Wigram, V.C. ("the claims of justice would be found superior to any difficulties arising out of technical rules"). In *Russell* v. *Wakefield Waterworks Co.* (1875) L.R. 20 Eq. 474 at 480 *per* Sir George Jessell, (". . . the exceptions must depend on the necessity of the case, that is the necessity for the Courts to do justice"); *cf.* Street, J. in *Hawkesbury Development Corp.* v. *Landmark Finance* [1969] 2 N.S.W.R. 782.

[48] Danckwerts, J. (a single judgment) doubted that the justice exception was applicable to any wider field than the established exceptions to the Rule in *Foss* v. *Harbottle*. It is submitted that *Heyting* v. *Dupont,* being a Court of Appeal decision is the better authority.

[49] E.g. *Cook* v. *Deeks* [1916] 1 A.C. 554; *Ngurli* v. *McCann supra* n. 43.

evident in *Daniels,* where elements of two separate duties fuse together is a totally different proposition, and is unsupported by authority or principle. Thus, it seems that Templeman, J.'s interpretation of the case law is misconceived. These conceptual difficulties disappear if the *Daniels* type of negligence is regarded as illustrative of an exception to *Foss* v. *Harbottle* based on the dictates of justice.

Nonetheless, on policy grounds, it is submitted that Templeman, J.'s decision is to be applauded. In practical terms, the decision in *Pavlides* v. *Jensen* means that there is no possibility of recourse against even the gross negligence of directors, if they control the majority of votes. This is tantamount to giving directors carte blanche as to the degree of responsibility they use in the discharge of their functions.

After *Daniels* a director is exposed to the threat of a minority suit if his negligence is of the self-serving variety.[50] As a result, directors will be encouraged to become more aware of their responsibilities, since it is in their own interests to do so. Hopefully, this will lead to a higher level of business competence.

An Alternative Ground for the Decision

From another perspective, Templeman, J.'s principle may be seen as a formulation of an established category of fraud on the minority, namely expropriation of company property. Lord Davey in *Burland* v. *Earle* described it thus:

> . . . where they (the majority) are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which the other shareholders are entitled to participate.[51]

In *Cook* v. *Deeks,* appropriation of property included the diversion of contractual opportunity by the directors, which they should have secured for the company. The Court held that the directors had dealt with property which in equity belonged to the company. Although fraud was expressly negatived, the minority shareholders successfully brought an action on the company's behalf.

It was alleged in *Daniels* that the directors obtained the company's land at an undervalue. If the plaintiffs' allegations were true, then, in terms of Templeman, J.'s principle, this necessarily constitutes a "benefit" to the directors (or at least Mrs Daniels) and a corresponding "harm to the company". By acquiring land which had belonged to the company both at equity and law, at a price they knew or ought to

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[50] *Daniels* only helps the minority shareholder to "have his day in Court". The difficulty he then faces is that the standard of care demanded of directors in performing their duties is not very high: *Re City Equitable Fire Insurance* [1925] 1 Ch. 407. *Semble,* to have a reasonable chance of succeeding on the merits the plaintiff must establish gross negligence.

[51] *Supra* n. 2 at 93.

have known was a substantial undervalue, the directors were guilty of misappropriation of company property.[52]

In *Cook* v. *Deeks* there was no allegation of fraud (in fact, the directors had gone to the trouble to obtain a ratification of their conduct). Similarly, the failure of the plaintiffs in *Daniels* to allege fraud would not have produced any different result.

One objection may be that, whereas previously, expropriation of company property involved either actual fraud[53] or breach of the duty to act *bona fide* in the interests of the company,[54] in *Daniels* the misappropriation of the company's property was a product of the directors' negligence. However, there is nothing in Lord Davey's *dictum* to suggest that appropriation of money, property or advantages effected through negligence or even unwittingly, is excusable.[55]

Similarly, in *Menier* v. *Hooper's Telegraph Works*[56] James, L.J. did not advert to the *male fides* of the majority in his decision which allowed the minority to bring an action. By implication, the basis for his decision was the *fact* of misappropriation of assets by the majority:

> Hooper's Company have obtained certain advantages by dealing with something which was the property of the whole company . . . (In) effect, the majority has divided the assets of the company, more or less between themselves to the exclusion of the minority.

In *Cook* v. *Deeks* Lord Buckmaster speaks of a duty not to:

> . . . sacrifice the interests which they are bound to protect, and while ostensibly acting for the company divert in their own favour business which should properly belong to the company.[57]

In effect, His Lordship juxtaposes the duty to act *bona fide* with a description of expropriation of company property. Arguably, he is suggesting that the *fact* of misappropriation in itself constitutes a breach of this duty.

From these authorities, it can be argued that the Courts would regard even the negligent appropriation of company property by a director for his benefit, as a species of "fraud on the minority".

If Templeman, J.'s principle is characterized as referring to this category of the exception to *Foss* v. *Harbottle* the omission of Templeman, J. to consider the issue of ratification is not a real problem. In *Cook* v. *Deeks* the Privy Council held that ratification is ineffective where the directors' own votes would cause the resolution to be passed:

52 *Pavlides* v. *Jensen supra* n. 16, did not involve expropriation of company property. The property went to the purchasing company, a separate legal entity from the defendant directors.

53 *Menier* v. *Hooper's Telegraph Works supra* n. 15.

54 *Cook* v. *Deeks supra* n. 49. The directors subordinated the company's interests to their own.

55 *Supra* n. 2 at 93.

56 *Supra* n. 15.

57 *Supra* n. 49 at 563.

> Even supposing it be not *ultra vires* of a company to make a present to its directors, it appears quite certain that directors holding a majority of votes would not be permitted to make a present to themselves.[58]

In *Daniels,* the defendants held the majority of votes and ratification would have permitted them to make a present to themselves (or at least to Mrs Daniels) of the money saved by the reduced purchase price, and the profit on the resale.

Since Templeman, J. expressly relies on *Cook* v. *Deeks* as support for his principle, there are good grounds for presuming that he implies ratification is ineffective.

One final point may be made in this context. Although the "company property" in *Daniels* was land, the principle in the case would appear to cover all forms of company property, including corporate opportunity and confidential information. But *Daniels* does not help reconcile cases like *Regal Hastings.* True, the principle requires that the company suffers harm, and Gower[59] suggests it "makes sense" to distinguish cases where the company is harmed (*Cook* v. *Deeks* — no ratification allowed) and where it is not (*Regal Hastings* — ratification allowed). However, the High Court of Australia has held ratification is possible irrespective of whether the company is damaged.[60] As such, *Daniels* is merely illustrative of the *Cook* v. *Deeks* line of reasoning.

The Principle Itself

The *ratio* of *Daniels* is not an application of the plaintiffs' wide submission that any breach of duty *per se* will found a minority shareholders' action. It is true to say that any breach of duty is *capable* of founding a derivative action, provided that two additional and essential elements are present: a benefit to the director, and a harm to the company.

Breach of any Duty

Current authorities suggest that *bona fide* breaches of the "no-conflict" duty, and the "proper purposes" duty are ratifiable, and thus not properly the subject of a derivative action.[61]

If *bona fide* breaches of duty lie outside the scope of the *Daniels* principle, then the decision does not alter the law in this area. However, it is possible that the grounds of Templeman, J.'s distinction of *Turquand* v. *Marshall* are to be read cumulatively, not separately. That is, the director must perhaps act *bona fide* and not benefit. The result of this is that the rule in *Foss* v. *Harbottle* is confined to those situations where a director's breach of duty does not result in a personal gain.

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58 *Id.* 564.
59 *Op. cit. supra* n. 5 at 618.
60 *Furs Ltd.* v. *Tomkies* (1936) 54 C.L.R. 583.
61 *Regal (Hastings) Ltd.* v. *Gulliver supra* n. 43; *Hogg* v. *Cramphorn supra* n. 44; *Ngurli* v. *McCann supra* n. 43.

This is an unjustified extension of the authorities, and must be incorrect.

There are no apparent limitations imposed on what comprises a "benefit" or a "harm to the company". Clearly, "benefit" includes profits obtained from appropriating corporate property (*Cook* v. *Deeks*) and the non-payment of calls on shares (*Alexander* v. *Automatic Telephone Co.*). "Harm to the company" includes the pecuniary loss resulting from the deprivation of a contract (*Cook* v. *Deeks*), moneys withheld from the company (*Alexander* v. *Automatic Telephone Co.*) and the pecuniary loss on a sale at under-value (*Daniels* v. *Daniels*). Presumably these examples are not exhaustive.

Thus, the princple is sufficiently flexible to accommodate a wide variety of circumstances. No answers are provided to questions such as whether the benefit or harm must be substantial, or whether in determining if harm is done to the company, the Courts should be prepared to decide issues of company policy and other matters which are properly reserved for businessmen.[62] However, since the facts of the case did not require a comprehensive analysis of these elements, there was no necessity for Templeman, J. to give one.

Conclusions

It is submitted that it is possible to interpret *Daniels* as being an illustration of expropriation of company property, an established category of fraud on the minority. If this is the case, then no significant alteration to the law is effected by this decision.

However, Templeman, J.'s express reluctance to concede that the exception to *Foss* v. *Harbottle* was so narrow that a director could indulge in self-serving negligence with impunity, raises a strong inference that a breach of the duty to take reasonable care was the contemplated foundation of the minority shareholders' action. The judgment presents certain ambiguities due to imprecise language, and with respect to the issue of ratification, silence. Nonetheless, on balance, it would seem that the decision in *Daniels* has extended the law relating to the Rule in *Foss* v. *Harbottle*. However, the extension is very limited in its scope. It is only when the plaintiff shareholders can point to negligence which benefits the malfeasant at the expense of the company, that the Rule in *Foss* v. *Harbottle* can be circumvented.

Given these limitations, the Courts' opportunity to expand this exception will be restricted to the amplification and elucidation of "benefit" and "harm to the company". All other manifestations of negligence (including gross negligence) may still be ratified and placed out of reach of a minority shareholder's derivative action. Clearly, *Pavlides* v. *Jensen* still remains a formidable obstacle to the minority

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[62] E.g. where the minority shareholders in an under capitalized company complain that the frustration of a takeover bid by directors harms the company because it impedes company expansion.

shareholder who seeks redress for a director's negligence. It is equally clear that negligent mismanagement is capable of causing tremendous economic harm, which ultimately reflects back on the shareholders. However, for any substantial alteration to this position, it would appear that the minority shareholder must look to statutory reform.[63]

JANE PHELAN, B.A. — Third Year Student.

[63] E.g. The Jenkins Committee proposes (para. 207) that the Court should have the discretionary power to permit an action in the name of the company on such terms as the Court may direct, for any breach of duty, including negligence on the part of a director.