THE DIRECTOR UNDER AMERICAN CORPORATION LAW

By H. A. J. Ford*

American law distinguishes between laws governing the incorporation of business enterprises and laws regulating the issue and sale of corporation securities. The federal legislature has no express incorporation power but only an implied power to incorporate when 'necessary and proper' to its express powers such as those over war, interstate commerce and the seat of government.[1] Thus, most American business corporations are incorporated under state law.

Legal regulation of directors is a necessary part of the state law governing incorporation but the director's position is also affected by the federal securities legislation.

The history of the state corporation laws discloses several stages of development. In the period immediately following the adoption of the United States Constitution, distrust of anything savouring of royal prerogative induced the view that the power to incorporate was vested solely in the state legislature and could not be exercised by a state governor. Incorporation by special Act of a state legislature became the usual method of incorporating a business enterprise until pressures exerted by the industrial revolution led to the enactment of general incorporation statutes. These statutes provided for general incorporation in the sense that, like the modern Companies Acts in Australia, they permitted business enterprises to be incorporated without special executive or legislative favour.[2]

As interstate commerce increased following the interstate railroads there emerged the problem of the corporation doing business in more than one state. The decision of the United States Supreme Court in *Paul* v. *Virginia*,[3] permitting a state to exclude a foreign corporation from intra-state commerce within the state, was thought to carry with it the corollary that a foreign corporation engaged in interstate commerce could not be excluded. The desire of interstate business enterprises to seek the most favourable state for incorporation led some states to engage in what Americans call 'charter-mongering'.[4] New

* S.J.D. (Harvard); LL.M. (Melb.); Professor of Commercial Law in The University of Melbourne.

1 *McCulloch v. State of Maryland* (1819) 17 U.S. (4 Wheat.) 316; 4 L.Ed. 579.

2 The reaction against special incorporation was so strong as to provoke the setting up by some states of constitutional provisions prohibiting special incorporation except in a limited number of cases.

3 (1868) 75 U.S. (8 Wall.) 168; 19 L.Ed. 357.

4 According to Henn, *Corporations* (1961) 17n, the matters on which lenient standards prevailed included: the acceptance of property or services in addition to cash as consideration for shares, abolition of maximum capitalization and indebtedness, broadening of permissible corporate purposes, authorization of non-voting shares and shares without par value, and broad authorization for charter amendments.

Jersey became known as the 'mother of corporations' from 1875. Delaware in 1899 based its statute on that of New Jersey and supplanted New Jersey as the most favoured resort for incorporation after New Jersey enacted anti-trust legislation in 1913 at the instigation of Governor Woodrow Wilson.

In later developments, suggestions for uniform corporation law[5] have not produced a degree of uniformity comparable with that now obtaining in Australia but many state legislatures in the period since the Second World War have re-organized and simplified their corporation statutes. Most of these revisions have followed to some extent the Model Business Corporation Act prepared by a Committee of the American Bar Association in collaboration with the American Law Institute.[6] Before considering the American law as to directors there are some matters of terminology requiring explanation.

The basic instrument required in the creation of a corporation is called in most states the 'articles of incorporation' or 'certificate of incorporation' and the general incorporation statute of each state prescribes its contents. It corresponds generally to the memorandum of association and it must set out the name of the corporation, its purposes, the classification of shares (if any), its authorized share capital, the minimum paid-in capital[7] and various other matters depending on the stringency of the particular incorporation statute. This document is filed, usually with the Secretary of State, and becomes a matter of public record. Depending on the jurisdiction concerned, the incorporators may include other matters in the articles of incorporation. There is an overriding requirement that the articles of incorporation may not contain anything inconsistent with the law and this requirement is especially important because American corporation statutes, unlike the Australian and English companies legislation, tend to lay down mandatory rules on many matters which in the British statutes would be included in the optional model provided by Table A. It has been observed that whereas the English companies legislation relies on the technique of the Partnership Act, providing a standard form which applies only in the absence of contrary agreement by the parties and thus treats the business incorporation as essentially contractual, the American draftsman has, included many mandatory provisions in the statute because he has the publicly held corporation in mind.[8] One result of this is that

[5] E.g. Stevens, 'Uniform Corporation Laws through Interstate Compacts and Federal Legislation' (1936) 34 *Michigan Law Review* 1063.

[6] A.B.A. Model Business Corporation Act Annotated 1960. 'Comment' (1960) 39, *Nebraska Law Review* 575.

[7] Corresponding to 'paid-up capital'.

[8] Gower, 'Some Contrasts between British and American Corporation Law' (1956) 69 *Harvard Law Review* 1369, 1376-77.

American laws have been less suitable for the organization of private companies[9] than for the publicly-owned corporation.

In addition to the articles of incorporation, a corporation will have by-laws which are enacted by it to regulate its affairs and the affairs of its shareholders, directors and officers. They are not usually required to be filed in any public office. The power to adopt, amend or repeal by-laws is sometimes vested in the shareholders, sometimes in the board of directors. Some statutes require shareholder approval for the adoption of alteration of certain by-laws such as: those limiting the power of the board of directors, providing that directors need not be shareholders, or providing for indemnification of directors.

APPOINTMENT AND REMOVAL OF DIRECTORS

I

Generally, American corporation statutes confide the management of the corporation in the directors. Sometimes the legislation provides that they shall have all the powers of management except such powers as are conferred by law or the by-laws of the corporation upon the shareholders.[10] The initial directors are usually named in the articles of incorporation or elected by the incorporators at their first meeting after incorporation. Thereafter, directors are to serve until the next succeeding annual meeting; except where directors may under the appropriate statute be divided into classes with one class elected each year. Casual vacancies are filled in accordance with the relevant statute or the by-laws and, in the absence of any provision, are filled by the shareholders.

Perhaps the main contrast with Australian law in the matter of appointment of directors is that the election of directors by shareholders is sometimes conducted by means of cumulative voting.[11] It is a form of proportional representation to assure minority representation on the board and the inspiration for it, as for the Australian Senate elections, comes from John Stuart Mill. Under a system of 'straight voting', as where each shareholder may cast one vote *per* share for a candidate for each vacancy to be filled, a bare majority of shares can elect the whole board of directors. Under a system of cumulative voting, the number of shares held by a shareholder is multiplied by the number of directors to be elected, and the shareholder may cast for a single candidate the total number of votes arrived at by this

9 Commonly called 'closely-held corporations' or 'close corporations'. The term 'close company' has been adopted in the United Kingdom in legislation on taxation of companies. Finance Act 1965, Part IV.

10 Delaware General Corporation Law s. 141 (a).

11 Young, 'The Case for Cumulative Voting' (1950) *Wisconsin Law Review* 49. Axley, 'The Case against Cumulative Voting' (1950) *Wisconsin Law Review* 278.

process of multiplication, or he may distribute the total among several candidates as he wishes. Some state constitutions[12] and some incorporation statutes[13] make cumulative voting mandatory in elections of directors. Those who argue for cumulative voting point to the need in large corporations, where the management virtually controls the board of directors, for someone with the power to assert the shareholders' point of view. They argue that a representative of a minority group may be able to prevent conflicts of interest between shareholder groups and management, and the board of directors. It is also said that the position of the management and the controlling interests is very strong in the event of a takeover bid and the presence on the board of a minority representative would offset this advantage. Those who argue against cumulative voting assert that the inclusion of partisans on a board of directors works against the best interests of the corporation, that frequently, opposition groups use it to secure a toe-hold in a long-term fight for control of the company and that as a result the management of the corporation is demoralized. Sometimes an unwary majority, by failing to cumulate their votes properly, have lost control to a minority.[14]

The absence of cumulative voting from English company law has been explained on the basis that the English regard the board of directors as supervisory managers who should be united in policy and outlook with the rest of the management, rather than as representatives of divergent interests overseeing the managers.[15]

Shareholders have inherent power to remove a director for cause and in the exercise of this power they must provide due process in the form of service of specific charges, adequate notice, and an

[12] Anno. (1955) 43 A.L.R. 2d. 1325, *e.g.* Illinois, Missouri, Pennsylvania.

[13] Model Business Corporation Act. s. 31, *e.g.* California, Michigan, Ohio.

[14] In *Pierce v. Commonwealth* (1883) 104 Pa. 150, involving a railroad company, the majority did not accumulate their votes, but distributed them equally over the six directors to be elected. Their opponents, however, concentrated their votes on four candidates who were elected. The court refused to disturb the result.

In order to reduce the possibility of this happening some statutes require the giving of notice of intention to vote cumulatively (*e.g.* Ohio, Rev. Code Ann, s. 1701.55 (c) Supp. 1957). There is a formula which assists determination of the number of shares needed to elect a given number of directors once the number of shares to be voted is known. Assuming one vote per share the formula is:

$$X = \frac{Y \times N^1}{N + 1} + 1$$

X = number of shares needed to elect a given number of directors; Y = total number of shares to be voted at the meeting; N^1 = number of directors which it is desired to elect; N = total number of directors to be elected. Thus suppose that the meeting has to elect eight directors and that out of a total number of 3,000 issued shares about 1,800 are expected to be represented at the meeting. If shareholder Smith wishes to be elected to the Board he will have to muster 201 of the 1,800 shares in order to be elected. If he could muster 1,001 votes he could hope to have five directors of the company and thereby secure control of the company.

[15] Gower, 'Some Contrasts between British and American Corporations (1956) 69 *Harvard Law Review* 1369, 1390.

opportunity to meet the accusations. This procedure, however, is rarely used.[16]

II

The common law of most states denied any power to the shareholders to remove a director without cause. His position was thought to be analogous to that of a public officer who had been elected for a fixed term of office. In some states a power to remove without cause could be included in the articles of incorporation. The modern corporation statutes usually confer power on the shareholders to remove directors without assigning any cause.[17]

Australian and English company law allows the appointment of a single director in the case of a proprietary or private company. By contrast practically all American corporation statutes require at least three directors and the idea of a single governing director is not known. This makes little formal allowance for the small quasi-partnership and it has provoked the suggestion that in many closely held enterprises there is really no need for a board of directors.[18] In some jurisdictions, however, it is possible by appropriate provisions in the articles of incorporation to give to the shareholders many of the powers normally exercised by directors and there are instances of clauses in the articles of incorporation which vest management powers in a single individual.[19]

Where the articles of incorporation confide the management to the board, another device used to widen the control of shareholders in a closely-held corporation is an agreement between shareholders designating the persons to be directors and determining the policies of the corporation on such matters as employment of officers, fixing of salaries, and the circumstances in which dividends are to be declared. Shareholders' agreements of this kind have met with varying judicial treatment. The New York Court of Appeals said: 'Clearly the law does not permit the stockholders to create a sterilized board of directors.'[20] In older cases agreements have been held invalid because they took away the powers of directors. The bases of invalidation have included conflict of the agreement with the provision in the corporation statute that the directors shall manage the corporation,

16 Baker and Cary, *Cases and Materials on Corporations* (3rd ed. 1959) 94.

17 *E.g.* Pennsylvania Business Corporation Law s. 405 empowers removal by an absolute majority of shareholders' votes, but unless the entire board is removed, no individual director may be removed where votes cast against the resolution would be sufficient, if cumulatively voted at an annual election, to elect one or more directors.

18 O'Neal, *Close Corporations*, Vol. i, s. 3·60. Winer, 'Proposing a New York "Close Corporation Law" ' (1943) 28 *Cornell Law Quarterly* 313, 315. One state, Iowa, does not require a board of directors.

19 *E.g. Group Property Inc. v. Bruce* (1952) 113 Cal. App. 2d. 549; 248 P.2d. 761, 766.

20 *Manson v. Curtis.* (1918) 223 N.Y. 313; 119 N.E. 559, 562.

concern that the agreement could cause directors to disregard their fiduciary duties to exercise their judgment for the benefit of the corporation and the shareholders as a whole, or concern that the agreement is unfair to shareholders who are not parties to it.[21] A change of attitude has occurred in more recent decisions. There is a tendency to uphold agreements to which all shareholders are parties even though the powers of directors are affected.

These decisions recognize that sections of corporation statutes entrusting management to the board are to be interpreted against a background of corporate practice in which the board is not always a body acting independently of the shareholders. The older strict interpretation of incorporation statutes was based either on the concession theory of incorporation that incorporation and limited liability were special privileges conferred by the state and that strict conformity with the traditional pattern of corporations was required; or, that the directors received their powers from the state and not from some compact among shareholders.

In American corporation law, unlike that of Australia and England, a corporation cannot be appointed a director.[22] In America a parent corporation needs to be sure that it has power to remove directors without cause from its subsidiary. One method is to have directors without a financial interest in the subsidiary sign undated resignations which are effective upon acceptance.

DUTY OF CARE

American law on this topic, like English and Australian law, contents itself with a broad principle and does not set out to provide detailed rules. There have been various formulations in case-law of the standard of care required of a director. It has been described by the New York courts as 'the same degree of care which a business man of ordinary prudence generally exercises in the management of his own affairs'.[23] A standard enunciated in another state required that degree of care which an ordinarily prudent director would exercise in a similar position under similar circumstances.[24]

Some corporation statutes now lay down a standard of care. The Pennsylvania statute provides that: 'Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with the diligence, care and skill which ordinarily prudent

21 O'Neal, *Close Corporations* Vol. i, s. 5·16.

22 The corporation seeking to act as director under English or Australian law should have the necessary power set out in its memorandum. In practice a company which is a director nominates someone to attend board meetings on its behalf.

23 *Simon v. Socony-Vacuum Oil Co.* (1942) 179 Misc. 202, 38 N.Y.S. 2d. 270.

24 *Lippitt v. Ashley* (1915) 89 Conn. 451, 94 Atl. 995.

men would exercise under similar circumstances in their personal business affairs'.[25] The New York provision requires directors and officers to use 'that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions'.[26]

The Revisers of the statute law have said of this last provision that it 'will allow the court to envision the director's duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director'.[27] This may be compared with the explanation of Romer J. in the leading English case[28] that the duties of directors will vary from company to company, it being necessary, in order to ascertain them in any particular case, to take into account the nature and size of the company's business and the way in which the work of the company is distributed between the board of directors and the staff of the company, due regard, of course being paid to what is practicable, to what is reasonable in the circumstances and to what is laid down in the articles of association.

In the American decisions there are indications that in the application of the 'prudent man' formula the result will depend to some extent on the business function for which the corporate form was adopted. Failure of an inexperienced married woman to do anything to supervise as director the corporation's affairs may be something less than negligence when the corporation is substantially a one-man company formed to take over her husband's trucking business[29] whereas the same inactivity in a banking corporation may well attract liability.

The formulations in terms of the standard of a prudent man reveal that the office of director is not yet a distinct calling having its own settled incidents similar to those attached to the various professional callings of solicitor, medical practitioner and the like. It is possible to have a workable standard in the shape of the reasonable medical practitioner because the class of medical practitioners is sufficiently homogeneous. The persons grouped together under the name of directors are much more diverse.

Moreover, the failure to arrive at settled rules as to the duty of care of a director is also explained by the variety of viewpoints. Some see the problem as one of imposing liability for negligence on one who has received little or no compensation for his services. Others see it as a problem of protecting the investing public.

[25] Pennsylvania Business Corporation Law s. 408.
[26] New York Business Corporation Law s. 717.
[27] N.Y. Leg. Doc. (1961) No. 12, Original Supplement, Revisers' Comment to s. 7·17, enacted as s. 717.
[28] *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, 427.
[29] *Allied Freightways v. Cholfin* (1950) 325 Mass. 630, 91 N.E. 2d. 765.

DIRECTOR'S CONTRACTS WITH HIS CORPORATION

American law, like English and Australian law, has special rules governing dealings between directors and their corporations. A situation of conflict of interest is also recognized in a transaction between corporations with common directors.[30]

It will be convenient to consider first the situation where a director has contracted with his corporation and, the board of directors having a quorum not including that director, authorizes the contract by an independent majority not including the contracting director. In English law the contract would be voidable by the corporation in the absence of a waiving provision in the articles of association. Authorization by the board could not effectively waive the company's right to set the contract aside but authorization by the shareholders in general meeting could do so. A few American jurisdictions have similar rules but most hold, in order to facilitate business, that the contract is not voidable if there is a disinterested quorum and voting majority of directors providing the director can discharge a burden of showing that the transaction was fair.[31]

If the contracting director's presence is necessary to a quorum or his vote is necessary to a voting majority on the board, in many jurisdictions the contract is voidable at the election of the corporation even though the transaction could be shown to be fair. Some jurisdictions, however, hold the contract valid *if the contracting director can show* that the transaction is fair.

Commonly the articles of incorporation contain a provision that a director shall not be disqualified from dealing with his corporation by reason of being a director. Such a provision is effective if kept within proper limits. Thus, for example, no provision could relieve a director or other fiduciary from liability for acts performed in bad faith.

Transactions between corporations having common directors, executed through the participation of the common directors, have been treated in some old decisions as being voidable by either corporation without regard to whether the transaction was fair or not. The more general rule now is that the transaction cannot be avoided if it is a fair transaction. In some jurisdictions the burden of showing that the transaction is fair is on the corporation which seeks to uphold the contract.

In some types of corporation the formation of interlocking directorates is inhibited by statute. Thus interlocking directorates in banks which are members of the Federal Reserve System are forbidden

30 Ward, 'Some Notes on Transactions Involving Interested and Interlocking Directors in Pennsylvania' (1949) 23 *Temple Law Quarterly* 107.

31 Note, 'The Fairness Test of Corporate Contracts with Interested Directors' (1948) 61 *Harvard Law Review* 335.

by federal statute, subject to certain exceptions.[32] As part of anti-trust regulation, it is unlawful for any person to be a director of two or more corporations, other than banks or railroads, any one of which has a capital and surplus of over $1,000,000, if the two corporations are competitors so that the elimination of competition between them by agreement would violate the anti-trust laws.[33]

Regulation of loans to directors by all except exempt proprietary companies and certain subsidiaries is an established part of Australian and English companies legislation. American jurisdictions similarly regulate loans to directors. Under Illinois law,[34] for example, directors who vote for or assent to a loan to an officer or director are jointly and severally liable to the corporation until its repayment. Some other legislation[35] prohibits loans to directors except with the approval of a majority of disinterested shareholders. The Illinois provision is broader in that it protects creditors against any improvidence on the part of the shareholders.

DIRECTOR'S FIDUCIARY DUTY NOT TO USURP A CORPORATE OPPORTUNITY

One aspect of a director's duty not to compete with the corporation is embodied in the so-called doctrine of 'corporate opportunity'. Officers of a corporation may not divert to themselves any opportunity which belongs to the corporation. This is the American equivalent of the doctrine applied by the House of Lords in *Regal (Hastings) Ltd.* v. *Gulliver*.[36] When does an opportunity belong to the corporation? If the corporation's personnel have been used to develop it or if the opportunity has been offered to the corporation rather than to individual officers it would belong to the corporation. Does an opportunity offered to the corporation cease to belong to the corporation merely because the corporation is unable to finance it? In *Regal (Hastings) Ltd.* v. *Gulliver* the answer was 'No'. Some American courts would give a similar answer. The leading case is *Percy L. Deutsch v. Irving Trust*;[37] Directors of the Sonora Company exercised in their own names an option procured by the Sonora Company for $100,000 worth of shares in another corporation which controlled patents needed in the business of Sonora. The directors defended on the ground that Sonora was financially unable to take up the

32 15 U.S.C.A. s. 19.
33 *Ibid.*
34 Ill. s. 42 (d).
35 *E.g.* That of New York.
36 [1942] 1 All E.R. 378.
37 (1934) 73 F.2d. 121 (2d. Cir.), cert. denied, (1935) 294 U.S. 708, 55 S.Ct. 405, 79 L.Ed. 1243, petition for rehearsing denied, (1935) 294 U.S. 733, 55 S.Ct. 514, 79 L.Ed. 1242.

option. The Second Circuit Court of Appeals reversing the District Court, held that the corporation's financial inability to take up the option was no answer and the directors were held accountable jointly and severally for profits made.[38] This strict approach relieves directors of the temptation to give themselves the benefit of the doubt. Not all American jurisdictions, however, adhere to the strict approach.[39]

Ratification by shareholders is no defence unless *all* shareholders rejected the corporate opportunity in advance or ratified the officer's personal acquisition after the event and creditors are not adversely affected. The remedies accrue to the corporation and not to the shareholders so that the American doctrine could produce the same result as in *Regal (Hastings) Ltd.* v. *Gulliver* where the order to the directors to disgorge benefited the new owners of the corporation rather than those who were shareholders when the breach of duty occurred.

In some American jurisdictions it is possible to regard the director's duty not to compete as being no wider than one not to divert corporate opportunities. Thus, if directors acquire for themselves a business which has been in operation for many years it can be said that they are not depriving their corporation of any opportunity in a case where the business was not offered to the corporation and the corporation had never considered its acquisition. There would, however, be another ground of liability in damages if, while they remained directors, they used information which came to them as directors so as to make the other business competitive with that of the corporation.[40]

DIRECTOR'S SHARE TRADING

Directors and officers buying or selling shares of the corporation know more about the corporation than the prospective seller or buyer with whom they deal. Should they be under a duty of disclosure to (a) shareholders and (b) would-be shareholders with whom they deal? Fraud and misrepresentation on the part of the director or officer would, of course, attract the ordinary remedies for such wrongdoing. But is the transaction to be affected by non-disclosure of facts known to the director or officer by reason of his position in the corporation?

It is accepted in Australian law that directors owe their fiduciary duties to the corporation and not to the individual shareholders. Some American jurisdictions have established fiduciary duties owed by

38 Note, 'Financial Inability as a Defence Under the Corporate Opportunity Doctrine' (1951) 39 *Kentucky Law Journal* 229.

39 E.g. *Johnston v. Greene* (1956) 121 A.2d. 919 (Deleware Sup. Ct.).

40 *Lincoln Stores Inc. v. Grant* (1941) 309 Mass. 417, 34 N.E.2d. 704. Noted (1941-42) 55 *Harvard Law Review* 866.

directors to shareholders in relation to what is, there, called insider-stock-trading.[41] In a number of state jurisdictions, including Delaware, the common law rule prevails and a director or officer owes no fiduciary duty to a shareholder with respect to transactions in the shares of the corporation. This is still characterized as the 'majority rule'. There are two other approaches: the 'special facts rule' and the 'minority rule'. Under the 'special facts rule' a director or officer engaging in share transactions is subjected to a duty of disclosure when there are special facts which justify departure from the 'majority rule'.[42] Usually, the cases in which this duty has been established have concerned close or private corporations.

In *Strong* v. *Repide*[43] a former shareholder, in a company which had owned estates in the Philippine Islands, sought to rescind a sale of her shares to the defendant who was a director, agent, administrator-general of the company, and holder of three fourths of its shares. At the time before the sale of her shares the company was without funds, and, owing to conditions in the Philippines the value of its shares was wholly dependent on making an advantageous sale of its properties to the United States government. The defendant was in charge of negotiations between the company and the government. The plaintiff had appointed one, Jones, to be her attorney to sell her shares. Jones had an office next door to the defendant. While negotiations about the land were pending, the defendant, knowing that a sale to the government was probable, employed one, Kauffman, to buy the plaintiff's shares from Jones through a broker who did not know that the defendant was the purchaser. Jones received no information as to the state of the negotiations about the land, and the price paid for the shares was about one tenth of what they became worth when the government bought the land within three months later.

Rescission was granted on the basis that the special facts raised a duty of disclosure. The defendant was not only a director but, because of his ownership of three-fourths of the shares, his position as administrator-general, and the acquiescence of other shareholders, he had also full charge of the negotiations with the government. His dealing with Jones was underhanded. Jones made the sale because the company was paying no dividends and the negotiations with the government had already gone on so long that there appeared to him to be no prospect of a sale for a very long time.

The departures from the majority rule establish a fiduciary relation

[41] Brudney, 'Insider Securities Dealings During Corporate Crises' (1962) 61 *Michigan Law Review* 1. Note, 'Insider's Duty to *Disclosure* when Purchasing Stock from a Shareholder' (1957) 43 *Iowa Law Review* 109. Conant, 'Duties of Disclosure of Corporate Insiders who Purchase Shares' (1960) 46 *Cornell Law Quarterly* 53.

[42] *Strong v. Repide* (1909) 213 U.S. 419, 29 St.Ct. 521, 53 L.Ed. 853.

[43] (1909) 213 U.S. 419, 29 St.Ct. 521, 53 L.Ed. 853.

between the director and the outsider-shareholder. An insider's use of inside information in many instances will be a misuse of something belonging to the corporation and logically, the corporation should be the one to recover improper personal profits from the insider.[44] This is apparently the theory underlying section 124(2) of the uniform Australian legislation. But this puts too much on the theory that the corporation is a distinct legal entity. The need for ethics in business is more pressing than the need to preserve a fiction which came into existence only to assist business organization. Close adherence to the idea that the fiduciary duty is owed to the corporation produced the curious result in *Regal (Hastings)* v. *Gulliver*.[45]

The 'minority rule' goes further by likening the director's duty to that of a trustee. It subjects directors and officers to a general duty of disclosure of inside information when dealing with shareholders for the purchase or sale of shares.[46] The limits of the minority rule are that there will be no relief unless there was a failure to disclose facts as distinct from opinions and unless the plaintiff relied on the director or officer.[47]

Although there is an evolving common law fiduciary duty to shareholders, this has not been accompanied by the development of any common law duty of disclosure to an outsider who is not already a shareholder and with whom a director or officer is negotiating for the sale of his shares.

Further progress in the direction of higher standards of fair dealing by insiders has come from federal law as administered by the Securities and Exchange Commission.[48] Federal intervention carries the advantage that the law will be expounded by a federal judiciary commanding consistent respect.

The federal legislation in pursuing its general aim of securing a fair and honest market in securities, which would reflect an evaluation of securities in the light of all available and pertinent data, seeks to protect outsider-shareholders against short-term speculation by insiders—directors, officers and principal shareholders—who may have advance information. Under section 16(a) of the Securities and Exchange Act 1934 every beneficial owner of more than ten *per centum* of any class of equity security which is registered on a national securities exchange and every director and every officer of a

[44] As argued by Conant, 'Duties of Disclosure of Corporate Insiders who Purchase Shares' (1960) 46 *Cornell Law Quarterly* 53.

[45] *Supra* P.

[46] *Dawson v. National Life Ins. Co.* (1916) 176 Iowa 362, 157 N.W. 929.

[47] A transaction on a stock exchange will not be affected by non-disclosure. In such a case the element of reliance is missing, *Goodwin v. Agassiz* (1933) 283 Mass. 358, 186 N.E. 659.

[48] Rubin and Feldman, 'Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders (1947) 95 *University of Pennsylvania Law Review* 468. Cook and Feldman, 'Insider Trading Under the Securities Exchange Act' (1953) 66 *Harvard Law Review* 385, 612.

company which has issued such a security must disclose to the exchange and to the Securities and Exchange Commission the amount of all equity securities which he owns and, if any change occurs in his ownership, he must within ten days after the close of the month in which the change occurred file a statement with the exchange and the Commission indicating his ownership at the close of the month and such changes as have occurred during the month. Under section 16(b) any profit[49] on securities listed on a national exchange which is realized by the insider within any period of less than six months is recoverable by the corporation. The purpose of this measure was not only to prevent the personal use of advance corporate information by insiders but also to discourage insiders from turning the corporation's financial policies, such as the timing of dividends, to their own ends. The legislation expressly holds the insider liable irrespective of any intention to sell the security within six months after purchases and thus dispenses with a difficult burden of proof. The statute not only authorizes the corporation to bring proceedings for recovery of the profit but also empowers any shareholder to bring suit on behalf of the corporation.

In a sense the legislation supplements the common law by imposing a fiduciary duty on insiders *vis-a-vis* outside shareholders: the common law does not impose that duty on insiders in listed corporations.

This legislation, combined with an active financial press which follows and publishes extracts from the statements filed, has been successful. The courts have been rigorous in applying the statute. For instance, they have developed a method of computing profits realized which operates *in terrorem*. Where an insider has had several sales during a period of six months, in theory, there are various methods of computation of profits. Thus, sales could be matched with purchases by reference to the identity of share certificates, or there could be an application of a first-in, first-out rule, or again the cost could be averaged. In practice the federal courts have determined the profit realized by matching the lowest purchases against the highest sale, then matching the next lowest purchase against the next highest sale, and so on: the total of all differences being the profit realized.[50] Thus, they have adopted a rule which ensures that all possible profits will be recovered.

The limits of the legislation are that it covers only listed securities and it cannot apply to securities in a closed corporation where inter-

49 Commonly called a 'short-swing' profit.

50 *Smolowe v. Delendo Corp.* (1943) 136 F.2d. 231 (C.C.A. 2d. 1943); *Gratz v. Claughton* (1951) 187 F.2d. 46 (C.C.A. 2d.). In the latter case this method of computation of profits was taken to be an application of a doctrine in *Armory v. Delamirie* (1722) 1 Strange 505, that when damages are at some unascertainable amount below an upper limit and when uncertainty arises from the defendant's wrong, the upper limit will be taken as the proper amount.

state commerce is not involved. Moreover, the insiders designated in the legislation are liable only in respect of their own profits: they are not liable for profits earned by persons with whom they have shared inside information.

Section 16 is now supplemented by a recently developed body of doctrine based on section 10(b) of the Securities Exchange Act 1934. This new doctrine is now much wider than section 16 and has proved a powerful supplement to the existing law on liability for non-disclosure. The new doctrine rests on a theory of civil liability arising from penal legislation[51] broadly similar to the English theory of tortious liability for breach of statutory duty, but the American doctrine has been developed with a boldness having no counterpart in contemporary English law. The basic penal provision is section 10(b) of the Federal Securities Exchange Act 1934 which makes it unlawful for any person, directly or indirectly, by the use of interstate commerce or the mails or any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security, whether listed or not on any exchange, any manipulative deceptive device or contrivance in contravention of rules and regulations of the Securities and Exchange Commission.

In 1942 the Commission promulgated rule X-10B-5, whcih provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud.
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleding, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[52]

The operation of the doctrine is illustrated by *Kardon* v. *National Gypsum Co.*[53] in which two of the four shareholders in a closely held corporation purchased the shares of the other two at a time when one of the buyers was negotiating a sale of the corporate assets. At a meeting at which the sale of shares was completed, a preliminary question was put to one of the buyers by the sellers' attorney. According to the plaintiffs the question was whether he had made any agreement for the sale of the shares or the assets of the corporation.

[51] Shulman, 'Civil Liability and the Securities Act' (1933) 43 *Yale Law Journal* 227.

[52] Note, 'Securities regulation—Civil Liability under Rule X—10B—5 for Fraud in the Purchase or Sale of Securities' (1954) 52 *Michigan Law Review* 893.

[53] (1947) 73 F.Supp. 798.

According to the defendants the question related only to the shares. The sale of shares then proceeded and subsequently the sale of the corporate assets was completed. The sellers of the shares sued the buyers claiming an account of profits realized through the sale of the corporate assets. A Federal District Court in Pennsylvania held that even on the defendants' version of the question there was a breach of rule X-10B-5 in that in the circumstances in which the question was answered there was an omission to state a material fact necessary to make the answers not misleading. An accounting to ascertain and restore to the plaintiffs their proportionate share of the profits was ordered. The case illustrates that the remedy based on rule X-10B-5 is not confined to listed securities and, moreover, the benefit of the remedy accrues to the aggrieved seller rather than to the corporation as is the case under section 16(b).

Subsequent developments have widened the liability under rule X-10B-5. Contractual privity between the plaintiff and the defendant is not required. In *Cochran v. Channing Corporation*[54] an insurance company whose policy was controlled by another corporation was alleged to have reduced its dividends so that the other corporation could buy the insurance shares at depressed prices. The plaintiff, because of the dividend reduction sold his shares. He sued the other corporation and three of its directors claiming damages for loss caused by a violation of rule X-10B-5. He argued that the defendant corporation had employed a 'device to defraud' within the meaning of that rule. There was no proof that he had sold his shares to any of the defendants. A District Court in New York refused a motion to dismiss the complaint holding that privity between the plaintiff and the defendant was not a necessary element of the cause of action.

The principle derived from rule X-10B-5 that a director may not improperly use inside information is wide enough to reach his business associates who obtain inside information from him. This was shown by a ruling of the Securities and Exchange Commission in 1961.[55] D, a representative of a brokerage firm, was a director of C. W. Corporation and participated in the vote when the corporation reduced its dividend. Before the news was public he telephoned the news to G, a partner in the brokerage firm, who then sold shares of C. W. Corporation in the brief interval before the news of the dividend cut became public. The Commission held that G had committed an offence against rule X-10B-5. G was suspended from the New York Stock Exchange for 20 days by order of the Commission, and was fined $3,000 by the Exchange. The ruling extended rule X-10B-5 to omissions to disclose by persons who previously had not been con-

[54] (1962) 211 F.Supp. 239.

[55] Matter of Cady, Roberts & Co. referred to by Hornstein, *Corporation Law and Practice* s. 443 (1964 Pocket Part).

sidered 'insiders' and it established that a duty of disclosure could be owed even in sales to unidentified persons on a public exchange.[56]

Critics[57] of the widening federal law on insider-trading have pointed to the possibility of injustice to the insider in that, being about to buy or sell shares in his corporation, he may have inside information, but he might also have a duty to his corporation not to disclose the information. If the insider is to be liable to investors for failing to reveal the information, he may be foreclosed from buying or selling shares in his corporation over a considerable period of time. Those who support the new federal law[58] answer that, at least in regard to publicly held securities, if the insider's information relates to decreased earnings, dividend cuts *etc.*, and it is thought that the disclosure of it would be harmful to the corporation, the need for disclosure to public investors of facts material to their investment outweighs any harm to the company that might result from disclosure. Of course, an insider wishing to sell shares at the best prices obtainable would not wish to publicize information likely to reduce the market value of the shares. This is recognized by supporters of the federal law who say that in those circumstances the insider should forego the transaction or suffer any consequences that might follow from his failure to make adequate disclosure. He would be foreclosed from buying or selling only while he possessed information not publicly available.

In any case, so it is argued, the policy in favour of providing public investors with all available material information is considered to outweigh a policy of allowing corporate insiders to trade freely, *on the basis of inside information,* in the securities of their corporations.

Perhaps the most striking thing to emerge from this survey is the boldness with which America has established legal standards of conduct for directors. The pace has been set by the Securities and Exchange Commission.

[56] Comment, 'Insider Liability Under Securities Exchange Act Rule 10b—5. The Cady, Roberts Doctrine' (1962) 30 *University of Chicago Law Review* 121.

[57] *E.g.* Ruder, 'Civil Liability Under Rule 10b—5: Judicial Revision of Legislative Intent' (1963) 57 *Northwestern University Law Review* 627.

[58] Joseph, 'Civil Liability Under Rule 10b—5. A Reply' (1964) 59 *Northwestern University Law Review* 171.