NOTES

Liability of Directors to Shareholders for negligence under American Law and their Indemnification

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"Inside Trading", "Disclosure", "Short-swing profits", "S.E.C.", "Rule 10b-5", "Shareholders suits", seem to be fashionable but frightening expressions in today's business community. The recent appeal decision in the *Texas Gulf* case [1] and the proceedings taken by the Securities and Exchange Commission against *Merrill, Lynch, Pierce, Fenner and Smith Inc.*[2] seem to account for much of the corporate directors' worries. Though the personal liability of directors in securities transactions is becoming increasingly important, this is only one facet of the wide range of the liabilities of directors to shareholders. The corporate director may be subject to heavy responsibilities both in the daily management of the company's affairs as well as in such specialized areas as corporate control, conduct of subsidiaries or antitrust violations.

Some five Canadian provinces have enacted securities legislation [3] similar in many respects to the *American Securities Act* of 1933 and *the Securities and Exchange Act* of 1934; the Province of Ontario now has the *Ontario Business Corporations Act*,[4] in which the standard of conduct expected of directors closely resembles that of some American States. An assessment of the liabilities of American directors to their shareholders has thus been thought to be of interest to Canadian lawyers.

This study will be divided into four parts: the position of the director, his liability for negligence, some areas of liability which warrant a special degree of care from directors and how a director can be protected from the monetary consequences of liability either by indemnification or by insurance.

I — THE POSITION OF THE CORPORATE DIRECTOR

A - The Director - Corporation relationship

With respect to the corporation, it seems well settled that the director occupies the same position of trust as his Anglo-Canadian counterpart.[5] It should however be noted that various expressions

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[1] *S.E.C.* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y., 1966), rev'd. in part (C.A. 2, Aug. 13th, 1968), Docket No. 30,882, p. 3587; 401 F. 2d 833 (1968).

[2] *Securities & Exchange Act*, 1934, S.E.C. Release No. 8394, August 27th, 1968.

[3] *Ontario Securities Act*, 1966, c. 142 as amended; *British Columbia Securities Act*, 1967, c. 45 as amended; *Alberta Securities Act*, 1967, c. 76 as amended; *Saskatchewan Securities Act*, 1967, c. 81 as amended; *Manitoba Securities Act*, 1968, c. 57.

[4] *Ontario Business Corporations Act*, 1970, 19 Eliz. II, c. 25.

[5] 19 C.J.S., para. 761, at p. 103; Fletcher, *Cyclopedia of Corporations* (Perm. Ed.), para. 838.

have been used by the courts to describe the relationship between the director and the corporation: they have been termed trustees,[6] under an implied or constructive trust, as the Court of Appeal of Oklahoma once held:

> An officer and director of corporation was not a trustee of an express trust arising from contract or privity, but rather the trustee of an implied or resulting trust created by operation of law from his official relation to corporation, as respects liability to corporation for transactions with it...[7]

The more recent cases are not conclusive: some describe the relationship as one having a fiduciary character,[8] some others go further and hold that:

> [The] relationship of directors to their corporation was essentially that of trustee and *cestui que* trust.[9]

In that respect, the position of the American director is not different from that of his Canadian colleagues. In the well-known case of *Regal (Hastings) Ltd.* v. *Gulliver et. al.*,[10] the House of Lords expressed the view that the various appellations used, e.g. agents,[11] trustees,[12] managing partners,[13] are only convenient analogies to describe a statutory position.[14]

B - The Directors - Shareholders relationship

One of the main differences between our company law and that of the United States, is the position occupied by directors *vis-à-vis* the shareholders.

1 - *Under Anglo-Canadian Law*

The celebrated case of *Percival* v. *Wright*[15] seems to have established the absence of a fiduciary relationship between directors and

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[6] *Ashman* v. *Miller*, 101 F. 2d 85 (C.C.A. Mich.); *U.S.A.* v. *Gates*, 376 F. 2d 65 (C.A. Colo., 1967); *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385 (D.C.N.Y., 1967); *Wilshire Oil Company of Texas* v. *Riffe*, 381 F. 2d 646 (C.A. Okla., 1967).

[7] *Farmer* v. *Standeven*, 93 F. 2d 959 (C.C.A. Okla.).

[8] See cases cited *supra*, n. 6.

[9] *Diamond* v. *Oreamuno*, 287 N.Y.S. 2d 300 (A.D. 1968), at p. 301.

[10] [1942] 1 All E.R. 378, at p. 387.

[11] *Ferguson* v. *Wilson*, [1866] L.R. 2 Ch. 77.

[12] *In re Exchange Banking Co. Flitcroft's case*, [1882] 21 Ch. D. 519, at p. 525; *Cape Breton Cold Storage Co.* v. *Rowlings*, [1929] S.C.R. 505.

[13] *Automatic Self-Cleansing Filter Syndicate Co. Ltd.* v. *Cuninghame*, [1906] 2 Ch. 34, at p. 45.

[14] See also Wegenast, *Canadian Companies*, at p. 360, and, Fraser and Stewart, *Company Law of Canada*, (5th ed., 1962) at p. 584.

[15] [1902] 2 Ch. 421.

shareholders.[16] A good summary of the Canadian position may be found in the Kimber Report:

> The wide scope of this decision *(Percival* v. *Wright)* was qualified to a certain extent by the Privy Council in *Allen* v. *Hyatt*,[17] where it was held that in certain special circumstances there is a fiduciary relationship. The extent to which *Allen* v. *Hyatt* qualifies *Percival* v. *Wright* is uncertain. It is probably limited to a very narrow class of cases in which the shareholder and the director meet virtually face-to-face and the director is put in a fiduciary relationship by the conduct of the parties.[18]

2 - *Under American Law*

Under American law, a distinction is to be made between the shareholders as a body and as individual shareholders. The American Courts, though disagreeing on the precise nature of the relationship, hold that corporate directors stand in a fiduciary relationship to the body of stockholders. The accepted principle seems to be that:

> The directors of a corporation are intrusted with the management of its business and property for the benefit of all the stockholders, and occupy the position of trustees for the collective body of stockholders in respect to such business. They are subject to the general rule, which prevails to trust and trustees, that they cannot use the trust property, or their relation to it, for their own personal gain. It is their duty to administer the corporate affairs for the common benefit of all stockholders, and exercise their best care, skill and judgment in the management of the corporation business solely in the interest of the corporation.[19]

The leading case of *Ashman* v. *Miller* adds that:

> The ordinary trust relationship of directors of a corporation and stockholders is not a matter of statutory or technical law. It springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the stockholders.[20]

In 1932, the Harvard Law Review witnessed a great debate between Professor Dodd and Professor Berle, the former asking "For whom are corporate managers trustees" ? [21] the latter answering "For whom corporate managers *are* trustees: a note".[22] The issue raised was whether the corporate managers' responsibility is primarily owed

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[16] See Fraser and Stewart, *op. cit.*, n. 14, at p. 587; *Report of the Company Law Committee*, (Jenkins Report), (1962), H.M.S.O. Cmnd. 1749, para. 89.

[17] (1914), 17 D.L.R. 7.

[18] *Report of the Attorney General's Committee on Securities Legislation in Ontario*, (Kimber Report), (1965) para. 2.22.

[19] *Blum* v. *Fleischhacker*, 21 F. Supp. 527, at p. 534; Fletcher, *op. cit.*, n. 5, para. 838, at p. 179; 19 C.J.S. para. 761, at pp. 103-105; Berle, *Corporate Powers as Powers in Trust*, 44 Harvard L.R. 1049.

[20] 101 F. 2d 85, at p. 91.

[21] (1931), 45 Harvard Law Review 1145.

[22] 45 Harvard Law Review 1365.

to the stockholders, that is, maximization of profits for the shareholders or whether, as Professor Dodd contends, the corporation, and therefore its management has a responsibility not only to the shareholders but also to the security holders, the workers ... in short to the community at large. In whose favour the debate was resolved was publicly admitted in 1954 by Professor A.A. Berle:

> Twenty years ago, the writer had a controversy with the late Professor E. Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention.[23]

What is the position of the directors towards individual shareholders? It is common ground that where a stockholder or any other individual has been personally aggrieved by the conduct of a director, the director may be called upon to restore the damage.[24] The loss suffered must however be something more substantial than a depreciation of stock since it has been held on numerous occasions that the act of a director causing a decline in the value of the stock held is not a sufficient cause of action, even if there is only one shareholder.[25] In the above instances it may be said that the shareholder does not sue *qua* shareholder but *qua* aggrieved person. The area of litigation where the shareholder *qua* shareholder may have a right of action is the field of securities transactions which shall be dealt with later in this article. For the moment, we shall therefore refrain from dwelling upon the question of whether a director stands in a fiduciary relationship to individual shareholders in securities transaction.

C - The Enforcement of the Director's fiduciary duties: the Derivative suit

If the individual stockholder is deemed to be a stranger to the corporation,[26] this should mean that he could not enforce the corpo-

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[23] A.A. Berle, *The 20th Century Capitalist Revolution*, 1954, at p. 169. For a modern discussion of this controversy see: J.L. Wiener, *The Berke-Dodd Dialogue on the Concept of Corporation*, 64 Colum. L.R. 1458.

[24] *E.K. Buck Retail Stores* v. *Harkert*, 62 N.W. 2d 288.

[25] *Funk* v. *Spalding*, 246 p. 2d 184; *Sutter* v. *General Petroleum Corporation*, 170 p. 2d 898; *Green* v. *Victor Talking Machine Co.*, 24 F. 2d 78, cert. den. 278 U.S. 602; *Cullum* v. *G.M.A.C.*, 115 S.W. 2d 1196; *Smith* v. *Bramwell*, 143 Or. 611, (1934), 31 P. 2d 647; *Watson* v. *Button*, 235 F. 2d 235 (C.A. 9, 1956), at p. 237. See generally Baker and Cary, *Cases on Corporations*, (3e ed. Unabr., 1959), at p. 636.

[26] 19 Am. Jur. 2d para. 524.

rate rights of action. The most he could do would be to demand that the directors institute proceedings against themselves. As equity will not suffer a wrong to be without a remedy, stockholders were permitted to institute the so-called "derivative action" to enforce a corporate right or to prevent or remedy a wrong to the corporation.[27]

1 - *Nature of the derivative action*

The nature of this action has been well summarized in the case of *Meyer* v. *Fleming* where the Court expressed the view that:

> Stockholder's derivative suits are one of the remedies which equity designed for those situations where the management through fraud, neglect of duty or other cause declines to take the proper and necessary steps to assert the corporation's rights...[28]

The difference between an individual and a derivative action may be expressed by the following excerpt from the opinion of the late Justice Frankfurter in *Swanson* v. *Traer*:

> The contrasting difference between a stockholder's suit for his corporation and a suit by him against it, is crucial. In the former, he has no claim of his own; he merely has a personal controversy with his corporation regarding the business wisdom or legal basis for the latter's assertion of a claim against third parties. Whatever money or property is to be recovered would go to the corporation, not a fraction of it to the stockholder. When such suit is entertained, the stockholder is in effect allowed to conscript the corporation as a complainant on a claim that the corporation, in the exercise of what it asserts to be uncoerced discretion, is unwilling to initiate. This is a wholly different situation from that which arises when the corporation is charged with invasion of the stockholder's independent right. Thus, for instance, if a corporation rearranges the relationship of different classes of security-holders to the detriment of one class, a stockholder in the disadvantaged class may proceed against the corporation as a defendant to protect his own legal interest.[29]

2 - *The double derivative action*

Before leaving the subject of derivative actions it should be noted that the view has been taken,[30] with some authority to the contrary,[31] that a stockholder in a corporation which holds stock in

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[27] *Isaac* v. *Marcus*, 258 N.Y. 257, 179 N.E. 487; *Klopstock* v. *Superior Court*, 108 P. 2d 906 (Cal.).

[28] 327 U.S. 161, at p. 167; Ballantine in his work on *Corporations* (1946), at pp. 343-344, describes the shareholder's suit as combining two causes of action: (1) a right in equity to compel the assertion of (2) a corporate right when the management refuses to act.

[29] 354 U.S. 99 (1957).

[30] *Goldstein* v. *Groesbeck*, 142 F. 2d 422, (C.A. 2 N.Y.), cert. den. 323 U.S. 737; *Martin* v. *D.B. Martin Co.*, 88 A. 612 (Del. Chancery), 102 A. 373.

[31] *Buseh* v. *Mary Riddle Co.*, 283 F. 443 (D.C. Del.).

a second corporation may maintain a derivative action for wrongs to the second corporation where it appears that neither corporation is willing to enforce the right of action. The reason given to justify these "double derivative suits" is that the loss will ultimately be sustained by the shareholders through the depreciation of stock. The scope of these suits has however been limited to cases where the relationship between the companies is that of holding and operating companies [32] or where a parent owns and controls a subsidiary [33] though the subsidiary need not be wholly owned.[34]

Conclusion

At this stage, it does not seem necessary for the purposes of this article to dwell further upon the procedural aspects of the derivative suits. In conclusion, the position of directors may thus be described as fiduciary both to the corporation and to the body of shareholders. But, to again borrow Justice Frankfurter's words:

> ...to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?...[35]

II — LIABILITY FOR NEGLIGENCE

A - Basis of the Liability

Liability for negligence may be based upon either a common law duty or a statutory requirement. Relatively few Americans States (10 out of 50 in 1965)[36] have enacted statutes codifying the standard of conduct of directors. As often happens the legislative enactment is an outgrowth of judicial thinking. Being a fiduciary, the director has a duty of care to the corporation and to the shareholders. He is bound to act honestly and in good faith in the management of the corporation. Breach of that duty will, at common law, entail personal liability for the director. But, by which standard should this duty be measured? Should the director account for his *"culpa lata"* only or even his *"culpa levissima"*?

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[32] *Hirshorn* v. *Mine Safety Appliances*, 54 F. Supp. 581 (D.C. Pa.).

[33] *Breswick Co.* v. *Harrison Rye Realty Corp.*, 114 N.Y.S. 2d 25, rearg. and app. den. 115 N.Y.S. 2d 302, app. dism. 109 N.E. 2d 712.

[34] *Kaufman* v. *Wolfson*, 151 N.Y.S. 2d 530.

[35] *S.E.C.* v. *Chenery Corp.*, 318 U.S. 80 (1943), at p. 85.

[36] Adkins and Janis, *Some Observations on the Liabilities of Corporate Directors*, (1964-65), 20 Bus. Law 817.

The question, thus, is what constitutes negligence? As the Supreme Court of the United States said in the much-quoted case of *Briggs* v. *Spaulding*:

> What may be negligence in one case may not be want of ordinary care in another, and the question of negligence is, therefore, ultimately a question of fact, to be determined under all the circumstances.[37]

B - What constitutes actionable negligence?

Various attempts have been made by the Courts to determine the degree of negligence giving rise to liability. As Fletcher states:

> In determining whether directors are liable for negligent mismanagement, the Courts have been prone to use fine-sounding phrases in defining the duties of directors, and then proceed to decide the case without reference thereto — The rules laid down being such glittering generalities that the case could be decided either way thereunder without violating the rules. For this reason, it is almost impossible to say that there is any considerable conflict of opinion.[38]

1 - *Failure to exercise the highest degree of care?*

The Courts, though, seem to all agree that directors are not bound to exercise the highest degree of care: directors are neither insurers nor guarantors of the company's success.[39] This excuse for *"culpa levissima"* seems to have been first stated in 1829 in Louisiana[40] and followed ever since.[41]

2 - *Gross negligence?*

Whether gross negligence should be retained as test is a more controversial issue. At this point one should remember the caveat issued by the Court in the Rhode Island case of *Conaty* v. *Torghen*:

> There is much discussion in the cases about gross negligence which is not defined; whether negligence is to be tested by a man's care in his own affairs, or only by the conduct of the average prudent man; how far the elements of wanton and wilful misconduct are necessary.[42]

The Courts using the "gross negligence" standard have applied it as meaning that want of care and attention which ordinarily prudent men give to their affairs, or as being that *"culpa lata"* which amounts to *"dolus"*, or as being *"crassia negligentia"* as was held by the House of Lords in *Overend & Gurney Co. Limited* v. *Gibb*.[43] Such being the state of confusion, it is not surprising that

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[37] 141 U.S. 132, at p. 152.
[38] Fletcher, *op. cit.*, n. 5, para. 1029, at pp. 540-541.
[39] *Cutler* v. *Hicks*, 268 Ill. App. 161, at p. 178.
[40] *Percy* v. *Millandon*, 18 Martin N.S. 68 (La.), at p. 74.
[41] See Fletcher, *op. cit.*, n. 5, para. 1033.
[42] 128 A. 338, at p. 341.
[43] L.R. 5 (H.L.) 480, at p. 487, per Lord Hatherley, L.C.

Morawetz[44] describes the rule of gross negligence as being at best misleading.

Despite the absence of uniformity in the language used by the Courts, one leading case is often referred to as an illustration of the gross negligence rule. In the *Spering's Appeal* case[45] directors were alleged to have made improvident loans. Judge Sharwood first proceeded to term them as mandatories:

> They can only be regarded as mandatories-persons who have gratuitously undertaken to perform certain duties, and who are therefore bound to apply ordinary skill and diligence, but no more.

They, therefore, were only liable for "gross inattention and negligence by which fraud has been perpetrated" but not for mistakes in judgment "even though they may be so gross as to appear absurd and ridiculous". In keeping with such a line or reasoning the judge candidly added:

> But it is evident that gentlemen selected by the stockholders from their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate. Were such a rule applied, no gentleman of character and responsibility would be found willing to accept such places.

3 - *Ordinary negligence?*

Less than ten years later, the New York Court of Appeals took an opposite view in *Hun* v. *Cary*.[46] The facts were almost identical to those of the *Spering* case. A bank had been operating at a loss for several years and at a time when it owed some $70,000 to its clients and had assets of $13,000 in cash plus certain mortgages, the directors sought to enhance the prestige of the bank and thereby induce confidence in its financial standing with the erection of a new bank building. For this purpose, the directors contracted on behalf of the bank for the purchase of very expensive lots of land for some $74,500. After various transactions the cost of the building and the land was in the vicinity of $57,000 with a mortgage of $30,000. The New York Court considered the *Spering* case but was of the opinion that:

> ...like a mandatory to whom he has been likened, he is bound not only to exercise proper care and diligence, but ordinary skill and judgment. As he is bound to exercise ordinary skill and negligence, he cannot set up that he does not possess them.[47]

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[44] 1 Morawetz *Corporations*, para. 552.
[45] 71 Pa. 10 (1872).
[46] 82 N.Y. 65 (1880).
[47] *Ibid*, at p. 74.

The Court went on to say that it is the duty of bank directors to:

> ...exercise the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.

The Court, concluded that in view of the precarious financial situation of the bank, the directors' action was:

> ...not a mere error of judgment ... but it was a case of improvidence, of reckless, unreasonable extravagance, in which the (directors) failed in that measure of reasonable prudence, care and skill which the law required.[48]

Both the New York and the Pennsylvania Courts attempted to clarify the standard of conduct expected of directors by resorting to analogies of mandatories. As already seen, this approach has been used very frequently by the Courts for the elucidation of the nature of the director's position. As previously noted, the accepted doctrine and jurisprudence hold directors to be fiduciaries. This seems to be why in most jurisdictions ordinary or reasonable care and diligence is the test and what amounts to lack of care is a question of fact.[49] According to this, directors only have to account for their *"culpa levis"*. As a Montana Court said in *McConnell* v. *Combination Mining and Milling Co.*:

> [The directors], when acting within the scope of their authority, are bound only to the exercise of good faith and the use of their best judgment in the conduct of the business... Their duties do not make them insurers of the property of the company, nor guarantors that the enterprise undertaken by the corporation shall be successful and profitable.[50]

A statement which echoes that of the North Carolina Court can be found in *Minnis* v. *Sharpe*:

> Directors are not guarantors of Corporation's solvency; nor are they insurers of the honesty and integrity of the officers and agents. Not are they required to personally supervise all the details of business transactions.[51]

Directors are thus required to exercise ordinary care but are not supposed to be overcautious: there is a wide difference between a trustee under the Quebec *Civil Code* and a corporate manager whose job is chiefly to take risks. Assuming "ordinary" or "reasonable" care and diligence as the generally accepted standard [52] one still has to determine what is meant by these expressions.

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[48] For an analysis and a summary of this case, see Baker and Cary, *op. cit.*, n. 25, at p. 403, and Adkins and Janis, *loc. cit.*, n. 36.

[49] Fletcher, *op. cit.*, n. 5, para. 1035, and cases cited *supra*.

[50] 31 Mont. 563, 79 P. 248. See also *Bayer* v. *Beran*, 49 N.Y.S. 2d 2.

[51] 202 N.C. 300, 162 S.E. 606, at p. 607; see also *Medford Trust Co.* v. *McKnight*, 292 Mass 1, 197 N.E. 649, reviewed in 16 Boston U.L.R. 736.

[52] See Adkins & Janis, *loc, cit.*, n. 36, at p. 820; Fletcher, *op. cit.*, n. 5, para. 1036.

C - Analysis of the "ordinary care, prudence and skill" standard

The answer to this question lies not so much in the field of corporation law as in the law of negligence. At common law, one has to answer the question "What would the reasonable man have done under the same or similar circumstances?" to determine whether ordinary care has been applied.[53] Unfortunately, the law of negligence as applied to corporate managers does not present such a clear picture. As usual the situation may be clarified by resorting again to the Roman law classifications: should the *"bonus paterfamilias"* be judged *"in abstracto"* or *"in concreto"*?

1 - *The "own personal affairs" qualification*

In a number of jurisdictions, the directors' conduct is appreciated *in concreto*: they have to apply to the management of the corporation the same degree of care that they, being ordinarily prudent businessmen, exercise in the management of their own personal affairs. This subjective standard has been laid down in several New York leading cases. In *Hun* v. *Cary*, Judge Earl wrote:

> When one deposits money in a savings bank, or takes stock in a corporation, thus divesting himself of the immediate control of his property, he expects, and has a right to expect that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trust committed to them — *the same degree of care that men prompted by self-interest generally exercise in their own affairs.*[54]

Failure to use such care renders directors liable to the corporation for damages.[55] A later decision of the New York Court of Appeals seems to have somewhat limited Judge Earl's statement to financial institutions. In *Hanna* v. *Lyon*, Chief Justice Parker wrote:

> The law is settled in this state that directors of monetary corporations are held to the same degree of care that men of ordinary prudence exercise in regard to their own affairs.[56]

The subjectivity of such a standard does not render it very workable. A person might conceivably take much greater risks in personal affairs than in the affairs of others, or what a director deems prudent might not be considered so by a court.[57] In the

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[53] John G. Fleming, *The Law of Torts*, (Sydney, 1965) at p. 113.

[54] *Supra*, n. 46.

[55] *Kavanaugh* v. *Gould Trust Co.*, 223 N.Y. 103, 119 N.E. 237; *Gerdes* v. *Reynolds*, 28 N.Y.S. 2d 622.

[56] 179 N.Y, 107, 71 N.E. 778.

[57] Adkins & Janis, *loc. cit.*, n. 36.

myriad of cases on the directors' liability, we have been unable to discover any which applied this standard. In Pennsylvania, for instance, the *Corporations Act* requires the director to discharge his duties:

> With that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs.[58]

2 - *The "ordinarily prudent man under similar circumstances" qualification*

But in the leading case of *Otis & Co.* v. *Pennsylvania Railway Co.*,[59] the Court in applying Pennsylvania law reached the conclusion that the proper test of liability is the care, skill and diligence which the *ordinary* prudent man would exercise in similar circumstances. Pointing out this discrepancy, Adkins & Janis make the following comment:

> Characterizing the standard as being that expected from an *"ordinary* prudent man" seems to be a common error. The word "ordinarily" is an adverb and it is obviously intented to modify and give added meaning to the word "prudent" while the word "ordinary" is an adjective and used in this context would have to describe the word "man". When the word "ordinary" is used, it gives the statutory standard meaning quite apart from that obviously intended.[60]

The position of the Court in the *Otis* case appears to be very close to that taken by a line of British *locii classici.* In *In re Brazilian Rubber Plantations and Estates Limited*,[61] Justice Neville, following what had been laid down by Lord Hatherley, L.C. in *Overend & Gurney* v. *Gibb*,[62] wrote that:

> Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf.[63]

With the objective standard, *a contrario*, the Court will parallel the conduct of the director with the degree of care an *ordinarily* prudent man would have exercised under similar circumstances. This standard has been said to be a more fair and satisfactory

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[58] Pa. Stat. Ann. tit. 15, para. 2852-408.

[59] 61 F. Supp. 905 (E. D. Pa. 1945).

[60] Adkins & Janis, *loc. cit.*, n. 36, at p. 820, note 17.

[61] [1911] 1 Ch. 425, at p. 437.

[62] L.R. 5 (H.L.) 480.

[63] This statement has been quoted with approval in *In Re City Equitable Fire Insurance Co.*, [1925] 1 Ch. 407, at p. 408, per Romer, J., and in *Can. Guarantee Trust Co.* v. *Young*, [1931] 3 D.L.R. 519, at p. 522, per MacDonald, C.J.K.B., (Man.).

rule.[64] In effect it was adopted by the Supreme Court of the United States in the *Briggs* v. *Spaulding* case [65] where it was held that the degree of care required is that which ordinarily prudent and diligent men would exercise "under similar circumstances, and in determining that, the restrictions of the statute and the usages of business should be taken into account".

This doctrine has been followed by various jurisdictions, e.g. Arkansas, Massachusetts, Michigan,[66] and it may be said that the *Briggs* case is one of the most often cited decisions in this branch of Company Law.[67] *In abstracto* appreciation of the director's conduct provides a much more flexible standard for routine affairs. As Art. 1053 of the Quebec *Civil Code*, its ostensible vagueness renders it extremely workable. This advantage seems to have prompted some States to embody this rule in their statute law (10 out of 50 jurisdictions have statutes prescribing the standard of conduct expected from directors).[68]

Amusingly enough, the State whose courts laid down the "personal affairs" standard, enacted what soon became a model for the "objective" standard: s. 717 of *New York Business Corporation Law* provides that:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

An echo of this may be found at s. 131 of the *Ontario Business Corporations Act*,[69] which provides that:

> Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interest of the corporation, and in connection therewith shall exercise the degree of care and skill that a reasonably prudent director or officer would exercise in comparable circumstances.

It may thus be said that the objective standard of the "ordinarily prudent man" is becoming more and more widely accepted in statutory enactments as well as in jurisdictions still governed by the Common Law.

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[64] H.W. Ballantine, *Ballantine on Corporations*, Chicago, (1927), (Rev. Ed.), at pp. 158-159.

[65] 141 U.S. 132.

[66] Fletcher, *op. cit.*, n. 5, para. 1038, at p. 563.

[67] *Ibid.*, at p. 564.

[68] N.Y. Bus. Corp. Law, para. 717; Idaho, Michigan, Kentucky, Oklahoma, Washington, Pennsylvania and Alabama. See: Adkins & Janis, *loc. cit.*, n. 36, at p. 818.

[69] *Supra*, n. 4.

3 - *Mistakes and errors of judgment*

Since a director needs only be an "ordinarily prudent man" when managing the corporation's affairs, how far will he be exculpated from liability for mistakes and errors of judgment? Mistakes of judgment may be of fact or of law. Mistakes of law ordinarily are mistakes pertaining to the powers of the company or of the director. This type of mistake will be treated separately, together with the problem of the reliance upon counsel. Apart from this particular type of mistake, the so-called "business judgment" rule is too well settled to admit controversy. The basis of this rule appears to be the common sense notion that directors are only human beings whose decision-making involves the undertaking of risks and who, therefore, may err. As stated by Morawetz:

> Directors merely undertake to make honest use of such judgment as they possess. They do not insure the correctness of their judgment; and they cannot be charged with the consequences of an honest error of judgment or accidental mistake in the exercise of their discretionary powers.[70]

In the leading case of *Litwin* v. *Allen*,[71] Shientag, J. wrote what may be said to fairly represent the state of the law on this point:

> In other words, directors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence... But clairvoyance is not required even of a bank director. The law recognizes that the most conservative director is not infallible, and that he will make mistakes, but if he uses that degree of care ordinarily exercised by prudent bankers he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty.
>
> Finally, in order to determine whether transactions approved by a director subject him to liability for negligence, we must "look at the facts as they existed at the time of their occurrence, not aided or enlightened by those which subsequently take place.[72]

Thus, it may be said that directors are excused for their "honest" mistakes. In other words, courts decline to interfere in matters of business judgment provided that reasonable care, skill and diligence have, *de facto*, been exercised to avoid mistakes.[73] In that sense, the "business judgment rule" does not conflict with the concept of negligence.

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[70] Morawetz, *op. cit.*, n. 44, para. 553.

[71] 25 N.Y.S. 2d 667 (S.C.N.Y., 1940).

[72] *Purdy* v. *Lynch*, 145 N.Y. 462, at p. 475, 40 N.E. 232, at p. 236.

[73] *Casey* v. *Woodruff*, 49 N.Y.S. 2d 625; *Pool* v. *Pool*, 16 So. 2d 132 (La. App.).

The *Otis & Co.* v. *Pennsylvania Railway Co.* case[74] provides a good illustration of the rule. In this case the directors of the railway company decided to refund large bond issues but did not have recourse to competitive bidding. Noteworthy is the Interstate Commerce Commission's refusal to require such bidding. Though using their honest business judgment, the directors failed to obtain the "best possible" prices therefor and were sued on that ground. The Court held they were not liable for failing accurately to foretell what the bond market would absorb.

In short, as long as reasonable care has been exercised, the court will not substitute its judgment for that of directors in matters of purely business and economic problems.[75]

D - Factors affecting the degree of care and possible defences

How is the standard of conduct expected of directors applied in practice? In other words, what are the factors which affect the degree of care and which, thus, may be set up as possible defences? Rather than endeavour to exhaust them, we shall concentrate on those which seem to occur most frequently.

When it is said that the director shall "bestow the care and skill"[76] that an ordinarily prudent man under similar circumstances would bestow, it implies that the degree of care will depend upon, *inter alia*, the kind of corporation, the facts or knowledge available at the time of decision-making, the provisions of charter...

That the degree of care varies according to the kind of corporation seems to be well established. This holds true especially for banks and other monetary institutions. As Judge Earl wrote in *Hun* v. *Cary*:

> ...What would be slight neglect in the care exercised in the affairs of a turnpike corporation, or even of a manufacturing corporation, might be gross neglect in the care exercised in the management of a savings bank entrusted with the savings of a multitude of poor people, depending for its life upon credit and liable to be wrecked by the breath of suspicion.[77]

and Judge Shientag in *Litwin* v. *Allen*:

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[74] 61 F. Supp. 905, aff'd. 155 F. 2d 522.

[75] *Helfman* v. *American Light & Traction Co.*, 121 N.J. Eq. 1, 187 A. 540; *Everett* v. *Phillips*, 288 N.Y. 228, 43 N.E. 2d 18 (C.A.N.Y., 1942); *Allied Freightways* v. *Cholfin*, 91 N.E. 2d 765 (S.J.C. of Mass. 1950); *Bates* v. *Dresser*, 251 U.S. 524 (U.S. S. Ct. 1920, per Holmes, J.).

[76] *New York Central Railroad Co.* v. *Lockwood*, 17 Wall. 357, at pp. 382-383.

[77] *Supra*, n. 46.

> Undoubtedly, a director of a bank is held to stricter accountability than the director of an ordinary business corporation.[78]

As a general rule, one may conclude that being entrusted with the funds of others entails greater responsibility for directors, whatever kind of corporation it may be.[79]

Earlier in this chapter, facts or knowledge available at the time of decision-making have been referred to as bearing on the degree of care. Several situations will be envisaged under this heading.

To say that a director shall not be charged with negligence on grounds of *ex post facto* knowledge is not only fair but just:

> A wisdom developped after an event, and having it and its consequences as a source, is a standard no man should be judged by.[80]

In view of the foregoing, one may wonder whether a plea of ignorance or good faith based on reliance on either counsel or statements prepared by officers or president could succeed.

Ordinarily, a plea of ignorance of the company's affairs would not succeed unless such ignorance could not have been remedied by the exercise of reasonable care.[81]

Neither will, ordinarily, honesty and good faith be valid excuses. In *Mann* v. *Commonwealth Bond Corp.* the Court stated that:

> Good faith alone will not excuse them when there is lack of the proper care, attention and circumspection in the affairs of the corporation which is exacted of them as trustees.[82]

But when the directors relied *bona fide* on financial statements produced by officers or by the President to make public announcements respecting the financial status of the company, declared dividends, or filed registration statements with the S.E.C. under the *Securities Act* of 1933,[83] they are usually absolved from liability.[84] Though some early cases had held directors liable for reliance upon erroneous reports from officers or employees,[85] cases of this type are very

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[78] 25 N.Y.S. 2d 667 (1940 S.C.N.Y.), at p. 678.

[79] See Fletcher, *op. cit.*, n. 5, para. 1042; as to trust companies the leading cases seem to be *Medford Trust Co.* v. *McKnight*, 292 Mass. 1, 197 N.E. 649, at p. 655, and, *Prudential Trust Co.* v. *McCarter*, 271 Mass. 132, 171 N.E. 42.

[80] *Costello* v. *Costello*, 209 N.Y. 252, at p. 262, 103 N.E. 148, at p. 152.

[81] *Dinsmore* v. *Jacobson*, 242 Mich. 192, 218 N.W. 700.

[82] 27 F. Supp. 315; *Commercial Bank of Bay City* v. *Chatfield*, 121 Mich. 641, 80 N.W. 712.

[83] Ss. 10, 11, and 12.

[84] See Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, (1963), 76 Harv. L.R. 1403, at pp. 1418-19; 3 Loss, *Securities Regulation*, (2e Ed. 1961), at p. 1726.

[85] *Cornell* v. *Seddinger*, 237 Pa. 389 (1912); *Loan Society* v. *Eavenson*, 248 Pa. 407 (1915).

rare in modern times since accounting techniques have greatly improved and since many jurisdictions [86] have enacted provisions insulating directors from such liability.

There are two types of situations where reliance upon counsel may cause a loss to the corporation: either the directors cause the corporation to act in what turns out to be *ultra vires*, or they act or refrain from acting, though in no way *ultra vires*, in such a fashion as to ultimately cause a financial loss to the corporation.[87] If, for instance, the company, after taking counsel's advice decides not to litigate a claim, a disgruntled shareholder can sue on the grounds of alleged loss suffered by the company. As a general principle in this matter it may be said that whenever a *bona fide* director, having exercised reasonable care in choosing competent counsel relies upon advice of same, he will not incur liability for mistakes of lay [88] or for *ultra vires* acts [89] or for acts falling within his business judgment's province, provided of course that there is no obvious or prima facie breach of a statutory requirement.

For instance, in the case *Spirt* v. *Bechtel*,[90] the directors authorized an agreement with the Treasury Department whereby the corporation waived a claim to tax deductions for expenses incurred under its employee stock option plan. Involved were the duty of loyalty (since directors had adverse interests) and the duty of care. When sued by a shareholder on behalf of the corporation, the directors tendered as defence their counsel's opinion as to the absence of breach of duty of loyalty since in his opinion the company was not entitled to the tax deduction. The court held that the directors were entitled to rely on counsel's advice and further that they acted within allowable limits of business discretion in waiving what seemed to be a doubtful claim.

In *Hornstein* v. *Paramount Pictures Inc.*,[91] a disinterested director's decision, based on the advice of the legal member of the board, no to sue past and present directors was held sufficient defence against a charge of fraud.

[86] See Adkins & Janis, *loc. cit.*, n. 36, no. 52, at p. 829.
[87] Baker and Cary, *op. cit.*, n. 25, at pp. 429-430.
[88] Thompson, *Corporations*, (3rd Ed.), para. 1382.
[89] *Ibid.*, *para.* 1404; *Hodges* v. *New England Screw Co.*, 1 R.I. 312.
[90] 232 F. 2d 241 (C.A. 2, 1956); See Note 66 Yale L.J. 611.
[91] 37 N.Y.S. 2d 404 (Sup. Ct. 1942), at p. 418; aff'd. 266 App. Div. 659; 41 N.Y.S. 2d 210 (1st Dept.); aff'd. 292 N.Y. 468, 55 N.E. 2d 740 (1942).

But in *People* v. *Marcus*,[92] directors of a safe deposit company were advised that a transaction was legal. Charged with violation of the Penal Law they pleaded reliance upon their counsel. The court held that under the circumstances, *"ignorantia juris non excusat."*

Illness and age can sometimes be valid defences in negligence suits. As Chief Justice Fuller of the Supreme Court of the United States wrote in *Brigg* v. *Spaulding*:

> Invalids are permitted to indulge in the hope of recovery, and are not called upon by reason of illness to retire at once from the affairs of this world and confine themselves to preparation for their passage into another.[93]

This statement has been qualified in *Michelsen* v. *Penney*:

> If a director's physical condition is such as is likely to prevent attention to duty for a considerable length of time, he should resign and make way for another who is able to discharge the duties of the office.[94]

Custom and usage of business may be taken into consideration in determining whether or not a director is liable for negligence.[95] However, no custom or practice may render a directorship a mere honour, void of responsibility.[96]

As often happens, directorates have non-resident members. Whether this fact may serve as excuse remains an unsettled question. Since most cases involve bank directors, their applicability to ordinary corporate managers is doubtful.

In *Bowerman* v. *Hamner*,[97] the U.S. Supreme Court held that inability to attend meetings by reason of residence at a distance (200 miles) is no excuse for complete neglect of duty of supervision (the bank director did not attend a single meeting in over five years).

But the case of *Wallach* v. *Billings* [98] seems to suggest a distinction between the duties of resident and non-resident directors. The court referred to the provisions of the *National Bank Act* stating that "at least three-fourths of the directors must have resided in the state... in which the association is located..." [99] to imply a distinction between resident and non-resident directors, the latter being possibly held to a less strict accountability than the former.

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92 261 N.Y. 268; 185 N.E. 97 (1933).

93 141 U.S. 132, at p. 155.

94 135 F. 2d 409.

95 Fletcher, *op. cit.*, n. 5, para. 1053.

96 *Kavanaugh* v. *Commonwealth Trust Co. of New York*, 223 N.Y. 103, at p. 106, 119 N.E. 237, at p. 238.

97 250 U.S. 504 (1919).

98 277 Ill. 218, 115 N.E. 382 (1917), cert. den. 244 U.S. 659 (1917).

99 12 U.S.C.A. para. 72; see Fletcher, *op. cit.*, para. 1057.

Whatever course of action a court would take, it should be of comfort to the director that the plaintiff still has to prove a causal relation between the non-residence and the loss suffered by the company.

Applied to acts of officers and codirectors the standard of reasonable care leads to the following grounds of liability: connivence or participation in the wrongful act,[100] negligence in supervising the corporate business,[101] negligence in the appointment of the wrongdoer,[102] negligence of executive committee. As a rule it may be said that the judicial tendency is towards a stricter accountability for directors.[103] It has, thus, been said by the Court of Appeals of New York:

> The law has no place for dummy directors.[104]

According to this terse statement, directors can no longer stay away from directors' meetings as a practice, or rely entirely upon others to attend to the corporate business, and escape liability for the wrongful acts of omission or commission of other directors or officers.[105]

Directors may, however, rely upon officers: they are not insurers of the officers' fidelity. As stated by Fuller, C.J.U.S. in *Briggs* v. *Spaulding*: [106]

> [Directors] are not insurers of the fidelity of the agents whom they have appointed, who are not their agents but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention or in neglecting to use proper care in the appointment of agents.

One remaining problem arises from the board of directors' custom of appointing executive committees. Though this practice is a

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[100] *Movius* v. *Lee*, 30 Fed. 298, at p. 307, Fletcher, *op. cit.*, n. 5, para. 1089.

[101] Fletcher, *op. cit.*, n. 5, para. 1070; *Angelus Securities Corp.* v. *Ball*, 20 Cal. App. 2d 423, 67 P. 2d 152.

[102] *Scott* v. *Depeyster*, 1 Edw. Cn. (N.J., 513); *Loan Society of Philidelphia* v. *Eavenson*, 248 Pa. 407, 94 A. 121; *Roseville Trust* v. *Mott*, 107 A. 462, aff'd. *La Monte* v. *Mott*, 116 A. 269.

[103] Fletcher, *op. cit.*, n. 5, para. 1065.

[104] *Kavanaugh* v. *Gould*, 147 App. Div. 281, at p. 289; 131 N.Y. Supp. 1059, at p. 1064, aff'd. 223 N.Y. 103, 119 N.E. 237.

[105] *Michelsen* v. *Penney*, 135 F. 2d 409, noted in 42 Mich. L.R. 184 and in 17 So. Calif. L.R. 181.

[106] 141 U.S. 132, at p. 147.

reasonable one, the *caveat* issued by the Court in *Kavanaugh* v. *Gould* should remembered:

> ...This custom, however, does not relieve directors generally of all responsibility... [and they have] the right, however, ordinarily to rely upon the vigilance of the executive committee to ascertain and report any irregularity or improvident acts in its management.[107]

In conclusion, directors acting in good faith exercising ordinary care, diligence and skill in the management of the company as well as in the choice of competent counsel will, in most cases, be immune from attack.

III — AREAS OF LIABILITY

Though the standard of conduct required from directors is usually that of an ordinarily prudent man under similar circumstances, some specific areas warrant a greater degree of awareness on the part of directors.

A - Securities Transactions

When dealings in stocks occur between directors and individual shareholders, what is the relationship between them? To answer this question, two sets of rules have been developed: the common law rules and the "federal corporation law" rules stemming from the *Securities and Exchange Act* of 1934.

1 - *The Common Law Rules*

At common law, there is conflicting authority on the precise nature of the director — individual shareholder relationship: some jurisdictions follow the so-called majority rule, others the Kansas or minority rule, and an increasing number adhere to the compromise known as the "special facts" doctrine.

It should, however, be pointed out that none of these rules would result in prohibiting directors from dealing with their company's stock, as was established by the U.S. Supreme Court in *S.E.C.* v. *Chenery Corp.*[108] But, with respect to the disclosure of "inside" information, the various rules come into play.

Under the "majority rule", no fiduciary relationship exists between the shareholder and the director. The Tennessee case of *Shaw* v. *Cole Mfg. Co.* provides for a classical formulation of the rule:

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[107] *Supra*, n. 104; as leading case on the liability of directors for acts of codirectors see *Campbell* v. *Watson*, 62 N.J. Eq. 396, 50 A. 120 (1901, per Vice Chancellor Pitney, later J.U.S.S.C.).

[108] 318 U.S. 80.

...While directors occupy a trust relation to the corporation which they direct, their duty does not apply to the stockholder in the sale and purchase of stock. Dealing in its own stock is not a corporate function. In buying or selling stock directors may trade like an outsider, provided they do not affirmatively act or speak wrongfully, or intentionally conceal facts with reference to it. There is also the qualification that no other relation of trust exists between the parties.[109]

Needless to say, such a rule has been "criticized as a rule of unconscionable laxity which has been condemned by almost all text writers and commentators, as well as by a minority of the courts." [110]

A minority of the courts, led by Kansas, holds on the contrary that directors are fiduciaries for individual stockholders with respect to their stock. The leading case seems to be *Hotchkiss* v. *Fischer*.[111] There, a widow in need of money had gone in advance to the annual meeting to ascertain whether a dividend would be declared. She had several interviews with the president who declared himself unable to inform her and who showed her the year-end financial statement. He explained the items on it but painted a somewhat dark picture. As a result of these conversations, the widow sold her stock to him at $1.25 per share. Three days later, a dividend of $1.00 per share was declared. Faced with such a situation, the Court used the trustee analogy to describe the director's duties and said that the director is under a duty to:

...Communicate to [her] all material facts in connection with the transaction which the [director] knows or should know.

The director must also explain the statement:

Without being analysed and interpreted the statement would convey little information respecting financial condition to a shareholder who did not acknowledge special competency.

The court, then, justified its draconian approach in stating that:

...Experience teaches such transactions too often result in gross fraud.

Followed by a minority of states,[112] the Kansas rule received an interesting comment from a Minnesota Court in *Seitz* v. *Frey*:

In many of the cases in which the minority rule was applied, it appeared that some radical and important change in the property, condition or affairs of the corporation, largely increasing the value of the capital stock, was

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109 177 S.W. 479; *See Agatucci* v. *Corradi* 63 N.E. 2d 630 (Ill.); *Hooker* v. *Midland Steel Co.*, 74 N.E. 445 (Ill.); *Bawden* v. *Taylor*, 98 N.E. 941 (Ill.).

110 H.W. Ballantine, *op. cit.*, n. 64, at p. 213, quoted with approval by Fletcher, *op. cit.*, n. 5, para. 1068, 1; see also 19 C.J.S. para. 793(b).

111 136 Kan. 530, 16 P. 2d 531 (1932); noted (1933), 46 Harvard L.R. 847; 139 Kan. 333, 31 P. 2d 37 (1934); see generally a very helpful note on directors' purchases of shares in Baker & Cary, *op. cit.*, n. 25, at p. 558.

112 See Fletcher, *op. cit.*, n. 5, para. 1068.2.

being effected secretly or had been so effected either by the officer himself or by others with his knowledge and concurrence, which was concealed from the stockholders from whom he purchased. In most of these cases the special circumstances shown would have justified the result without applying the stringent rule governing a trustee when dealing with his *cestui que* trust.[113]

The "special facts" or "special circumstances" doctrine referred to by the above Court, has been laid down by the U.S. Supreme Court in *Strong* v. *Repide*.[114] Under this doctrine a corporate officer or director owes a limited fiduciary duty in transactions with a shareholder involving the transfer of stock.[115] In *Strong* v. *Repide*, Strong was a shareholder of a company located in the Philippine Islands. The future of this company depended almost exclusively upon an advantageous sale of its lands to the United States Government. Defendant Repide, a director of the company, was in charge of the negotiations and knew they would soon be successfully completed. Repide used an agent to buy Plaintiff's shares through a stockholder.

Repide concealed his identity as purchaser and failed to make any declarations as to the state of the negotiations. As a result Strong sold his shares at about one-tenth of what they became worth three months later when the sale to the government was completed. Justice Peckham commented:

> It is here sought to make defendant responsible for his actions, not alone and simply in his character as a director, but because, in consideration of all the existing circumstances above detailed, it became the duty of the defendant, acting in good faith, to state the facts before making the purchase. That the defendant was a director of the corporation is but one of the facts upon which the liability is asserted, the existence of all the others in addition making such a combination as rendered it the plain duty of the defendant to speak. He was not only a director but he owned three-fourths of the shares of its stock, and was, at the time of the purchase of the stock, administrator-general of the company, with large powers, and engaged in the negotiations which finally led to the sale of the company's lands... to the Government at a price which greatly enhanced the value of the stock... Concealing his identity when procuring the purchase of the stock, by his agent, was in itself strong evidence of fraud.[116]

As to what "special facts" may be, a Michigan Court in *Buckley* v. *Buckley* said:

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[113] 152 Minn. 170, 188 N.W. 266, at p. 268 (1922). As a complement see *Amen* v. *Black*, 234 F. 2d 12 (C.A. 10, 1965), at p. 21 — "whether we apply the Kansas strict accountability rule... or the less stringent rule applicable in Illinois... equity will not condone fraudulent representations".

[114] 213 U.S. 419 (1909).

[115] Fletcher, *op. cit.*, n. 5, para. 1171.

[116] *Ibid.*, at p. 431.

> The special circumstances producing exceptional cases seem to be an assured sale, merger, or other fact or condition enhancing the value of the stock, known by the officer or officers, not known by the stockholder, and not to be ascertained by an inspection of the books.[117]

In 1933, the Supreme Judicial Court of Massachussetts in *Goodwin* v. *Agassiz* [118] greatly reduced the scope of the special facts doctrine. In that case a mining company had shut down exploratory operations on a property. At about the same time, an experienced geologist formulated in writing a theory as to the possible existence of copper deposits on the property. Directors, thereupon, bought many shares of the company through the facilities of the Boston Stock Exchange without revealing the geologist's theory to the selling shareholders. Had the Plaintiff known about it, he would not have sold his stock.

To this Chief Justice Rugg answered:

> The contention that directors also occupy the position of trustees toward individual shareholders in the corporation is plainly contrary to repeated decisions of this court and cannot be supported.

The learned Justice, then, proceeded to apply the special facts doctrine:

> ...Where a director personnally seeks a stockholders for the purpose of buying his share without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances.[119]

The Court, in freeing the director from liability, rested its conclusions on the following grounds:

1. The transactions were effected through the anonimity of a stock exchange.

2. Disclosure of theory would have been detrimental to the interests of another mining company in which the defendants were directors.

3. "Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness."[120]

4. The Plaintiff was no novice.

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[117] 230 Mich. 504, 202 N.W. 955, at p. 956.

[118] 186 N.E. 659.

[119] *Ibid.*, at pp. 660-661; The Court, in support of this contention, cited *Strong* v. *Repide* and *Allen* v. *Hyatt*, 30 T.L.R. 444, commented *supra*, n. 18 in text.

[120] *Strong* v. *Repide*, *supra*, at p. 661.

5. He made no inquiries of the defendant or of other officers of the company.[121]

The foregoing seems to indicate that the special facts doctrine, though repeatedly applied,[122] appears confined to cases of virtually face-to-face meeting between the director and the shareholder.

Aside from the three rules outlined *supra*, the common law principle respecting "half-truths" may be a source of liability in situations where directors individually buy shares from holders. As Fleming writes:

> ...A half-truth may just as much be a false representation as a complete lie.[123]

Of British origin,[124] this principle was applied in *Von Au* v. *Magenheimer*.[125] There the Court held that if buying directors, in negotiations with the seller, purport to speak with respect to the affairs of the corporation, mere literal truth is not enough, where they know undisclosed facts which, if stated, would qualify such truth and explain apparently unfavourable conditions.[126]

If, instead of dealing for himself, the director buys shares for the corporation, is he subject to any common law duty of disclosure? As a rule, it may be said that the director owes his fiduciary duty primarily to the corporation and not to the selling shareholders:

> ...In buying the five shares that he [the director] bought for the company his duty was to the company for which he was acting and not to the seller of the stock.[127]

An exception should be made in the case of an acquisition by a closed corporation of a substantial part of its shares. It has been

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[121] See further notes to this case in (1933), 47 Harvard L.R. 353, (1933), 19 Cornell L.Q. 103 and (1933), 32 Michigan L.R. 678.

[122] *Nichol* v. *Sensenbrenner*, 220 Wis. 165, 263 N.W. 650 (1935); *Taylor* v. *Wright*, 69 Cal. App. 2d 371, 159 P. 2d 980 (1945); *Broffe* v. *Horton*, 172 F. 2d 489 (C.A. 2, 1949); see Baker & Cary, *op. cit.*, n. 25, at p. 560; Fletcher, *op. cit.*, n. 5, para. 1171; 19 C.J.S. para. 793; *Janigan* v. *Taylor*, 344 F. 2d 781, (C.A. 1, 1965), at p. 784,

[123] Fleming, *The Law of Torts*, 3rd Ed. (1965), at pp. 599-600; Prosser, *Torts*, (1941), at p. 722.

[124] *Tapp* v. *Lee*, (1803), 3 Bos. & P. 367; *Curtis* v. *Chemical and Dying Co.*, [1951] 1 K.Q. 805; *Link* v. *Schaible*, (1961), 27 D.L.R. (2d) 461.

[125] 126 App. Div. 257, at pp. 260-261, 110 N.Y.S. 629 (2d Dpt., 1908), aff'd. memo. 196 N.Y. 510, 89 N.E. 1114 (1909).

[126] See Baker & Cary, *op. cit.*, n. 25, at p. 561; Restat. Torts, para. 529, com. a.

[127] *Gladstone* v. *Murray Co.*, 314 Mass. 584, 50 N.E. 2d 958 (1943), at p. 960; see also *Steven* v. *Hale Haas Corp.*, 249 Wis. 205, 23 N.W. 2d 620 (1946).

held [128] that if the shares are bought at a low price and if the persons acting for the corporation hold a substantial number of shares, the transaction is only an indirect way of benefiting the remaining shares and disclosure is required.

Directors may also be subject to conflicting duties when authorizing or negotiating a purchase by the corporation of its own shares. According to Baker and Cary,[129] corporations making a general offer to their shareholders to purchase their holdings forward with the offer an amount of information equivalent to what has been termed a "reverse" prospectus. In connection with this, it has also been held that a company may buy its shares at private sales without a *pro rata* offering to all the holders of stock of the class affected. As stated by the Supreme Court of Delaware in *Martin* v. *American Potash & Chemical Corp.*:

> We see no sound reason why it should be held as a matter of law that the method of reducing capital by purchasing shares at a private sale for retirement may not be invoked simply because the purpose or motive of the reduction is to eliminate a substantial number of shares held by a stockholder at odds with management policy, provided of course that the transaction is clear of any fraud or unfairness.[130]

It may thus be said that, at common law, there is a conflict of authority as to the precise nature of the relationship between directors and individual shareholders and hence as to the degree of disclosure. The general trend, (if any), would, however, seem to impose a certain duty of disclosure upon the director when he trades on his account meeting almost face to face with the individual holder and when the "special circumstances" exist.

2 - *The Federal Corporation Law*

The very year the decision in *Goodwin* v. *Agassiz* [131] was rendered, Congress passed the first *Securities Act* [132] which it complemented the following year by the *Securities Exchange Act.*[133] Some thirty years

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[128] *Wood* v. *McLean Drug Co.*, 266 Ill. App. 5 (1932); *MacGill* v. *MacGill*, 109 A. 72 (1919); *Johnson* v. *Mansfield Hardwood Lumber Co.*, 143 F. Supp. 826 (W.D.La. 1956).

[129] See Baker & Cary, *op. cit.*, n. 25, at p. 563.

[130] 92 A. 2d 295 (Sup. Ct. 1952), at p. 302; For a discussion of these problems see Note, (1946), 59 Harvard L.R. 769, at pp. 775-778; Smith, (1921), 19 Mich. L.R. 698, Berle, (1927), 25 Mich. L.R. 827; Walker, (1923), 32 Yale L.J. 637; Laylin, (1918), 27 Yale L.J. 731; Wilgus, (1910), 8 Mich. L.R. 267; Ballantine, *op. cit.*, n. 64, para. 80.

[131] 286 Mass. 358, 186 N.E. 659 (1933).

[132] 1933, 73rd Congress, Sess. I, Ch. 38, hereinafter referred to as the 1933 Act.

[133] 1934, 73rd Congress, Sess. II, Ch. 404, hereinafter referred to as the 1934 Act.

later, the Court of Appeals of the Third Circuit commented the 1934 *Act*:

> That Act deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. ... As implemented by Rule 10*b*-5 and Section 29(*b*), Section 10(*b*) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act, of which Sections 10(*b*) and 29(*b*) are parts, constitutes far reaching federal substantive corporation law.[134]

Under this new and rapidly expanding body of law, directors are subjected to an extended duty of disclosure and to a certain standard of behaviour[135] with, of course, corresponding liabilities.

A — The Duty of Disclosure

The prevailing philosophy underlying the *Securities Acts* may be described as one of "full, true and plain disclosure" in all the literature pertaining to securities: prospectuses, reports filed with the Securities and Exchange Commission, proxy statements and even press releases.[136] As Brandeis wrote in *Other People's Money:*

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of desinfectants; electric light the most efficient policeman.[137]

The duty of disclosure is twofold: not only must every "material" fact be disclosed but every promise must be kept. If, for instance, the company advertises annual certified statements to shareholders, then failure to publish this statement will entail liability for management.

The main question to be answered remains what is a material fact since Rule 10b-5 makes it unlawful for any person:

> 2 — To make an untrue statement of a material fact or to omit to state a material necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[138]

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[134] *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824, (1961), at p. 834.

[135] Much of the following discussion is taken from Arthur Fleischer, Jr., *Federal Corporation Law: An Assessment,* (1965), 78 Harvard L.R. 1146, hereinafter referred to "Fleischer".

[136] See generally Loss I, *Securities Regulations,* 121-128, (2 Ed. 1961).

[137] 1st Ed., 1914, at p. 92.

[138] Rule 10b-5 was promulgated by the S.E.C. in 1942 and the sub section quoted is identical to the operative liability clauses in s. 11 and s. 12 of the 1933 Act pertaining to registration, statements, prospectus and communications.

The leading case on materiality is *S.E.C.* v. *Texas Gulf Sulphur Co.*[139] In determining what should be the proper test of materiality, the majority of the Court of Appeals of the Second Circuit first stated the objectives of the act. [The act requires]

> Nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of insiders.[140]

The Court, approving earlier decisions,[141] ruled that:

> The basic test of materiality... is whether a *reasonable* man would attach importance... in determining his choice of action in the transaction in question. This, of course, encompasses any fact... which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities.[142]

The Court then concludes:

> Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy or sell or hold the company's securities.[143]

According to this test, the following facts would be (or have been) considered material: a significant merger, a dividend cut,[144] important changes in sales or earnings,[145] a new line of products or a new contract.

Knowledge of a fact might not be quite enough to subject an insider to the hardships of rule 10b-5; the fact has to be material. In some instances it is far from easy to determine when a fact has

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[139] 401 F. 2d 833 (C.A. 2, Aug. 13, 1968) Docket No. 30883 p. 3587; rev'd in part 258 F. Supp. 262, noted at 80 Harv. L.R. 468. This case was the subject of much comment before it was decided: Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* (1961), 51 Va.L.R. 1271, at p. 1289; Kennedy & Wander, *Texas Gulf Sulphur: A most unusual case,* (1964), 20 Bus. Law 1057; R.A. McDowell, *Director's Liabilities in Securities Transactions,* (1966), 22 Bus. Law 76, at pp. 83 et s.; Whitney, *Section 10b-5: From Cady Roberts to Texas Gulf: Matter of Disclosure,* (1965), 21 Bus. Law 193; Deniel B. Posner, *Developments in Federal Securities Regulations,* (1966), 21 Bus. Law 703; *Insider Trading in Stocks,* Symposium held in New York on Nov. 22, 1965 with J. Farmer, W.L. Cary, A. Fleischer, T.A. Halleran, reproduced at (1966), 21 Bus. Law 1009. The *Texas Gulf* decision has been subsequently approved in *Weitzen* v. *Kearns,* 271 F. Supp. 616 (S.D.N.Y., 1967), at p. 619.

[140] *Supra,* n. 139, at p. 3608.

[141] *List* v. *Fashion Park Inc.,* 340 F. 2d 457 (2d Cir. 1965), at p. 462, citing *Kohler* v. *Kohler Co.,* 319 F. 2d 634 (7 Circ., 1963), at p. 642.

[142] *Supra,* n. 139, at p. 3608.

[143] *Ibid.,* at p. 3609.

[144] See *Cady Roberts,* 40 S.E.C. 911.

[145] *E.g., Weitzen* v. *Kearns,* 271 F. Supp. 616 (S.D.N.Y., 1967).

become material. In the *Texas Gulf* case the Court held that the materiality of a fact depends on two factors. It will first depend "at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company activity".[146] The second factor is the importance attached to the event by those who knew about it. In such a context, proof of insider trading becomes highly pertinent evidence. Applying these criteria to the *Texas Gulf* facts, the Court came to the conclusion that the visual assay of the drill core completed on November 12th, 1963 was a material fact, thus reversing the finding of the Circuit Judge. In the case of a proposed merger, the issues become difficult. For example, the Board of Company A might decide to acquire Company B at a certain exchange ratio but no concrete discussions have yet taken place. What if negotiations have started but no agreement has been reached so far? It would seem that the line would be drawn at the moment where some form of consensus between the two Boards has been reached.[147]

What are the sanctions attached to violations of the duty of disclosure? Three main areas will be examined in answering that question: the required reports, the discretionary reports, and non-disclosure not related to securities transaction.

Under s. 11 of the 1933 *Act*, directors will be responsible for omissions or misstatements contained in the registration statement, whether or not they sign it, unless after reasonable inquiry they believed it adequate. Under s. 18(a) of the 1934 *Act*, directors, unless they can prove their good faith and their absence of knowledge, are responsible for false and misleading statements filed with the S.E.C. to any person who, in reliance upon such statement, bought or sold stock at a price affected by the statement.

Daily practice of the securities business raises the problem of misleading information in gratuitous reports and circulars distributed by a company.[148] In the *Texas Gulf* case, management was also charged with having issued a false and misleading press release prior to the public announcement of the ore discovery. Rule 10b-5 applies only to statements made "in connection with the sale or purchase of a security". What then does this "in connection with" requirement mean in the case of a press release? Does this mean that Rule 10b-5

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146 *Supra*, n. 139, at p. 3609.

147 Fleischer, Symposium on "Insider Trading in Stocks", *supra*, n. 139, at p. 1017.

148 See Fleischer, *loc. cit.*, n. 135, at p. 1156.

is only violated when the purpose of the press release is "to affect the market price of a company's stock to the advantage of the company or its insiders", as contended by Judge Bonsal in the *Texas Gulf* case?[149] The majority of the Court of Appeals seems to hold different views: legislative history shows that the intent of Congress was to outlaw any form of device which would cause reasonable investors "to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities".[150] Thus giving a broad interpretation to the "in connection with" requirement, the Court held that:

> Rule 10*b*-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, *e.g.*, by means of the financial media, if such assertions are false and misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10*b*-5 would not have been violated.[151]

This being the principle, how will it be applied in practice? To answer this question the Court of Appeals proposes a twofold test: the trial judge will have to decide:

1. whether the reasonable investor in the exercise of due care would have been mislead by the press release and

2. if yes, whether the issuance of the release resulted from a lack of due diligence.

In a separate but concurring opinion, Judge Friendly makes an interesting distinction between private and public suits under Rule 10b-5(2). In his opinion, negligent misstatements are sufficient to give rise to injunctive relief, as asked by the S.E.C. in its brief. He adds however:

> The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964 may impose civil liability on the corporation are frightening.[152]

To Judge Friendly, legislative history shows that Rule 10b-5(1) & (3) are intended to provide for civil liability but that Rule 10b-5(2) was only intended to afford a basis for injunctive relief and criminal

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[149] 258 F. Supp. 262, at p. 293.

[150] *Supra*, n. 139, at p. 3630; the minority of the court, speaking through Mr. Justice Moore, voiced a strong dissent against this interpretation of the legislative history of s. 106 and Rule 10b-5 and approved Judge Bonsal's opinion.

[151] *Ibid.*, at p. 3634.

[152] *Ibid.*, at p. 3644.

liability. Judge Friendly leaves a doubt as to whether or not *"scienter"* is a necessary element in a private damage action.

The position adopted by the Court of Appeals in the *Texas Gulf* case thus rejoins the policy of the New York Stock Exchange. As stated in the New York Stock Exchange Company Manual, the Exchange policy is to require:

> Timely disclosure, to the public and to the Exchange of information which may affect security values or influence investment decisions, and in which stockholders, the public and the Exchange have a warrantable interest.[153]

In some instances, however, sound management, in the absence of any securities transactions, requires the news to remain secret. Could thus a person who, because of justified non-disclosure, bought or sold stock at an inflated or deflated price, have a right of action under s. 10b and Rule 10b-5? It is possible to argue that management ought to be held responsible since it has the power to disseminate information.[154] Though this argument does not seem to have been tested by the Courts, M. Fleischer[155] writes:

> The imposition of liability for simple non-disclosure would seem to be a significant enough departure from state law requirements to warrant a clear congressional directive.[156]

B — The standard of behaviour

The standard of behaviour which directors and generally insiders will be expected to observe, derives from the so-called "anti-fraud" provisions of the *Securities Acts*. That the use of inside information is basically unfair is at the root of these provisions. As a consequence Section 16(b) of the 1934 *Act* imposes an absolute liability on insiders for "short-swing" profits realized in the company's stock and section 10(b) together with Rule 10b-5 of the same *Act* prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the sale or purchase of any security. Below are examined some problems arising from Section 16(b) and Section 10(b) with Rule 10b-5.

Until recently, most of the litigation seeking to hold directors liable for securities transactions alleged violations of s. 16(b) of

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153 S. A-2, Listing Agreement-objectives of the Agreement.

154 Halleran, Symposium on *Insider Trading in Stocks, supra,* n. 139, at p. 1025.

155 See Fleischer, *loc. cit.,* n. 135, at p. 1158.

156 In this section we did not consider the liability arising from nondisclosure of important news specifically required by the S.E.C. rules. According to Fleischer, *loc. cit.,* n. 135, the S.E.C. may compel the filing of reports but, when no securities transactions occur, no private right of action seems to be warranted, except when management deliberately withholds information because of the effect that disclosure might have on the markets.

the 1934 *Act.* The intent of this section is to provide a "crude rule of thumb" [157] for the prevention of the use of inside information. Short-swing profits, within a six-month period, realized by a director on *any* pair of transactions shall inure to the corporation at anybody's request. The liability imposed by s. 16(b) is absolute; it depends neither upon the use of insider knowledge, nor upon whether the other party suffered any loss or damage, nor whether the other party is the plaintiff seeking recovery on behalf of the corporation.[158]

In spite of its apparent clarity, s. 16(b) is not entirely free of doubt with respect to the meaning of "sale" or "purchase" of a security. Thus the conversion of a convertible security (whether debenture or preferred stock) into common stock originally construed as a "purchase" of the common [159] is now by S.E.C. rule no longer deemed to be a "purchase".[160] In the same vein, Rule 16b-7 exempts certain acquisitions and disposals of securities pursuant to mergers or consolidations.[161] Whether the receipt, disposal and exercise of stock options, warrants or stock bonuses falls within the ambit of s. 16(b) is still unclear.[162] Reclassification of the company's stock

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[157] Corcoran, Hearings before the Comm. on Banking and Currency on S. 84, 72d Congress, 2d Sess; and S. 56 and S. 57, 73d Congress, 1st and 2d Sess., 1934, at p. 6557.

[158] See Allan Kramer, *An Examination of s. 16(b),* (1965), 21 Bus. Law 183; R. McDowell, *Director's Liabilities in Securities Transactions,* (1966), 22 Bus. Law 76 at p. 80; Loss II, pp. 1037-1132 (2 Ed. 1961); *Smolowe* v. *Delendo Corp.,* 136 F. 2d 231 (C.A. 2, 1943), cert. den. 320 U.S. 751 (1943).

[159] *Park & Tilford* v. *Schulte,* 160 F. 2d 984 (C.A. 2, 1947), cert. den. 332 U.S. 761 (1947); *Heli-Coil Corp.* v. *Webster,* 352 F. 2d 156 (C.A. 3, 1965), noted in Posner, *Developments in Federal Securities Regulations,* (1966), 21 Bus. Law 703, at p. 719; *contra: Ferraiolo* v. *Newman,* 259 F. 2d 342 (C.A. 6, 1958), cert. den. 359 U.S. 927 (1959); *Blau* v. *Lamb,* 363 F. 2d 507 (C.A. 2, 1966), cert. den., Jan. 11, 1967, 385 U.S. 1002; *S.E.C.* v. *Sterling Precision Corp.,* 276 F. Supp. 772 (July 7 1967), reviewing many cases on "purchase" under s. 16(b).

[160] Rule 16b-9, S.E.C. Release No. 34-7826, Feb. 17, 1966.

[161] A recent amendment provides that the exemption shall not be available to anyone who made short-term purchases or sales other than those involved in the merger or consolidation. It also provides that in such a case the exemption will be unavailable only to the extent of such purchases and sales: S.E.C. Release No. 34-8177, Oct. 10, 1967.

[162] Some cases hold that such receipt is a purchase: *Bleau* v. *Hodgkinson,* 100 F. Supp. 361 (D.C.S.D.N.Y.); the S.E.C. promulgated rule 16b-3 to exempt these stock option plans but after *Greene* v. *Dietz,* 247 F. 2d 689 (C.A. 2, 1957), 71 Harv. L.R. 386, revoked it and then re-enacted it under an amended form, (S.E.C. Release No. 34-7776, Dec. 23, 1965); see also *Perlman* v. *Timberlake,* 172 F. Supp. 246 (D.C.S.D.N.Y., 1959); *Rheem Manufacturing Co.* v. *Rheem,* 295 F. 2d 473 (C.A. 9, 1961) and R.S. Kelly and H. Green, *Application of s. 16b . . . to insiders' transactions under employee stock option plans,* 17 Bus. Law 402; *Phantom Stock Plans,* (1963), 76 Harv. L.R. 619.

was held not to be a purchase since there had been full prior disclosure, vote by the shareholders and distribution of a proxy statement.[163]

From this cursory analysis of section 16(b)'s impact on directors' behaviour, it should be remembered that, whatever the intent, the liability for short-swing profits is absolute.[164]

While both section 16(b) and 10(b) appeared on the statute books, the remedy provided by s. 10(b) and Rule 10b-5 was, as Professor Loss writes, "not appreciated for some years".[165] The prohibition of section 10(b) of the 1934 *Act* is subtantially the same as that of s. 17(a) of the 1933 *Act*, except that s. 10(b) applies to purchases as well as to sales, rendering it unlawful for any person:

> *b*) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules or regulation as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of the investors.

In a preceeding section,[166] Rule 10b-5(2) has been examined in connection with the duty of disclosure. Under the remaining subsections of Rule 10b-5, it is unlawful for any person:

> 1 — To employ any device, scheme or artifice to defraud.
>
> 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.

Such being the language of the law, one may wonder first, what is the 10b-5 fraud, second, who may be defrauded and third, what are the available remedies?

Fraud in this context may take numerous forms: false statements, failure to correct a misleading impression left by a statement already made, or not stating anything at all when there is a duty to disclose.[167] One form of fraud, however, is of special importance to

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[163] *Roberts* v. *Eaton*, 212 F. 2d 82; cert. den. 348 U.S. 827.

[164] In connection with this, it has been held that segregation of shares for the purpose of matching the transactions under s. 16(b) is not available as a defence; *Western Auto Supply Co.* v. *Gamble-Skogmo Inc.*, 348 F. 2d 736 (C.A. 8, 1965). Before leaving this subject of short-swing profits it should be noted that a parent may not recover from subsidiary's officer or director realizing short-swing profit in parent's stock: *Lee National Corp.* v. *Segur*, 281 F. Supp. 851 (D.C. Pa. March 26, 1968).

[165] III, at p. 1424, (2d Ed., 1961).

[166] *Supra*, text accompanying n. 139.

[167] *Cochran* v. *Channing Corporation*, 211 F. Supp. 239 (S.D.N.Y., 1962), at p. 243,

directors: in *Texas Gulf,* Judge Bonsal, resting his opinion on the "special facts" doctrine of *Strong* v. *Repide,*[168] ruled that:

> ...Trading by an insider on the basis of material undisclosed information constitutes a deceptive practice in violation of the statute and rule.[169]

At this point, one may ask whether liability for trading on the basis of material undisclosed information comprises merely "face-to-face" transactions, as was held in *Goodwin* v. *Agassiz.*[170] In *Texas Gulf,* the Court held that:

> An insider's liability for failure to disclose material information which he uses to his own advantage in the purchase of securities extends to purchases made on national securities exchanges as well as to purchases in "face-to-face" transactions.[171]

In support of this contention, Judge Bonsal quotes *Cochran* v. *Channing Corp.*:

> It is the use of inside information that gives rise to a violation of Rule 10*b*-5. Lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10*b*-5 has been violated.[172]

And as noted in *Cady, Roberts*:

> It would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions.[173]

What should, thus, a director do, when legitimate business reasons require a period of non-disclosure? The answer is now clear: he should forego any transaction.[174]

It should, however, be pointed out that this should not be construed as prohibiting insiders from possessing specialized knowledge (not material though) to acquire some stock of the company: insiders should not be penalized for their "educated guesses".[175] In the *Texas Gulf* case, the Court of Appeals held that speculation by an insider in the company's stock is basically wrong: insiders may buy for growth but not for speculation on a short-term basis.[176]

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[168] *Supra,* n. 115.

[169] 258 F. Supp. 278. This part of the opinion was left undisturbed by the Court of Appeals of the Second Circuit Docket No. 30882, p. 3587, at pp. 3606-3607; see Loss, pp. 1445-1473, (2d Ed., 1961).

[170] *Supra,* n. 119.

[171] 258 F. Supp. 279; this part of the opinion was also left undisturbed by the Court of Appeals decision; see also *List* v. *Fashion Park Inc.,* 340 F. 2d 457 (C.A. 2, 1965), at pp. 461-462.

[172] *Supra,* n. 167.

[173] 40 S.E.C., at p. 914.

[174] *Cady Roberts,* 40 S.E.C., at p. 911; *S.E.C.* v. *Texas Gulf Sulphur Co.,* 258 F. Supp. 279; *Oliver* v. *Oliver,* 118 G.A. 362, 45 S.E. 232 (1903), at p. 234.

[175] Loss III, *supra,* n. 165, at p. 1463.

[176] *Supra,* n. 139, at p. 3613.

In the same vein, the Court added that "tipping" material inside information violates Sec. 10(b) and Rule 10b-5(3).[177]

The question raised by the above principle is thus: when may insiders trade? Insiders should, of course, not be permitted to "beat the news". Here again the Court of Appeals sets out the principle that:

> Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public.[178]

To achieve this end, the Court suggests that the insider should at least wait until the news has appeared on the Dow Jones broad tape and adds in *obiter* that the proper waiting period should be determined by the S.E.C.

Supposing now that a director, believing in good faith that the news has been disseminated, trades on the basis of what is still undisclosed material information. Would his good faith be a defence under Rule 10b-5? While proof of a specific intent to defraud is not necessary either in public or in private actions, the Court of Appeals in the *Texas Gulf* case required that some form of *scienter* be shown[179] and concluded that the insider's beliefs are to no avail if they are not reasonable under the circumstances. The Court seems thus to suggest that good faith and exercise of due care and diligence would normally be a defence under Rule 10b-5.

In a period of justified non-disclosure, the granting of stock options by a committee ignoring material facts to directors aware of such facts raises an interesting question. May the directors accept the options without disclosing the material information to the issuer? In the *Texas Gulf* case, the Court of Appeals proposed what seems to be a reasonable rule, satisfying both the corporate trust and the requirements of sec. 10(b) and Rule 10b-5: the director should accept the option but "abstain from exercising it until such time as there shall be a full disclosure and, after the full disclosure, a ratification such as was voted here".[180]

Obviously, any individual buying or selling stock may be the victim of a 10b-5 fraud, but can the corporation be defrauded by its directors? One may immediately raise the conceptual problem of finding how the corporation can be deceived at all when those who manage and act for the corporation are fully aware of the

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[177] *Ibid.*, at pp. 3615-3616.
[178] *Ibid.*, at p. 3618.
[179] *Ibid.*, at pp. 3620-3621.
[180] *Ibid.*, at p. 3624.

situation and are in fact responsible for it.[181] Though the distinction between a 10b-5 fraud on the corporation and fraudulent mismanagement (giving rise to a cause of action under State law) has not yet been clearly drawn, it seems established that management can be charged with deceiving the corporation. The legal basis for such a theory is that the issuance by a corporation of its own shares is a "sale" to which the anti-fraud policy expressed in the federal securities laws extends.[182] A concrete example of fraud may be found in *Ruckle* v. *Roto American Corp.*: [183] some directors of Roto American had caused the corporation to issue shares without disclosing to the remaining directors material facts concerning the transaction or the financial condition of the corporation. The Court, after rejecting such clichés as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself, held that the corporation had been defrauded on the ground that:

> There can be no more effective way to emasculate the policies of the federal securities laws than to deny relief solely because a fraud was committed by a director rather than by an outsider. Denial of relief on this basis would surely undercut the congressional determination to prevent the public distribution of worthless securities.[184]

The case of *O'Neil* v. *Maytag* raises the further question whether it is sufficient for an action under Rule 10b-5 to allege a breach of one of the director's general fiduciary duties where such breach does not involve deception. The Court's answer was categoric:

> At least where the duty allegedly breached is only the general duty existing among corporate officers, directors and shareholders, no cause of action is stated under Rule 10b-5 unless there is an allegation of facts amounting to deception.[185]

In spite of this statement, the broad meaning imported by the courts [186] in the word "deception" as used in Rule 10b-5 should be

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[181] See *Shareholders' derivative suit to enforce a corporate right of action against directors under S.E.C. Rule 10b-5*, 114 U. Pa. L.R. 578; see also Fleischer, *Federal Corporation Law ...*, 78 Harv. L.R. 1146, at pp. 1161-1167.

[182] *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5, 1960), at pp. 200-203, cert. den. 365 U.S. 814 (1961); *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y., 1963).

[183] 339 F. 2d 24 (C.A. 2, 1964).

[184] *Ibid.*, at p. 29.

[185] 339 F. 2d 764 (C.A. 2, 1964), at p. 767.

[186] In *Cochran* v. *Channing Corp.*, *supra*, n. 167, deception took the form of non verbal acts: reducing dividends in order to drive down the price of the corporation's stocks. More recently, the *Texas Gulf* case held that the use of insider knowledge is a deceptive practice with the consequence that, if some directors, aware of a "material fact", withhold it from the rest of the Board, and cause the corporation to issue stock options to its directors, those directors having withheld the information may be found guilty of fraud on the corporation. See *Pappas* v. *Moss*, 393 F. 2d 865 (C.A. 3, 1968), at p. 870.

remembered as source of possible exposure to shareholders' derivative suit under Rule 10b-5.[187]

One final question remains to be answered: what are the remedies for violations of Section 10(b) and of Rule 10b-5? Apparently it was not the intent of Congress to provide civil liability under Section 10(b).[188] The federal courts, however, have read Section 10(b) and Rule 10b-5 as implying a civil right of action.[189] Such a practice received implicit approval from the Supreme Court in *P.I. Case Co.* v. *Borak* when it was held that the Federal Courts have a duty to "be alert to provide such remedies as are necessary to make effective the congressional purpose".[190] Thus, apart from the S.E.C., any victim of a director's deceptive practice may seek redress against him. But, in so doing, must the plaintiff prove the common law elements of fraud — *scienter, privity and reliance*[191] — to be allowed a civil recovery? This question was the subject of much writing and of much controversy among Federal Courts and, though the answer is by no means free from doubt, one of the latest cases in point, *Miller* v. *Steinbach*,[192] held that:

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187 Loss, at p. 1764, writes: "When a corporation has a cause of action under the Rule a stockholder may sue derivatively under the usual conditions"; *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385 (S.D.N.Y., 1967), at pp. 394-396; for a thorough study of the liability for corporate mismanagement and for negligent misconduct see: Comment, *Civil Liability under Section 10b and Rule 10b-5: A suggestion for Replacing the Doctrine of Privity*, (1965), 74 Yale L.J, 658, at pp. 680-690.

188 See, Ruder, *Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?*, (1963), 57 N.W. U.L.R. 627; Loss, III, (2e Ed., 1961), at pp. 1757-1797.

189 See Comment, *loc. cit.*, n. 187; Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, (1964), 59 N.W. U.L.R. 185; Ruder, *loc. cit.*, n. 188; Joseph, *Civil Liability under Rule 10b-5: A Reply*, (1964), 59 N.W. U.L.R. 171; *Kardon* v. *National Gypsum*, 73 F. Supp. 798 (E.D. Pa. 1947); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2, 1951); *Speed* v. *Transamerica Corp.*, 235 F. 2d 369 (C.A. 3, 1956); *Estate Counselling Service Inc.* v. *Merrill, Lynch, Pierce, Fenner and Smith Inc.*, 303 F. 2d 527 (C.A. 10, 1962); *Kohler* v. *Kohler Co.*, 208 F. Supp. 808 (E.D. Wis. 1962), aff'd 319 F. 2d 634 (C.A. 7, 1963).

190 377 U.S. 426 (1963), at p. 433, noted at *The Supreme Court: 1963 Term*, (1964), 78 Harv. L.R. 143, at p. 296.

191 For a more detailed account of the common law elements of fraud see 37 C.J.S. vo Fraud, para. 3.

192 268 F. Supp. 255 (S.D.N.Y., 1967), at p. 279.

Although plaintiff need not prove common law fraud to prevail in a 10b-5 action,[193] he must at least allege that the purchase or sale and the fraud complained of had some interrelationship.[194]

The old ingredients of fraud, i.e. privity [195] and knowledge that representations are false (*scienter*),[196] seem thus to have disappeared from civil actions brought under Rule 10b-5; only "some interrelationship" between the fraud and the sale or purchase need be proven.

The measure of damages to which a defrauded investor may be entitled is still unclear. Professor Loss suggests that defendants could presumably pay the injured parties the difference between the price at the time of the transaction and the price at the time of the judgment.[197] Usually though, the Courts tend to apply the tort or "out-of-pocket" measure.[198] The *Texas Gulf* case was expected

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[193] *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10, 1965), at p. 379; *Royal Air Properties Inc.* v. *Smith*, 312 F. 2d 210 (C.A. 9, 1962), at p. 212; *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9, 1961), at p. 274; *S.E.C.* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 277 (1966).

[194] *Royal Air Properties Inc.* v. *Smith*, *supra*, n. 193; *Barnett* v. *Anaconda*, 238 F. Supp. 766 (S.D.N.Y. 1965), (Court's Footnote).

[195] The privity requirement and its erosions is explored in depth in the Comment, *supra*, n. 187. In summary, it may be said that the courts evolved the requirement of a "semblance of privity", *Joseph* v. *Farnsworth Radio & Television Corp.*, 99 F. Supp. 701 (S.D.N.Y. 1951), at p. 706, aff'd. *per curiam* 198 F. 2d 883 (C.A. 2, 1952), to the holding that privity is only "an evidentiary fact to be considered in conjunction with other material facts in determining whether the relationship (such as it is) between the plaintiffs and the defendants and the nature of the particnlar acts and transactions involve the duty created by the statute", *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), at p. 230, quoted with approval in *Cochran* v. *Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y., 1962). The Texas Gulf case goes even further in holding that the Rule applies as well to transactions effected on national exchanges as well as to face-to-face transactions (*supra*, text accompanying n. 171).

[196] The *Scienter* element was required by Judge Wyatt in *Weber* v. *C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y., 1965), at p. 324, declining to follow *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9, 1961), (noted (1965), 20 Bus. Law 595, at p. 604,) which was cited with approval in *Stevens* v. *Vowell*, *supra*, n. 193; see further the decision of the Court of Appeals on the Texas Gnlf case at pp. 3620-3621, and *Miller* v. *Steinbach*, *supra*, n. 192. See also Posner, *Developments in Federal Securities Regulation*, (1966), 21 Bus. Law 703, at p. 713 and R. McDowell, 22 Bus. Law 76, at p. 83; Note *Proof of Scienter Necessary in a Private Suit Under S.E.C. Anti-fraud Rule*, (1965), 63 Mich. L.R. 1070.

[197] III, at p. 1793, (2e Ed. 1961).

[198] *E.g. Estate Counselling Service Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith*, *supra*, n. 189; *Kohler* v. *Kohler Co.*, 208 F. Supp. 808 (E.D. Wis., 1962), at pp. 825-826, aff'd. 319 F. 2d 634 (C.A. 7, 1963).

to shed some light on this troublesome question[199] but all it did was conclude that:

> In accordance with the agreement with the parties, the Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.[200]

A director may thus be held liable but, due to a "decided lack of clarity on the appropriate measure of damages",[201] he may be unable to measure the extent of his liability!

This analysis of the director's liabilities under the "Federal Corporation Law", seems to reveal one basic principle governing the director's conduct in securities transactions: "inside information" is an asset of the entire body of stockholders and of the corporation which directors, as fiduciaries, may not use to their own advantage.

B — Transactions Involving Corporate Control

Two basic types of transactions involving corporate control may result in liability for a director: the sale of control and the protection of control.

1 - *The Sale of Control*

As often happens, members of the board own substantial blocks of shares. These blocks are, in most instances, likely to carry "control" of the corporation. The question, thus, is whether a director may sell his controlling shares at the best price he can obtain. Numerous reasons may be given for paying a premium for control in excess of the share value.[202] The sale of "control" is generally coupled with an understanding that the control-seller will resign and cause a majority to resign *seriatim* from the board to facilitate or accelerate control by the buyer.[203]

As a stockholder the director is, by the weight of authorities, free to sell his shares at whatever price he can obtain whether or not the same price is offered to the other stockholders. As fiduciary, the control-selling director must ascertain that the purchaser does

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[199] See Kennedy & Wander, *Texas Gulf Sulphur: A Most Unusual Case*, (1965), 20 Bus. Law 1057, at pp. 1072-1073; Note, (1966), 79 Harv. L.R. 468, at p. 475.

[200] 258 F. Supp. 262, at p. 296.

[201] D.S. Henkel, *Codification-Civil Liability under the Federal Securities Laws*, in *Proceedings: Conference on Codification of Federal Securities Laws*, (1967), 22 Bus. Law 793, at pp. 868, 870.

[202] See Andrews, *Stockholder's Right to Equal Opportunity in the Sale of Shares*, (1965), 78 Harv. L.R. 505, at pp. 522-536.

[203] Baker & Cary, *op. cit.*, n. 25, at p. 590.

not intend to loot the corporation and may not accept any premium as compensation for his resignation as director. In *Ferraioli* v. *Cantor*,[204] decided on Feb. 15, 1968, Judge Bonsal wrote:

> [A] controlling shareholder may be free to bargain for and receive a premium in the sale of controlling stock so long as the sale does not result in injury to the corporation.[205]

Directors have been found liable for the sale of their controlling shares but the basis for liability is difficult to determine from the existing case law. Several theories have been advanced but none are entirely satisfactory since the legal nature of "control" has not yet been elucidated.

As indicated, liability has been imposed on directors when they knew or should have known that the purchaser intended to loot the company. The cases usually involve an outsider who buys a controlling block of shares in an investment company at a premium over the market value and who, then, causes *seriatim* resignations on the board to have his nominees appointed. Once control of the board has been secured, looting of the assets is effected.[206] In these cases the directors have been held liable to the corporation for the loss suffered by it as well as for any premium they may have received.

According to Berle & Means:

> [The power of control] is an asset which belongs only to the corporation; and... payment for that power, if it goes anywhere, must go into the corporate treasury.[207]

Sale of control for private profit would thus amount to a breach of the director's fiduciary duty to the corporation. Though this theory was the subject of much comment among legal writers,[208] it does not seem to have received the Courts' sympathy. In *Honigman*

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[204] 281 F. Supp. 354 (D.C.N.Y., 1967), at p. 357.

[205] In support of this view, the Court quotes *Essex Universal Corp.* v. *Yates*, 305 F. 2d 572 (C.A. 2, 1962), Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, (1965), 32 U. Chi. L.R. 420; Hill, *The Sale of Controlling Shares*, (1957), 70 Harv. L.R. 986.

[206] *E.g. Bosworth* v. *Allen*, 168 N.Y. 157, 61 N.E. 163 (1901); *Gerdes* v. *Reynolds*, 28 N.Y.S. 2d 622 (Sup. Ct. 1941); *Insuranshares Corp.* v. *Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa., 1940); see Andrews, *loc. cit.*, n. 202; Hill, *loc. cit.*, n. 205, at pp. 989-990; Jennings, *Trading in Corporate Control*, (1956), 44 Calif. L.R. 1, at pp. 8-9, 11-13; Leech, *Transactions in Corporate Control*, (1956), 104 U. Pa. L.R. 752, at pp. 812-814; Berle, *'Control' in Corporate Law*, (1958), 58 Colum. L.R. 1212.

[207] Berle & Means, *The Modern Corporation and Private Property*, (1932), at p. 244.

[208] *Supra*, n. 206.

v. *Green Giant Co.*,[209] the issuance of the premium stock under the plan of reclassification to the Class A shareholders was attacked on the theory that Class A shareholders were in effect surrendering their control of the Green Giant Corporation and that, as fiduciaries, they were not allowed to profit at the expense of the company and of the Class B shareholders. The Court of Appeals rejected the plaintiff's contention on the ground that Professor Berle's view rests on no authorities and is disputed among legal writers and that no Minnesota cases were urged in support of Berle's thesis.

A third theory, termed by one writer "theory of disguised premium for the Corporate product",[210] takes its roots in the much discussed case of *Perlman* v. *Feldmann*.[211] Feldmann was a dominant shareholder of Newport Steel Corp., a company producing steel sheets for sale to manufacturers of steel products. Due to the Korean war, a steel shortage was felt which prompted the formation of a manufacturers' syndicate to acquire control of steel suppliers and, *inter alia*, of Newport. Feldmann sold his block of shares to the Wilport Syndicate at a premium. Perlman, a minority shareholder of Newport, brought a derivative action against Feldmann to compel accounting for and restitution of the gains realized on the sale. Various attempts [212] have been made to decipher the *ratio decidendi* of the case which would appear to be summarized in the statement:

> ...Where a call on a corporation's product commands an unusually large premium, in one form or another... a fiduciary may not appropriate to himself the value of this premium.[213]

A fourth theory, the "corporate action" theory, involves a fact pattern which reveals that the purchaser's ulterior motive is not the acquisition of control as such but the acquisition of the company's assets. Accountability for the profits was found on the basis that the transaction had originated as a corporate opportunity to sell its assets and that the directors-sellers had profited from their position to effect a transaction constituting corporate action.[214] The real price was to be pooled, divided by the number of outstanding

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[209] 208 F. Supp. 754 (D.C. Minn., 1961), aff'd. 309 F. 2d 667 (C.A. 8, 1962), cert. den. 372 U.S. 941 (1963).

[210] Andrews, *loc. cit.*, n. 202, at p. 513.

[211] 219 F. 2d 173 (C.A. 2, 1955).

[212] See *supra*, n. 206.

[213] 219 F. 2d 173, at p. 178.

[214] Baker & Cary, *op. cit.*, n. 25, at p. 592; *Commonwealth Title Ins. & Trust Co.* v. *Seltzer*, 227 Pa. 410 (S.C. Pa., 1910); 76 A 77 *Roby* v. *Dunnett*, 88 F. 2d 68 (C.C.A. 10, 1937), cert. den. 301 U.S. 706 (1937); *American Trust Co.* v. *California Western States Life Ins.*, 15 Cal. 2d 42, 98 P. 2d 497 (S.C. Cal., 1940); comment, (1940), 29 Cal. L.R. 67.

shares and the defendants were to pay to the plaintiff the difference between this amount and the amount they received on liquidation of the acquired company.

Under the theory of the "sale of corporate office", courts have found that the premium received by the controlling directors was not only for control but for the use of their official position to cause the corporation to adopt a course of conduct favorable to the buyer. In the leading case of *Porter* v. *Healy*,[215] the opinion does not clearly reveal the basis for accountability; it seems to have been rested on the theory that the price for the sale of directorship and control of the corporation was a corporate asset to which all holders were entitled to share *pro rata*.[216]

In recent years those learned in the problems of the sale of control have advocated the adoption of a rule requiring management to transmit to stockholders any offer to purchase a substantial number of shares at more than the current market price.[217] In view of the developments of the Federal Corporation Law, it is believed that such a rule already exists as a result of the Courts' interpretation of Section 10(b) and of Rule 10b-5. In *Ferraioli* v. *Cantor*,[218] directors were approached to sell their controlling shares at a premium. They, in turn, "tipped" some of their friends who, also, were able to sell at a premium. Such a behaviour was termed "fraudulent" under Section 10(b) and Rule 10b-5 as taking unfair advantage of the other stockholders.

It may thus be deduced that, beyond the various attempts made to impose liability for the sale of controlling shares, the omnipresent and omnipotent Rule 10b-5 has generated a duty for directors to offer an equal opportunity to other holders of the same class when asked to sell their controlling shares at a premium.

2 — *The Protection of Control*

The protection of control is an area of liability which does not involve the director *qua* controlling shareholder but *qua* corporate manager. The question is whether management, faced with an outside threat, may or should use corporate funds to repurchase the corporation's own shares in order to protect the incumbent management's control. Recent Delaware cases illustrate this problem.

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[215] 244 Pa. 427; 91 A. 428 (S.C. Pa., 1914).

[216] Baker & Cary, *op. cit.*, n. 25, at p. 595; *McLure* v. *Law*, 161 N.Y. 78, 55 N.E. 388 (C.A.N.Y., 1899); *Ballantine* v. *Ferretti*, 28 N.Y.S. 2d 668 (S.C.N.Y., 1940), at pp. 678-680.

[217] Hill, *loc. cit.*, n. 205, at p. 1038; Andrews, *loc. cit.*, n. 202, at p. 515.

[218] 281 F. Supp. 354 (D.C.N.Y., Feb. 15, 1968).

In *Kors* v. *Carey*,[219] the directors of Lehn & Fink noticed an unusual buying activity in the company's stock. It was discovered that United Whelan, one of their customers, was buying up Lehn & Fink's stock, potentially bidding for control. Lehn & Fink studied the situation, called members of the Harvard Business School for advice, and resolved to buy out United Whelan with corporate funds. In the Court's opinion, Whelan's bid for control was a "clear threat" to the company's business and thus no charge of misconduct or abuse of discretion against Lehn & Fink's directors could be sustained.[220]

In *Bennett* v. *Propp*,[221] the board chairman of Noma Lites Inc. was advised by the board chairman of Textron that he intended to make an offer to purchase more than 50% of Noma Lites stock at $10.00 a share. Noma Lites' chairman who, with some directors, owned some 20% of Noma Lites stock, caused the company to buy for $2,000,000 of its own stock driving the price up to $13.00 from $9.00. An emergency directors' meeting was called on a Saturday to allow the chairman to obtain ratification for his acts. Most of the directors, though they were not aware of what had happened, ratified the chairman's action and a loan was secured at 1/30 of 1% a day to be able to pay for the stock on the following Monday. The Court, distinguishing the *Kors* case, held that corporate funds could not be used when no actual threat to corporate policy had occurred, to perpetuate control. The Court, however, absolved all the uninitiated directors who had ratified the action since, the court held, had they refused to ratify it the corporation would have been unable to meet its commitment and would probably have faced a costly litigation.

In *Cheff* v. *Mathes*,[222] the board of Holland Furnace Co. was threatened by A. Maremont, a well-known corporate "raider". Holland's directors had certain views regarding the sales methods of furnaces. After a careful investigation of Maremont's past, the directors concluded that his methods would be detrimental to Holland. As a result, the board decided to use Holland's funds to purchase Maremont's holdings at $14.40 a share, i.e. $3.40 above the current market price.[223] Approving *Kors* v. *Carey*, the Court held that:

> Similarly, if the actions of the Board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain

[219] 158 A. 2d 136 (Ch. Del., 1960), noted in (1960), 70 Yale L.J. 308.

[220] See Adkins & Janis, *loc. cit.*, n. 36, at p. 825; Harold Marsh, *Are Directors Trustees?*, (1966), 22 Bus. Law 35, at p. 60.

[221] 187 A. 2d 405 (Del., 1962).

[222] 199 A. 2d 548 (S.C. Del., 1964), noted in (1965), 78 Harv. L.R. 1253.

[223] Under Delaware law, 8 Del. C. para. 160, a corporation is granted statutory power to purchase and sell shares of its own stock.

what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course.[224]

The Court also held that the board was not required to prove that Maremont's take-over bid would be successful and subsequently detrimental to the company but only that they had reasonable grounds to reach such a conclusion. The Court further held that the $3.40 paid over the market price was not unreasonable since it represented a premium for control. In summary, the directors properly exercised their business judgment hence barring any judicial interference.

According to these cases, directors may use the corporate funds to purchase stock if the purchase aims at the removal of a "clear threat" to the corporate policy [225] and when they act primarily in the company's interest but, corporate funds may not be used to perpetuate control.[226]

In view of the foregoing analysis, it is the writer's belief that the "power to control" is a power held in trust by the directors for the benefit of the corporation and of the body of shareholders.

C — Conduct of Subsidiaries

Directors of parent corporations have a duty to be fair in their dealings with their subsidiaries insofar as they affect the rights of minority shareholders and of creditors. To answer the question of what is "fair", the Courts have used three main tests: the "model contractual transaction", the "model corporate structure" and the "business judgment".[227]

The test of the "model contractual transaction" has been frequently used. In *Pepper* v. *Litton*, Justice Douglas laid down the rule as:

> ...Whether or not under all circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.[228]

This test ignores the reality: how can an arm's length bargain take place since the same group controls both corporations?

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[224] *Supra*, n. 219, at p. 554.

[225] The fight must, of course, be over policy and not over personality.

[226] Adkins & Janis, *loc. cit.*, n. 36, at p. 826; *Bennett* v. *Propp.*, *supra*, n. 221.

[227] *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, (1964), 74 Yale L.J. 338; *Case* v. *New York Central Railroad*, 243 N.Y.S. 2d 620 (1963), rev'g. 232 N.Y.S. 2d 702 (1962); *Ewen* v. *Peoria & E. Ry.*, 78 F. Supp. 312 (S.D.N.Y. 1948, Learned Hand J.).

[228] 308 U.S. 295 (1939), at p. 306-307.

In other cases, courts have asked whether or not there was fraud involved in the transaction.[229] As actual fraud is extremely hard to prove in the context of parent-subsidiary relationships, courts have tended to use this rule to uphold challenged transactions.

In a third line of cases the emphasized notion is that of "good faith". This test has been particularly used when the courts disapproved of the defendant's objectives, e.g. elimination of minority shareholders.[230]

The inadequacies of the "model contractual transaction" test are revealed by the shifting of the onus of proving the fairness of the transaction on the defendants,[231] thus allowing the courts to escape a sometime difficult justification of their findings.

A second test proposed was that of the "model corporate structure". According to this test, directors are supposed to be independent managers and shareholders presumed to be capable of exercising effective supervision. With this prerequisite, courts have developed a set of technical rules to test the fairness of the transaction: has there been approval by a majority of disinterested directors? Had the meeting a disinterested quorum? Did the shareholders ratify the transaction?[232] The illogism of such an approach lies in the fact that one group controls both boards and is a majority shareholder of both companies.

According to a third criterion directors would be exonerated from liability if the court is satisfied that they have exercised their honest business judgment.[233] The recent Delaware case of *Epstein* v. *Celotex*[234] illustrates this rule. The Jim Walter Corp. which, through its wholly-owned subsidiary Celotex and through others, owned 56% of the South Shore Corporation's stock, made a written offer to the public holders of such stock to purchase their holdings at $35.00 a share. Jim Walter, Celotex and South Shore had some five common directors. Plaintiff alleged that the Jim Walter offer was made for

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229 Note, *loc. cit.*, n. 227, at p. 341; *Shelly* v. *Dockweiler*, 75 F. Supp. 11 (S.D. Cal., 1947), at p. 14; *Briggs* v. *Scripps* 56 P. 2d 277 (1936), at p. 278

230 *Chelrob Inc.* v. *Barrett*, 57 N.E. 2d 825 (1944), at p. 833; *Everett* v. *Phillips*, 43 N.E. 2d 18 (1942); *Austrian* v. *Williams*, 103 F. Supp. 64 (S.D.N.Y., 1952), at p. 75. It is also to be noted that practices such as "freeze-outs" of minority interests appear to be much less frequent nowadays than in the 1920's; see Berle, *The Corporation in Modern Society*, at p. 13, (Mason Ed., 1959).

231 See note, *loc. cit.*, n. 227, at p. 343.

232 *Twin-Lick Oil Co.* v. *Marbury*, 91 U.S. 587 (1876); *Parsons* v. *Tacoma Smelting & Refining Co.*, 65 P. 765 (1901); *Gamble* v. *Queens County Water Co.*, 123 N.Y. 91, 25 N.E. 201 (1890); see note, *loc. cit.*, n. 227, at p. 345, no. 37.

233 *Everett* v. *Phillips*, *supra*, n. 230.

234 238 A. 2d 843 (S. Ct. Del., Feb. 15, 1968).

the express purpose of enabling such corporation to acquire at least 90% of the outstanding capital stock of South Shore at the inadequate price of $35 per share and thereafter merging South Shore into Jim Walter under the short form merger provisions of Delaware Law. Sometime prior to the Jim Walter offer, one Crutcher had made an offer to buy the net assets of South Shore, then worth 31.5 million dollars, amounting to $50 a share in stock value. Jim Walter announced that it would vote against the offer before South Shore's Board considered the offer. The Court held that, as a rule:

> ...In a situation such as the one here presented, Jim Walter as a majority stockholder of South Shore and in a position to block any proposed sale of such corporation's assets, owed a higher duty to the public stockholders of such corporation.[235]

The evidence disclosed that Crutcher's proposal, were it carried through, would effectively result in the liquidation of South Shore. Jim Walter's board was of the opinion "that it is in the best interest of stockholders of South Shore to continue operation of that company and not to sell its assets and liquidate and dissolve South Shore" [236] and consequently decided to block the sale. The Court found that, in so doing, the directors had honestly exercised their business judgment and held further that plaintiff had not been able to prove the unfairness of the transaction.

As conclusion, it may be said that, as a parent stands in a fiduciary relationship to its affiliate's minority shareholders,[237] directors stand also in a fiduciary relationship to such shareholders which relationship obligates them to deal "fairly" with the subsidiary. In most instances, this duty will be fulfilled if the directors exercise their honest business judgment. From a practical point of view, directors should avoid that the affairs of the subsidiary become so interwoven with those of parent that the idea of each as a separate entity becomes a mere legal fiction.[238]

D — Antitrust Violations

Directors are subject to a wide range of legal proceedings for violations of the antitrust laws: criminal prosecutions, civil suits

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[235] *Ibid.*, at p. 847.

[236] Resolution of the Board of Jim Walter Corp., adopted on Feb. 28, 1967.

[237] *Case* v. *N.Y. Central Railroad*, *supra*, n. 229, at p. 623.

[238] *Weinert* v. *Kinkel*, 56 N.Y.S. 2d 92; see also Douglas and Shanks, *Insulation from Liability through Subsidiary Corporations*, (1929), 39 Yale L.J. 193; Latten, *Corporations*, (1959), at pp. 66-82, 90-97; Ballantine, *op. cit.*, n. 28, at pp. 283-333; Latty, *Subsidiaries and Affiliated Corporations*, (1936). The procedural aspect of double derivative suits has been considered *supra*, nn. 30-34, and Baker, & Cary, *op. cit.*, n. 25, at p. 673.

by the United States for injunction or for single damages, civil suits by businessmen for injunction and for treble damages and finally, derivative suits by shareholders for damages allegedly caused to the corporation by reason of the directors' violation of the antitrust laws. Bearing in mind the ulterior purpose of this study i.e., the insurability of corporate managers, it will not be attempted to examine the criminal and injunctive remedies but analysis will be focussed on the monetary consequences of antitrust violations.

1 — *The Legislative Background*[239]

Section 1 of the *Sherman Act*[240] makes any restraint of trade a misdemeanour punishable by fine not exceeding $50,000 and/or imprisonment not exceeding one year. Section 2 of the *Act* provides for the same penalties for monopolies.

Section 2 of the *Clayton Act*,[241] as amended by the *Robinson-Patman Act*,[242] renders price discrimination unlawful between purchasers of goods of like grade and quality where substantial restraints may result with the exception of cost-justified differences. Section 3 of that *Act* outlaws the sale or lease of goods on condition that the purchaser or lessee shall not deal in the goods of a competitor (this section embraces, *inter alia*, "tie-in sales" and "requirement contracts"). Section 4, the basis for private treble damage suits, provides that:

> Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor... and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee.

Section 5(a) provides that any final judgment or decree rendered in a suit on behalf of the United States may be used as *prima facie* evidence of a violation of the antitrust laws in a private suit.

Section 8 of the *Clayton Act* prohibits interlocking directorates and finally, section 14 provides that the corporation's violation of the antitrust laws shall be deemed to be also that of the individual directors who have committed, authorized or ordered any of the acts violating the antitrust laws. Apart from these statutes, reference should also be made to the *Wilson Tariff Act*, to the *Robinson-Patman Act* and the *Federal Trade Commission Act* dealing respectively with combinations to restrain trade or increase prices of

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[239] A good analysis of these provisions may be found in Van Cise, *Understanding the Antitrust Laws*, (Rev. Ed., 1966), at pp. 14-65.

[240] 15 U.S.C., Sects. 1-8.

[241] 15 U.S.C., Sects. 12-27.

[242] 15 U.S.C., Sects. 13, 13a, 13b, 21a.

goods imported into the United States, with the participation in any prohibited practice and with the FTC's power to prevent any unfair competition.[243]

From this cursory analysis of the legislative background, it may be deduced that the underlying philosophy of these enactments is the prohibition of anything that may hamper free competition. As will be seen, the practical application of this philosophy leads to results greatly at variance with those reached by courts interpreting Canadian antitrust laws.[244]

2 — *Single damage suits by the United States*

Although the government may sue directors for actual damages suffered to its business or property for violations of the antitrust laws, it seems that the government will not name directors as defendants unless it appears that the company may be unable to satisfy the judgment.[245]

3 — *Treble damage suits against directors*

Treble damage liability of directors derives from Section 4 of the *Clayton Act* which gives a right of action to *any* person injured in his business or property as a result of antitrust violations. Several problems arise under this section: what are the legal theories imposing liability on the director, what are the elements of a private treble damage suit and finally, what is the effect of Section 5(a) of the *Clayton Act?*

The first theory, and by far the most used, imposing liability on the directors is based on the so-called "rule of agency". If directors acting for the corporation within the scope of their employment violate the antitrust laws, they are liable on the ground that, as agents, they are liable for the torts in which they participated, as was held in the leading cases of *Kentucky-Tennessee Light & Power Co.* v. *Nashville Coal, Justin Potter and Henry Fitch*[246] and *Cott Beverages Corp.* v. *Canada Dry Ginger Ale Inc. et al.*[247]

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[243] Apart from this enumeration of the basic relevent statutes, one may find a very helpful table of statutes having antitrust implications in the Annex to R.N. Rooks, *Personal Liabilities of Officers and Directors for Antitrust Violations and Securities Transactions,* (1963), 18 Bus. Law 579, at pp. 607-611.

[244] See Gosser, *The Law on Competition in Canada,* (1962), at pp. 215-225.

[245] V. Kramer, *Liability of Corporate Officers and Directors under the Antitrust Laws,* (1962), 17 Bus. Law 897, at p. 898-899; R.N. Rooks, *loc. cit.,* n. 243, at p. 591.

[246] 37 F. Supp. 728 (W.D. Ky., 1941), aff'd. 136 F. 2d 12 (C.A. 6, 1943).

[247] 146 F. Supp. 300 (D. Ct. S.D.N.Y., 1956).

The second theory asserts the director's liability upon his corporation's civil liability thus combining sections 14 and 4 of the *Clayton Act.*

Under both theories the private treble damage action is considered to be an action in tort. In such suits the lack of specific intent is no defence: "Liability is phrased instead in terms of unlawful consequences" said the Supreme Court in *U.S.* v. *Griffith.*[248] Good faith has consequently been held not to constitute a defence.[249] Even if they do not promote or order activities violating the antitrust laws, directors can be charged with the acquiescence and ratification of the illegal activities.[250] In order to escape liability the director must repudiate the activity once he learns of it.[251]

In private treble damage suits, standing to sue has traditionally been limited to those plaintiffs most directly injured by a violation.[252] Courts have thus developed the "target area" doctrine limiting recovery only to those firms competing in the sector of the economy in which the violation immediately restrained competition.[253] To substantiate his contentions, plaintiff must then prove a public injury — the director's prohibited conduct — causing him a private injury: the sustention of damage. Economic harm being intangible, the measure of damage may be quite hard to determine.[254] Proof of the public injury is facilitated by Section 5(a) of the *Clayton Act* which provides that any final judgment or decree obtained on behalf of the United States shall serve as *prima facie* evidence of an antitrust violation in private suits.[255] It is, however, to be noted that a plea of *nolo contendere* does not fall within the ambit of Section 5(a).[256] One writer raises the question whether it is possible to advance a judgment of not guilty as a defence in a private suit. He

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248 334 U.S. 100 (1948), at p. 105.

249 *U.S.* v. *U.S. Gypsum Co.*, 340 U.S. 76 (1950), at p. 87.

250 *Phelps Dodge Ref. Corp.* v. *F.T.C.*, 139 F. 2d 393 (C.A. 2, 1943), at p. 397.

251 See Kramer, *loc. cit.*, n. 245, at p. 902, Manning, *The Antitrust Laws and the Corporate Executive's Civil Damage Liability*, (1965), 18 Vand. L.R. 1938.

252 Note, *Private Treble Damage Antitrust Suits: Measure of Damage for Destruction of All or Part of a Business*, (1967), 80 Harv. L.R. 1566, at p. 1571.

253 E. Timberlake, *Federal Treble Damage Antitrust Actions*, para. 4.03; *Waldron* v. *British Petroleum Co.*, 231 F. Supp. 72 (S.D.N.Y., 1964), at p. 85; Note, *Standing to Sue for Treble Damages under section 4 of the Clayton Act*, (1964), 64 Colum. L.R. 570.

254 Note, *loc. cit.*, n. 252, at pp. 1574-1586.

255 See *Proper* v. *John Bene & Sons*, 295 F. 729 (E.D.N.Y., 1923), at pp. 731.732.

256 See *e.g. Bausch Machine Tool* v. *Aluminum Co. of the American*, 79 F. 2d 217 (C.A. 2, 1935), at p. 226.

answers the question by the negative on the ground that the standard of proof in criminal actions is stricter than in civil proceedings.[257]

In view of the foregoing it may be concluded that, whatever theory the Court elects to follow, a director acting in his representative capacity is exposed to treble damage suits instigated by anyone directly injured by a violation of the antitrust laws. As indicated, the extent of such liability may be somewhat difficult to ascertain. Courts have used two main methods of proving the lost profits: the "before and after" method involving a comparison of the records of profit earned by plaintiff prior to the impact of the violation with those subsequent to it[258] and the "yardstick" test involving a study of the profits of companies closely comparable to plaintiff's.[259] Proof of the damages might be quite difficult in case of plaintiff alleging that defendant's conduct prevented him from entering in the market.[260] When plaintiff has been completely driven out of business, Courts have measured the damages by taking into account the probable duration of future profits mitigated by profits subsequently earned by plaintiff and the loss in market value caused by the violation. When the violation caused only a partial destruction of plaintiff's business, Courts tend to analyze the profits lost on the part injured or restrained in relation to the total performance of the business.[261] It should be noted that plaintiff seems to have some kind of a duty to minimize his damage either by buying substitute goods or defendant's goods at increased cost. In *Sun Cosmetic Shoppe Inc.* v. *Elizabeth Arden Sales Corp.*,[262] the cosmetic shop sued the manufacturer for refusal to supply him a free demonstrator of cosmetics as it had done for other shops. Judge Learned Hand

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[257] See Manning, *loc. cit.*, n. 251, at pp. 1945 et s.

[258] See note, *loc. cit.*, n. 252, at p. 1574, citing *Bigelow* v. *RKO Radio Pictures Inc.*, 327 U.S. 251 (1946); *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U.S. 359 (1927); *Central Coal & Coke Co.* v. *Hartman*, 111 F. 96 (C.A. 8, 1901).

[259] *William Goldman Theatres Inc.* v. *Loew's Inc.*, 69 F. Supp. 103 (Ed. Pa., 1946), at p. 104, aff'd. per curiam 164 F. 2d 1021 (C.A. 3), cert. den. 334 U.S. 811 (1948); *Richfield Oil Corp.* v. *Karseal Corp.*, 271 F. 2d 709 (C.A. 9, 1959), cert. den. 361 U.S. 961 (1960): *Union Carbide & Carbon Corp.* v. *Nisely*, 300 F. 2d 561 (C.A. 10, 1961).

[260] *Volasco Products Co.* v. *Lloyd A. Fry Roofing Co.*, 308 F. 2d 383 (C.A. 6, 1962), cert. den. 372 U.S. 907 (1963); *Waldron* v. *British Petroleum*, 231 F. Supp. 72 (S.D.N.Y., 1964).

[261] See note, *loc. cit.*, n. 252, at pp. 1577-1585; *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, *supra*, n. 258; *Wolfe* v. *National Lead Co.*, 225 F. 2d 427 (C.A. 9), cert. den. 350 U.S. 915 (1955); *Kiefer-Stewart Co.* v. *Joseph E. Seagram & Sons, Inc.*, 182 F. 2d 228 (C.A. 7, 1950), rev'd. 340 U.S. 211 (1951).

[262] 178 F. 2d 150 (C.A. 2, 1950).

held that if the loss caused to plaintiff by the diversion of customers to shops with demonstrators was greater than the cost of employing one, it would be plaintiff's duty to minimize damages by seeking one. Due to the enforcement purpose of the private treble damage suit, it is now generally agreed that a defence that the loss has been passed on will not be allowed.[263]

Though the mandatory trebling provisions were primarily enacted to encourage private prosecution by offering the prospect of a high reward to offset the difficulty of proof, statistics show that they failed to achieve this end.[264] As defence of an antitrust suit is very expensive, win or lose, the threat of these costs added to that of a prodigious treble damage judgment caused the settlement of numerous claims (even rather dubious ones) in favour of the plaintiff.

4 — *Derivative suits against directors*[265]

Directors owe a duty to use reasonable care in the management of the company. This familiar principle has been extended to cases in which the directors cause the corporation to suffer injury as a result of any violation of the antitrust laws. In such cases the directors are liable for the amount of damages sustained by the corporation.[266] The questions thus, are: what must a plaintiff prove and what damages can he recover on behalf of the corporation?

a — Elements of the derivative antitrust suit

Plaintiff must prove three basic elements: (a) a violation of the antitrust laws,[267] (b) knowingly committed by the director,[268] and (c) causing injury to the corporation. For (a) one need only note

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[263] See *Atlantic City Electric Co.* v. *General Electric Co.*, 226 F. Supp. 59 (S.D.N.Y., 1964), reviewing the state of the law. See also the opinion of Mr. Justice Holmes in *Southern Pacific Co.* v. *Darnell-Taenzer Lumber Co.*, 245 U.S. 531 (1918).

[264] See note, *loc. cit.*, n. 252, at p. 1568.

[265] See generally a very good review of the antitrust problem in R.A. Whiting, *Antitrust and the Corporate Executive*, (1961), 46 Va. L.R. n. 6 and (1962), 47 Va. L.R. n. 1; Blake, *The Shareholders' Role in Antitrust Enforcement*, (1961), 110 U. Pa. L.R. 143; Comment, *Stockholders' Remedies for Corporate Injury Resulting from Antitrust Violations: Derivative Antitrust Suit and Fiduciary Duty Action*, (1961), 59 Mich. L.R. 904; *Stockholders' action—Antitrust Laws*, 36 A.L.R. 2d 1345.

[266] See *Ramsburg* v. *American Investment Co.*, 231 F. 2d 333 (C.A. 7, 1956), at p. 339.

[267] *Diamond* v. *Davis*, 263 App. Div. 68, 31 N.Y.S. 2d 582 (1st Dept., 1941).

[268] *Simon* v. *Socony—Vacuum Oil Co.*, 38 N.Y.S. 2d 270 (Sup. Ct., 1942), at p. 274.

that, since derivative antitrusts suits are suits brought under state law and not under the antitrust laws,[269] Section 5(a) of the *Clayton Act* is of no assistance to plaintiff.[270] Element (b) leaves the door open to a variety of common law defences: mistake of law when the statute is ambiguous;[271] reliance upon subordinates when directors have no reason to suspect their conduct to be a violation of antitrust laws, as expressed by the Supreme Court of Delaware:

> ...There is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.[272]

For element (c) plaintiff must also adduce proof of an independent nature establishing the injury.[273]

b — The measure of damages

Should the damages awarded be single or treble? It seems now well established that only single damages can be recovered. There are two major arguments militating in favour of this. On one hand, stock ownership is not "business or property"[274] hence no treble damages can be awarded to a shareholder who suffered a loss of value in his stock.[275] On the other hand, recovery of treble damages is limited to those persons who have been injured by a break-down in the competitive system. The injury to the corporation does not arise from a "lessening of competition" when the director's illegal conduct results in injury to the corporation.[276] Recoverable damages are thus single damages amounting to the fines, damages and litigation expenses sustained by the corporation on account of the director.[277]

In 1955, the Report of the Attorney-General's Committee on Antitrust noted that:

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[269] *Meyer* v. *Kansas City So. Ry.*, 84 F. 2d 411 (C.A. 2), cert. den. 299 U.S. 607 (1936), Manning, *loc. cit.*, n. 251, at p. 1951.

[270] *Volk* v. *Paramount Pictures*, 91 F. Supp. 902 (D. Minn., 1950), at p. 904.

[271] *E.g.*, *Gilbert* v. *Burnside*, 216 N.Y.S. 2d 430 (2d Dept., 1961), at p. 432.

[272] *E.g.*, *Graham* v. *Allis-Chalmers*, 182 A. 2d 328, aff'd. 188 A. 2d 125, (Del., 1963), at p. 130.

[273] *Borden* v. *Cohen*, 231 N.Y.S. 2d 902, at p. 903.

[274] *Bookbout* v. *Schine Chain Theatres Inc.*, 253 F. 2d 293 (C.A. 2, 1958); *Peter* v. *Western Newspaper Union*, 200 F. 2d 867, (C.A. 5, 1953), at p. 872.

[275] *Loeb* v. *Eastman Kodak*, 183 F. 704 (C.A. 3, 1910); *Harrison* v. *Paramount Pictures Inc.*, 155 F. Supp. 312 (E.D. Pa., 1953).

[276] *Conference of Studio Unions* v. *Loew's Inc.*, 193 F. 2d 51, (C.A. 9, 1952), at pp. 54-55.

[277] *Clayton* v. *Farish*, 73 N.Y.S. 2d 727, at pp. 744-745.

[278] At p. 349.

...It may be difficult for today's businessman to tell in advance whether projected actions will run afoul of the Sherman Act's criminal strictures.[278]

In view of our study, the same conclusion may well be inferred from the civil damage provisions of the antitrust laws. Antitrust litigation is extremely complex. Directors face the possibility of substantial fines (up to $50,000), jail terms, single or treble damages and, on top of that, counsel fees somewhere between the distressing and the appalling. With the fine distinction existing between the pursuit of justified corporate purposes and illegal behaviour, the plight of directors is far from being enviable.

E — Tax and other special situations

1 — *Tax decisions*

Section 531 of the International Revenu Code provides that corporations improperly accumulating surplus will be subject to a heavy penalty tax. Surplus beyond the "reasonable needs of business" (S. 537 I.R.C.) is often accumulated to relieve shareholders from the dividends surtax. Pursuant to the imposition of such a penalty tax, derivative suits have been instituted against directors. These suits usually allege either that the directors were negligent in not distributing the earnings since they knew or should have known that such an accumulation would cause the imposition of a penalty tax on the corporation or that they used the corporation to avoid income tax on themselves and on shareholders who were in high tax brackets.[279] The latter situation occurs when one group of shareholders is more interested in the possibility of selling out at capital gains rates, the other group being more interested in income. One known action was brought against directors but was settled after a referee had filed a report in favour of the shareholder's claim.[280]

2 — *Corporate qualifications*

Failure to qualify to do business in a particular state may prevent the company from enforcing contracts in the courts of that state. Some states impose criminal sanctions on those performing local

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[279] Baker & Cary, *op. cit.*, n. 25, at p. 431; Griswold, *Cases on Federal Taxation*, (6th Ed., 1966), at p. 951.

[280] *Mahler* v. *Oishei*, No. A. 79,948, (Sup. Ct., Erie Co., N.Y.), discussed in (1948), 61 Harv. L.R. 1058; *Derivative Actions Arising from Payment of Penalty Taxes under Section 102*, (1949), 49 Colum. L.R. 394; Cary, *Accumulations Beyond the Reasonable Needs of the Business: the Dilemma of Section 102 (c)*, (1947), 60 Harv. L.R. 1282, at p. 1292.

corporate acts for a non-domesticated corporation; some others only impose civil liability.[281]

Failure to comply with statutory requirement may also entail personal liability for directors.[282] In one Massachusetts case, stock was issued to directors. One paid in cash, another did not pay at all, and the third supplied equipment to the corporation. The state statute provided that directors may be held jointly and severally liable for the corporation's debts if its stock is not fully paid. Since the company's charter did not mention the issuance of stock for property, the directors were held personally liable for the corporation's debts.[283]

3 — *Corporate undertakings*

When a resolution is adopted by the board, the failure to fulfill the obligations assumed renders directors liable. In *Emmert* v. *Drake*,[283a] loans were made to the corporation on the express condition that they should be repaid with the proceeds of a public sale of stock. The board authorized the loans but the proceeds were used for some other purpose and the company became insolvent. Creditors sued directors who were held personally liable.

Conclusion

From our analysis of the areas of business activity warranting special attention on the director's part, one fundamental idea seems to emerge. With the ever growing divorce of ownership from control, a mounting emphasis is being placed on the fiduciary character of the director's position. Be it in securities transactions or in any other of the areas studied, the standard of conduct to which directors are and will increasingly be held, can hardly be better expressed than through the words of Chief Judge Cardozo (as he then was) in *Meinhard* v. *Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sentitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided

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[281] Fletcher, *op. cit.*, vol. 17, para. 8525; Note, *Failure to Domesticate*, (1961), 100 U. Pa. L.R. 241, at p. 263.

[282] *Sheffield* v. *Nobles*, 378 S.W. 2d 391 (C.C.A., Texas, 1964); Adkins & Janis, *loc. cit.*, n. 36, at p. 824.

[283] *Bay State York Co.* v. *Cobb*, 195 N.E. 2d 328 (Mass., 1964); see also *Sharf* v. *Harstad*, 377 P. 2d 299 (C.A. 5, 1955).

[283a] 224 F. 2d 299 (C.A. 5, 1955).

loyalty by the "disintegrated erosion" of particular exceptions.[284] Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[285]

IV — THE PROTECTION OF DIRECTORS

A somewhat frightening footnote of the Court appears in the report of the *Texas Gulf* case:

> At least 49 private actions are now pending in this court against TGS, defendants named in the Commission's actions, and others, arising out of the transactions which are the subject matter of the Commission's action. Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action. At least 475 persons are included as plaintiffs. While many of the complaints do not specify the damages claimed, others, in the aggregate, claim compensatory damages in excess of $2,8000,000 and punitive damages in excess of $77,000,000.[286]

Further illustrations of the necessity of protecting directors seem superfluous. Two methods can be used to achieve protection: indemnification and insurance.[287] Both methods have to be examined in the light of the distinction between derivative actions and third party suits. In the former, the shareholder sues the director for a wrong done to the corporation; in the latter, the director is sued for acts done in his representative capacity causing tort to third parties.[288]

A — Indemnification

At the outset it should be pointed out that a director may not be indemnified if the acted outside the scope of his employment. An insider found guilty under Section 10(b) for transactions on his own account could certainly not claim his litigation expenses from

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[284] *Wendt* v. *Fisher*, 243 N.Y. 439, at p. 444; 159 N.E. 303, (Court's footnote).

[285] 249 N.Y. 458, at p. 464; 164 N.E. 545, at p. 546, (New York Court of Appeals, Dec. 1928).

[286] 258 F. Supp. 262, no. 1, at p. 267.

[287] See generally Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, (1963), 76 Harv. L.R. 1403, (hereinafter "The 1963 Note"); Washington & Bishop, *Indemnifying the Corporate Executive*, (1963); J.W. Bishop, *Indemnification of Corporate Directors, Officers and Employees*, (1965), 20 Bus. Law 833, (hereinafter, Bishop I); J.W. Bishop, *New Cure for an Old Ailment: Insurance against Directors' and Officers' Liability*, (1966), 22 Bus. Law 92, (hereinafter Bishop II); Anderson, *Directors and Officers Liability Insurance*, (1965), 47 Chi. B. Record 31; Note, *Liability Insurance for Corporate Executives*, (1967), 80 Harv. L.R. 648, (hereinafter, "The 1967 Note"); J.W. Bishop. *Current Status of Corporate Directors' Right to Indemnification*, (1956), 69 Harv. L.R. 1057.

[288] Bishop I, *loc. cit.*, n. 287, at p. 834.

the corporation. There are, however, some borderline cases such as litigation arising under Section 16(b) since one could possibly argue that the director would not have been subject to Section 16(b) had he not been a director, the litigation arising, therefore, out of his status as director. This particular problem does not seem to have been resolved by the courts.[289]

1 — *Derivative actions*

In 1939 the decision of the New York Supreme Court in *New York Dock Company* v. *McCollom*[290] gave impetus to the whole field of indemnification. After being completely successful on the merits in a derivative suit, directors sought to recover their expenses from the company. Judge Crouch ruled that the company, being unable to derive any benefit from the indemnification, could not indemnify the directors. The result of the decision was a proliferation first of by-laws and then of amendments to the various State Corporation Laws. Most statutes are rather closely copied from Section 122(10) of the Delaware Corporation Law.[291] This type of statute grants wide powers to the corporation to indemnify its directors except in relation to liability for negligence or misconduct in the performance of their duty to the corporation.[292]

Though the statutes clearly prohibit any indemnification of directors found builty of breach of their duty to the corporation, adjudication of breach of duty is not always possible. Lack of jurisdiction, prescription, procedural defects, settlements, are some of the events preventing a court from reaching a decision on the merits. Who should then assume the burden of litigation expenses? In *Essential Enterprises Corp.* v. *Dorsey Corp.*,[293] a stockholder's suit was compromised with court approval. The Court held that no indemnification could be allowed because the compromise was a tacit admission of breach of duty to the corporation. The Court admitted, however, that such indemnification might be permissible under the Delaware statute. This case, as well as a few others,[294] illustrates the judicial reluctance to permit indemnification when a finding of negligence appears from the circumstances. Two eminent writers in

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[289] Bishop I, *loc. cit.*, n. 287, at p. 835; 1963 Note, *loc. cit.*, n. 287, at p. 1410.
[290] 16 N.Y.S. 2d 844.
[291] Bishop II, *loc. cit.*, n. 287, at p. 97.
[292] The same provision is also found in S. 722 (a), of the N.Y. Bus. Corp. Law.
[293] 182 A. 2d 647 (Del. Ch., 1962).
[294] See *Teren* v. *Howard*, 322 F. 2d 949 (C.A. 9); *S.E.C.* v. *Continental Growth Fund*, CCH Fed. Sec. L.R. para. 91, 437 p. 94,719 (S.D.N.Y., 1964).

the field of indemnification, Judge Washington and Professor J.W. Bishop, give a sensible answer to the above question.[295] If the director is vindicated on the merits he ought to have a right to be indemnified; if he is only partly guilty, he should also be reimbursed, if possible, for the aspects of the case involving no breach of duty on his part. If the suit is not settled on the merits, assuming there is no payment to the corporation, he ought to be indemnified if some impartial agency e.g. a court or perhaps, an independant outside-counsel, finds that in fact he is guilty of no wrong-doing to the corporation. Another view, imposing greater hardship on directors, has been adopted by the New York Business Corporation Law whose Section 722(b)(1) prohibits indemnification for "amounts paid in settling or otherwise disposing of a threatened action, or a pending action with or without court approval."

2 — *Third party actions*

A director furthering what he conceives to be the best interests of his company may incur substantial liability to third parties, government included. Antitrust litigation is probably the most frequent type of third party suits. Not so long ago, Mr. Justice Van Voorhis described antitrust prosecution as "an occupational hazard to the officers and directors of large corporations, as truly as falling from a ladder is an occupational hazard to a painter or carpenter".[296] The construction of Rule 10b-5 adopted by the Court of Appeals of the Second Circuit in the *Texas Gulf* case[297] with respect to press releases will not alleviate the burden placed on directors by the Federal laws. Our analysis of the director's liabilities has shown that directors are subject to civil liability, including compensatory and punitive damage liability, and to criminal proceedings resulting in fines and, of course, in all instances, irrespective of the outcome of the case, to heavy litigation expenses.

a — Civil liability

(i) — Compensatory damage liability

The harm entailing liability upon directors may have been caused intentionally, unintentionally or liability may be imposed without specification of fault.

Unintentionally inflicted harm may result either from negligent violations or from the vagueness of the "ordinarily prudent man"

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[295] Bishop I, *loc. cit.*, n. 237, at p. 843.

[296] *Schwartz* v. *General Aniline & Film Corp.*, 112 N.Y.S. 2d 146, (1st Dept., 1952), at p. 150, aff'd. 113 N.E. 2d 533 (1953).

[297] *S.E.C.* v. *Texas Gulf Company* (Aug. 13, 1968; C.A. 2), Docket No. 30,882, rev'g. in part 258 F. Supp. 262 (S.D.N.Y., 1966).

standard. If, for example, the director and his counsel place a wrong construction on the *Robinson-Patman Act* and that all the way up to the Supreme Court split decisions uphold the conviction and allow generous private treble damages, who should pay for the damages and litigation expenses? The New York Business Corporation Law at Section 723 (a) answers the question in permitting indemnification for all expenses (for suit, settlement and attorney's fees) "if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in the best interest of the corporation and, in addition, in the case of criminal actions or proceedings, had no reasonable cause to believe that his conduct was unlawful". Such a reasonable rule seems to be approved by most commentators.[298]

As a rule, liability resulting from willful violations cannot be indemnified for obvious public policy reasons. There are, however, some borderline cases. In actions based on Rule 10b-5, not all courts agree on whether scienter is an essential element in private suits. By the weight of the latest authorities,[299] knowledge of the wrongdoing does not seem to be required in 10b-5 actions. But numerous tax, securities, or antitrust provisions are free from doubt. Allowing indemnification in case of flagrant violation of the law would negate the deterrent purpose of the damages imposed.[300]

Should a director be indemnified when liability does not require a showing of fault? In an action under Section 11 of the *Securities Act* of 1933, the plaintiff need only show that his injury was caused by a misleading registration statement. He does not have either to allege or prove that the defendants knew or had reason to know of the misstatement. The only defence available to directors is proof of the exercise of reasonable care in the preparation of the statement. As indicated, Courts tend to interpret Section 10(b) and Rule 10b-5 as providing strict liability. It has been suggested [301] that "when Section 10(b) liability is incurred without fault, indemnification seems consistent with federal policy". With the ambiguities left by the appeal decision in *Texas Gulf* regarding corporate disclosure, the adoption of a rule similar to that of Section 723(a) of the New York Business Corporation Law would seem equitable. If, however, the director is adjudged guilty of breach of his duty to the corporation, indemnification would be precluded under state law.[302]

298 Bishop I, *loc. cit.*, n. 287, at p. 844.
299 See *supra*, n. 196.
300 See 1967 Note, *loc. cit.*, n. 287, at p. 656.
301 1963 Note, *loc. cit.*, n. 287, at p. 1422.
302 *Ibid.*

Not infrequently are settlements reached and pleas of *nolo contendere* filed. In both cases, be they fines or damages, the amounts involved are substantial. Settlements are reached for a variety of reasons which do not necessarily involve an admission of guilt: it might be less expensive to make a small payment than to undergo the costs and risks of litigation.[303] The fairly recent case of *Koster* v. *Warren*[304] raises a rather difficult issue. Warren, the president of Safeway Stores, engaged in practices which were termed illegal by the Justice Department. He, of course, pleaded not guilty. The Justice Department offered a reasonable consent decree to the company if it would plead *nolo contendere* and if it could persuade Warren to plead *nolo contendere* in order to spare everybody the trouble of litigation. Warren, by then, was no longer president. From the company's viewpoint a consent decree was desirable to limit civil liability. As price for changing his plea, the corporation agreed to pay Warren's litigation expenses and whatever fine he might have to pay. Warren was sentenced one year suspended and fined $75,000, which seems to suggest that his violations were rather flagrant. If he willfully violated the law, his being indemnified is contrary to public policy. In a shareholder's suit challenging the indemnification the Court held that the corporation acted reasonably in reimbursing Warren. In *Simon* v. *Socony-Vacuum Oil Co.*,[305] the Court upheld the corporation's indemnification of two directors who entered pleas of *nolo contendere* on the ground that the peas were beneficial to the corporation in avoiding adverse publicity resulting from a trial and an adjudication of guilt which would have opened the door to private treble damage actions.[306] These decisions have been critized as contrary to public policy.[307] Despite these decisions, for which "the real guilt might rest with the Justice Department for making this sort of deal",[308] the rule laid down at Section 723(a) of the New York Statute should prevail.[309]

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303 *Ibid.*

304 176 F. Supp. 459 (N.D. Cal., 1959), aff'd. 297 F. 2d 418 (C.A. 9, 1961), Bishop I, *loc cit.*, n. 287, at p. 842.

305 38 N.Y.S. 2d 270 (Sup. Ct., 1942), aff'd. mem. 47 N.Y.S. 2d 589 (1944).

306 Section 5(a) of the *Clayton Act.*

307 1963 Note, *loc. cit.*, n. 287, at p. 1425.

308 Bishop I, *loc. cit.*, n. 287, at p. 842.

309 See *supra*, text accompanying n. 298. In *Diamond* v. *Diamond*, 120 N.E. 2d 819 (1954), and in *People* v. *Uran Mining Corp.*, 216 N.Y.S. 2d 985 (1961), the directors' misconduct was demonstrated in court but liability was avoided on other grounds. It could thus be argued that settlements would be indemnifiable except if misconduct which would be the basis for liability if adjudicated is shown. 1963 Note, *loc. cit.*, n. 287, at p. 1409.

(ii) — Punitive damage liability

Since in most jurisdictions the purpose of punitive damages is penal rather than compensatory,[310] it would seem clearly unlawful to indemnify directors for this type of damage. One problem is raised by treble damages: are the extra two-thirds of liability punitive or compensatory? Three theories have been advanced. One writer[311] argues that the trebling is intended to compensate the plaintiff for unprovable injuries. One Court held that the remedy had a primarily punitive objective.[312] Another Court was of the opinion that the purpose of treble damages was to provide an incentive to injured persons to litigate their grievances.[313] The latter view, promoting both deterrent and compensatory purposes, appears to be the most consistent with the enacting intent.[314]

b — Criminal liability

Generally public policy would forbid indemnification for criminal fines and penalties since it would undermine the purpose of the law. It has, however, been pointed out earlier in this chapter that some laws impose strict criminal liability. In the light of the statement of the Attorney-General's Committee on Antitrust to the effect that it is sometimes impossible to draw a clear line between the furtherance of legitimate corporate interests and violations of the law,[315] the New York rule of Section 723(a) seems reasonable.

c — Litigation expenses

Several arguments have been advanced against indemnification of the litigation expenses. It may be argued, for instance, that a defendant, who might have otherwise settled, may be encouraged to litigate, thus inflicting undue delays and expenses on the plaintiff. Conclusive arguments favouring indemnification, even in case of criminal proceedings, may be advanced. First, the possibility of being able to fully defend oneself should not be jeopardized by the fear of substantial counsel fees. Second, defendant's liability should not be aggravated by legal fees. Third, not all claims require the same amount of work: legal fees vary rather according to the difficulty of

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[310] 1967 Note, *loc. cit.*, n. 287, at p. 659; Note, *Exemplary Damages in the Law of Torts*, (1957), 70 Harv. L.R. 517, at pp. 520-521.

[311] Vold, *Are Threefold Damages Under the Antitrust Act Penal or Compensatory?*, (1940), 28 Ky. L.J. 117.

[312] *Commissioner* v. *Obear-Nester Glass Co.*, 217 F. 2d 56 (C.A. 7, 1954), at pp. 61-62, cert. den. 348 U.S. 982.

[313] *Julius M. Ames Co.* v. *Bostitich Inc.*, 240 F. Supp. 521 (S.D.N.Y., 1965), at p. 525.

[314] See Manning, *loc. cit.*, n. 252, at p. 1568.

[315] *Supra*, n. 278.

the defence than to the degree of misbehaviour.[316] It has been shown, for example, that the average person pleading *nolo contendere* was fined approximately $7,400 and a person pleading not guilty approximately $13,700.[317] It is thus agreed among most writers that litigation expenses ought to be indemnifiable when the director acted in his representative capacity.[318]

B — Insurance

Two types of insurance policies are on the market: insurance purchased by the director and insurance purchased by the corporation either to protect itself or its management.[319]

1 — *Insurance purchased by the director*

At the outset it should be examined whether this insurance is liability or indemnity insurance. Despite a somewhat faulty draftsmanship in existing policies[320] it seems generally agreed that the nature of this type of coverage is liability insurance rather than indemnity.[321]

According to those learned in this field, it appears that a director is able to obtain coverage for compensatory liability, including settlements, with, however, some doubts as to whether liability for intentionally inflicted harm is covered in the "dishonesty" exclusion found in most policies.[322] Coverage for this type of loss has been objected to on grounds of public policy.[323] One could conceivably argue that insurance is usually not available for losses depending upon the insured's volition. With respect to punitive damages liability, it has been argued that insurance covering such damages is contrary to public policy. A majority of courts, however, upholds this type of insurance in saying that the insured pays a premium commensurate with the insurer's assumption of that added risk.[324]

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316 1963 Note, *loc. cit.*, n. 287, at p. 1411.

317 Adkins & Janis, *loc. cit.*, n. 36, at p. 823; Note, (1963), 76 Harv. L.R. 579, at p. 583.

318 1963 Note, *loc. cit.*, n. 287, at pp. 1411-1412; 1967 Note, *loc. cit.*, n. 287, at pp. 661, 663.

319 Much of what follows is taken from the 1967 Note.

320 See Lloyd's Directors and Officers Form, para. 2(c).

321 See 1967 Note, *loc. cit.*, n. 287, at p. 652; Bishop II, *loc. cit.*, n. 287, at p. 108.

322 Bishop II, *loc. cit.*, n. 287, at no. 44.

323 1967 Note, *loc. cit.*, n. 287, at p. 656.

324 *Carroway* v. *Johnson*, 139 S.E. 2d 908 (S.C., 1965); *Lazenby* v. *Universal Underwriters Ins. Co.*, 383 S.W. 2d 1 (Tenn., 1964), *contra Northwestern National Casualty Co.* v. *McNulty*, 307 F. 2d 432 (C.A. 5, 1962).

Most insurance policies cover also criminal proceedings [325] but exclude "fines or penalties imposed by law".

In any event, it seems that purchase of insurance against third party liability should be permitted. Professor Bishop argues soundly that "whatever harm to public policy is implicit in freeing him from fear of a fairly unlikely consequence of his crime is outweighed by additional protection to the innocent victim".[326]

Could a director purchase insurance covering his liability to the corporation? The standard of care to which he is bound seems so vague that he should, in all fairness, be able to protect himself from ordinary negligence short of willfulness.[327] *In essentio,* such an insurance would be analagous to the lawyer's or doctor's liability insurance for malpractice.

2 — *Insurance purchased by the Corporation*

a — Insurance protecting the corporation

There seems to be no reason why a corporation should not be able to insure itself against loss caused by the directors' breach of duty. Such insurance, as Bishop points out,[328] is similar to the ordinary fidelity bond affording protection against agents' embezzlements.

Another type of coverage is being presently offered to corporations: reimbursement of any sum which the company properly pays to a director (or executive) by way of indemnification. The board has the power to control the extent of the losses covered by the reimbursement policy in cases in which it has discretion whether or not to indemnify a director. It could be argued that insurance could have the undesirable effect of inducing management to resolve borderline cases in favour of indemnification.[329] Conversely, it may be said that:

> ...By protecting executives who might otherwise not have received indemnity solely because of the financial burden of reimbursement, such insurance helps to enable the corporation, at relatively little cost, to attract and retain competent personnel.[330]

b — Insurance protecting the directors

Due to the lack of reliable statistics, the practice of insurance companies has been to sell one policy covering the entire board. Is the use of corporate funds to purchase such insurance justifiable?

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[325] American Home policy, Lloyd's Form; Bishop II, *loc. cit.,* n. 287, no. 66.
[326] Bishop II, *loc. cit.,* n. 287, at p. 109.
[327] See 1967 Note, *loc. cit.,* n. 287, at p. 654.
[328] Bishop II, *loc. cit.,* n. 287, at p. 110.
[329] 1967 Note, *loc. cit.,* n. 287, at p. 664.
[330] 1967 Note, *loc. cit.,* n. 287, at p. 665.

i — third party actions

Whenever indemnification is permissible, it would seem that the company may purchase insurance for its directors. Such insurance may be viewed either as a form of indemnification or as a part of the compensation for services rendered.[331] A company could not, of course, indemnify or insure a director against the penal consequences — fines and prison terms — of *deliberate* wrongdoing done within the scope of his employment.[332] To determine the validity of such a purchase, Washington and Rothschild[333] propose to examine the good faith of the directors in authorizing the purchase and not the amount involved, especially if the corporation is publicly held.

ii — Shareholders' derivative actions

It can easily be argued that the corporation's purchase of insurance covering the director's branch of duty to the corporation reduces the amount of the company's eventual recovery by the amount of the premium previously paid.[334] Arguments to the effect that a lowering of the degree of care exercised by the directors would ensue do not seem particularly persuasive. In any event, shareholders suits challenging the propriety of the payment of premiums appear unlikely since the amounts involved are too small to arouse the interest of a lawyer seeking a substantial contingent fee.

Conclusion

In view of the foregoing study, it may be said that the most efficient way to protect directors is insurance purchased by the corporation. Professor Bishop argues that such a purchase might be against public policy and, consequently, policies protecting directors should be paid for by the directors but he admits that his views are neither supported nor contradicted by authority.[335] Another writer contends that Bishop makes an "unsound identification of insurance with indemnification" and adds that:

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331 It has been pointed out (1967 Note, *loc. cit.*, n. 287, at p. 667) that a three-year policy with a $5,000,000 limit would cost at most $50,000 or some $17,000 per year. Since the allocation is usually 90%-10% between the corporation and the directors (see Anderson, (1965), 47 Chi. B.Rec. 31, at p. 32), the yearly cost per individual would be something less than $1700 divided by the number of insured.

332 Bishop II, *loc. cit.*, n. 287, at p. 107.

333 *Compensating the Corporate Executive*, (3rd Ed., 1962), at pp. 923-924.

334 Bishop II, *loc. cit.*, n. 287, at pp. 104, 106; 1967 Note, *loc. cit.*, n. 287, at p. 667.

335 Bishop II, *loc. cit.*, n. 287, at pp. 111-112.

> So long as the purchase of insurance can be justified simply as compensation, as would almost always be the case, such expenditures would seem unobjectionable.[336]

Whichever view will prevail is difficult to foretell: it will mostly depend upon the wording of future policies and their judicial construction.

CONCLUSION

Reinforcement of the director's fiduciary character has already been brought to light. Various devices used to protect directors from the hardship of liability have been examined. Beyond the law, taught Professor Berle at Columbia Law School,[337] there is the field of inchoate law affecting corporations holding market power, or on which the community has come to depend for some essential function. Corporate managers operate in "that no man's land where law, economics and political science meet, and where new law is daily cristallizing".[338] Thus, if directors adopt a course of conduct which, though legal from the technical standpoint, violates the ordinary standards of the community, state intervention is soon predictable. This intervention will, in most cases, not only remedy the situation but will also tighten the existing body of law. Two examples clearly illustrate this theory. In April 1962, American steel corporations pushed price administration into a dangerous area, not only were they the object of political action but also of antitrust and various other investigations.[339] In Canada, two major bankruptcies — those of the Alliance Corporation and of the Prudential Corporation — and a gigantic stock swindle[340] prompted the Government of Ontario to appoint a Committee[341] whose far-reaching recommendations were enacted in 1966. In conclusion, corporate directors should not only base their decisions on what the law is but also on what the community thinks is fair. History shows that the community's standard of fairness usually becomes the law; it is thus the lawyer's duty of clairvoyance to perceive this standard.

Pierre-Félix DE RAVEL D'ESCLAPON *

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[336] 1967 Note, *loc. cit.*, n. 287, at p. 669.

[337] Book Review, (1962), 76 Harv. L.R. 430, at p. 432.

[338] *Ibid.*, at p. 431.

[339] Berle, *loc. cit.*, n. 337.

[340] See *Report on Windfall Oil & Mines Ltd., (The "Kelly Report")*, disclosing the abuses of insider trading, Ontario Securities Commission.

[341] *Attorney General's Committee on Securities Legislation*, (1965), (The Kimber Report), Ontario.

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