SHARE DEALINGS BY A COMPANY'S OFFICERS: AN AUSTRALIAN-AMERICAN COMPARISON

If a company's officers receive some benefit from dealing in the company's shares which they are only able to receive because of their positions in the company, whether as directors or other employees, then on the principle laid down in *Regal (Hastings) Ltd v Gulliver and Ors*[1] they should account to the company for the profit that they have made. Of course this may mean, as in the *Regal Case,* that the new controllers of the company receive a completely unmeritorious windfall by way of a reduction in the price that they had freely agreed to pay for their shares, but this is another problem which will be considered later, in which the United States Courts have made significant and important advances on their English and Australian counterparts.

Regal (Hastings) Ltd v Gulliver illustrates that directors' duties are similar to, but not precisely the same as, the duties of trustees to trust property, and that no person in a fiduciary capacity is permitted to make a profit out of the property in relation to which the fiduciary position exists.

The strict application of this old established legal doctrine can being about an inequitable result, as happened in the *Regal Case,* but this did not prevent the House of Lords from unanimously overruling the decision of the Court of first instance, and the Court of Appeal, and applying the doctrine without regard to the individual merits of the defendants. The facts of this case are too well known to require repetition.

Although the decision of the House of Lords in the *Regal Case* undoubtedly caused hardship on the directors concerned, and profited those who had no merits in justice, the principle established can hardly be questioned, and the case has been followed and favourably commented on by a number of Dominion courts.[2] If directors were allowed

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1 [1942] 1 All ER 378.

2 See Smith Ltd v Smith [1952] NZLR 470; Zwicker v Stanbury [1952] 4 DLR 344 (Nova Scotia SC) Manson J in Canada Safeway Ltd v Thompson [1951] 3 DLR 295 referred to the decision of the House of Lords in the Regal Case in these words: 'That was a decision, if I may say so, of a very strong Court, and an exhaustive one on the subjects debated therein'. [1951] 3 DLR 319.

to accept opportunities for themselves, which their companies were unable to accept, this would certainly place a great temptation on them to induce the company to reject profitable contracts in order that they could benefit personally. On the other hand does the present law mean that if directors honestly decide not to invest their company's funds in a speculative venture, but some of them hazard their own resources and the venture proves profitable, they are then accountable to the company for the profits made? This would seem to be pressing the principle too far and it seems that the directors will be required to account for their profits if they were only able to enter into the contract by virtue of their fiduciary position with the company. Lord Russell of Killowen stated:[3]

> My Lords, I have no hesitation in coming to the conclusion, upon the facts of this case, that these shares, when acquired by the directors, were acquired by reason, and only by reason of the fact that they were the directors of Regal, and in the course of their execution of that office.

Lord Macmillan concurred with this approach and added:[4]

> However, that does not absolve them from accountability for any profit which they made, if it was by reason and in virtue of their fiduciary office as directors that they entered into the transaction.

Lord Porter emphasised that the principle involved had been established in equity as long ago as the eighteenth century in *Keech v. Sandford*.[5] His Lordship confirmed the views of the other members of the House of Lords and added:[6]

> In these circumstances, it is to my mind immaterial that the directors saw no way of raising the money save from amongst themselves and from the solicitor to the company, or, indeed, that the money could in fact have been raised in no other way. The legal proposition may, I think, be broadly stated by saying that one occupying a position of trust must not make a profit which he can acquire only by use of his fiduciary position, or, if he does, he must account for the profit so made.

Although the *Regal Case* has been widely applauded in most English speaking jurisdictions,[7] it was distinguished on its facts by the Supreme

3 Op cit 387.
4 Op cit, 391.
5 [1726] Sel Cas Ch 61.
6 Op cit, 395.
7 See also Phipps v Boardman [1967] 2 AC 46 (HL) where the decision in the Regal Case was applied.

Court of Canada in *Peso Silver Mines Ltd (NPL) v Cropper*.[8] The material facts of the Case were as follows. Peso Silver Mines was incorporated as a private company in early 1961 and was converted into a public company later that year. In April, 1961, the defendant was appointed as the company's managing director. During 1962 an offer was made to the plaintiff company to purchase certain mining claims, some of which were contiguous to the claims already owned by the plaintiff company. The then board of directors of the plaintiff company rejected this offer as other mining developments were imposing heavy strains on the company's finances. The major reason given for rejecting the offer was financial inability, but there was also some evidence that the directors considered the claims to be an unpromising risk. In any event the trial judge found that the decision was made 'in the best of faith and solely in the interest of the appellant, and not from any personal or ulterior motive on the part of any director, including the respondent'. Subsequently the defendant, in conjunction with two other directors and the company geologist, formed a company to purchase and exploit the claims. In 1963 the plaintiff, needing fresh supplies of capital, sold one million shares to Charter Oil Co Ltd. As a result of this, control of Peso was transferred to Charter.

Friction and disharmony occurred between the representatives of Charter and the defendant, who was ultimately dismissed. Peso then sued the defendant to account to the company for the shares held by him in the company formed to exploit the claims rejected by the plaintiff. The action was dismissed by the Court of first instance. This decision was affirmed, on appeal, by the British Columbia Court of Appeal (Norris JA dissenting), and on further appeal to the Supreme Court of Canada. Norris JA in the British Colombia Court of Appeal[9] delivered a forceful dissent and held that the defendant should be made to account as he had acquired the information relating to the claims in the course of the execution of his duties as a director. Norris JA held that the onus on the Plaintiff was only to prove that the defendant could have acquired the information by virtue of his corporate office, and not that the defendant could *only* have inquired the information in this way. The question of loss to the company or *mala fides* in the defendant was irrelevant, and following the reasoning in the *Regal Case* the defen-

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[8] [1966] 58 DLR (2d) 1.
[9] [1966] 56 DLR (2d) 117.

dant's liability was not affected by the fact that the plaintiff company was unable to avail itself of the opportunity to take up the claims.

Cartwright, J. who delivered the judgment of the Supreme Court of Canada, and after quoting extensively from the *Regal Case* said:[10]

> On the facts of the case at bar I find it impossible to say that the respondent obtained the interests he holds in Cross Bow and Mayo (the claims in question) by reason of the fact that he was a director of the appellant and in the course of the execution of that office.

The basic difference between the views of Norris JA, and the other members of the Canadian Court of Appeal, and the Supreme Court of Canada is, as D. D. Prentice points out,[11] a conflict as to the enforcement of more stringent fiduciary duties on directors of companies. Both sides referred to the 'complexities involved by interlocking subsidiary and associated corporations'. Norris JA took the view that these complexities made it imperative that stricter fiduciary standards should be enforced to prevent such complexities being used 'as a smoke-screen or shield behind which fraud might be perpetrated, while the majority took the opposite attitude and held that these complexities are such that it would not be 'enlightened to extend the application of these principles beyond their present limits'.

This conflict of views is also highlighted by the differences as to onus of proof required to be discharged by the plaintiffs. Norris JA took the reasonable and practical attitude that the onus resting on the plaintiff is only to prove that the information *could* have been acquired by the corporate officer in the execution of his office. Having established this, the onus would then shift to the defendant to satisfy the Court that the information in quesion was acquired from other sources. The majority of the Court of Appeal, on the other hand, held the view that for the plaintiff to succeed there had to be evidence that the disputed transaction was entered into 'by reason of the fact, and only by reason of the fact, that they were directors and in the course of the execution of that office'. This would of course throw a very difficult burden on the plaintiff to prove in the case of defendants holding a number of directorates from all of which they could be obtaining confidential information, as it is often impossible to say from which particular source certain information was obtained.

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10 Op cit, 8.

11 *Regal (Hastings) Ltd v Gulliver—The Canadian Experience* 30 MLR 450, 452 (1967).

There is at least one material distinction between the *Regal* and *Peso Cases,* and that is in the former case the directors had considered the leasing of the cinemas as a sound business proposition, but the plaintiff company was financially unable to take up more than 2,000 shares in the subsidiary company, while in the *Peso Case,* the directors, besides being concerned with the financial situation of the company, did not think the additional mineral claims were very promising. However, financial problems can often be overcome, and it is submitted that it is wiser to exclude the danger of a conflict of interests between directors and their companies by adhering to the strict fiduciary duties imposed by the House of Lords in the *Regal Case* rather than the somewhat more flexible and lenient standards applied in the *Peso Case.* Of course if it was illegal for the company to enter into a certain type of transaction, and there was no obvious way of acquiring a licence to carry on the activity, then there would be no breach of duty if a director or officer undertook the venture himself, as there could be no harm to the company concerned. If on the other hand the only reason that the company could not carry on the proposed venture was because this would be *ultra vires* its objects, then this would not be a sufficient excuse to allow the directors to take advantage of the opportunity themselves, as the company's objects could be altered by special resolution.[12]

A more difficult problem arises when members, who are often directors, are paid a higher price for their controlling shares, than are the ordinary members of the company. It is a well established fact that a buyer is often prepared to pay considerably more for the shares of a company which confer effective control, than for a smaller number of shares which do not confer such power. Depending on the existing shareholding in the company, and as a general rule the greater the number of shareholders, and the smaller their individual shareholdings, the smaller is the required percentage of the total number of shares in the company which is necessary to confer effective control. Gower suggests[13] that by acquiring a mere '20 per cent of the equity shares from the directors (and others if need be) and arranging with the directors to resign their offices and to fill the casual vacancies thus created by nominees of the bidder's effective control may be obtained. If those who have the power to control a company insist on a higher price than the ordinary shareholders, are they accountable to the

12 See Section 28 Uniform Companies Acts.

13 MODERN COMPANY LAW 3rd ed, 543 (Stevens).

company (or possibly the other shareholders) for the additional amounts that they receive? *Clark v Workman*[14] establishes that directors of a private company who have the power to refuse to register transfers of shares, are in a similar fiduciary relationship to the company as are trustees to the trust estate, when approving or rejecting transfers. In that case Ross J held that the transfer of a controlling interest in a company is not a matter of mere internal management, as it may involve a complete transformation of the company. Hence in a proper case such a transfer can be restrained by the Court. The case is authority for the proposition that directors should give shareholders all the information that they can reasonably expect. Ross J stated:[15]

> An opportunity for deliberation in the full light of the facts and circumstances is impliedly required. I must say that I think it is hardly within the spirit of the articles that shareholders holding 55% of the shares should be allowed to declare their desire to sell at 12.30 o'clock and that at 2.30 the Chairman, who had previously refused to give any information should disclose the names of the proposed transferees. We are not to forget the magnitude and importance of the proposed operation. It is a strong proposition to assert that a majority is to overbear and stifle a minority when the intention is to do such a serious thing as to give a controlling interest in one company to another company that is engaged in the same line of business and that may be to some extent a rival company.

The same principle may apply when the directors acquire knowledge of a possible take-over bid for the company.

In the well known United States case of *Perlman v Feldmann*[16] the Courts considered the problem of whether a controlling shareholder in a company, who sold his shares at a price not available to ordinary shareholders, could be forced to pay to the company, or to the other shareholders, the considerably higher price that he received for his shares than was available to the ordinary shareholders. This price is sometimes described as the premium in excess of the investment value of the shares. The facts of case may be summarized as follows:

The principal defendant Feldmann in August 1950 owned or controlled approximately 400,000 or 37 per cent of the outstanding shares of the Newport Steel Corporation. The remaining shares were owned

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14 [1920] IR 107.

15 Ibid, 113.

16 [1955] 219 F 2d 173, cert. denied 349 US 952 [1957] 154 Supp 436.

by several thousand other shareholders, mainly in small holdings. Feldmann was in effective control of the company, and was chairman of the board of directors and president of the company at a salary of $75,000 per annum. Newport manufactured rolled steel and steel sheets which were used by the manufacturers of steel products. Newport first entered the steel business in 1946, having acquired for approximately $1,665,000 the assets of the Andrews Steel Company. The big steel mills of the USA, and in particular those of the 'Big Six' were the main competitors of Newport's steel facilities. Normally Newport was only a marginal steel producer as its machinery and equipment were obsolete and were in need of modernization. Hence Newport could not normally compete with the 'Big Six' outside its own local area. However, in times of acute steel shortages, Newport had secured interest free advances from prospective purchasers in return for firm commitments from future production. These advances were in the main used to improve and modernize facilities and hence contribute to the future profitability of the company. This somewhat novel method of financing was followed by other steel manufacturers and became known as the 'Feldmann Plan'.

In 1950 owing to the Korean war there was a shortage of steel sheets in the USA, and Feldmann received certain overtures from persons interested in acquiring a controlling interest in Newport. A group of steel producers from a distant part of the USA made inquiries from Feldmann and formed a syndicate with the intention of purchasing his shares. Their intention was to obtain a reliable source of steel, and they were supplied by Feldmann with information as to Newport's productive capacity, advance commitments of output and other data.

Finally an agreement was reached by which Feldmann sold his 37 per cent holding of stock to Wilport Company, a Delaware Corporation which was incorporated especially by the syndicate for the purpose of acquiring Feldmann's shares. The purchasers initially offered $18 a share, Feldmann sought $22, and an agreement was ultimately reached at $20 a share. At this period the book value of the shares was $17 a share and the market price never exceeded $12. Feldmann became legally obliged to sell his shares on 24th August 1950. On that date Newport shares were quoted at between $8½ and $9½. Between 28th and 30th August Feldmann purchased approximately 15,000 shares in Newport at prices between $9.69 and $12 per share. The last sale took place on 31st August 1950, and these shares were then sold to Wilport at $20 per share. Thus shares that had belonged to outsiders frequently doubled in value when acquired by the controller. This it must be assumed represented the difference in their 'investment' and 'control' values.

In accordance with this agreement Feldmann transferred control of the company by inducing the original board of directors to resign and securing the election of nominees of Wilport. This change in the control and management of the company was made without notice to or the consent of the ordinary shareholders. Newport then proceeded to supply steel sheets to the members of Wilport, the sales being made on ordinary terms and conditions. Later a derivative action was commenced by certain outside shareholders of Newport naming Feldmann and certain members of his family as the principal defendants. The allegation in the complaint was that the transaction involved an unlawful sale of the control of Newport. Feldmann as persident, director and controlling shareholder was in fiduciary relationship to the company and to the outside shareholders. Therefore he could not take advantage of his position to obtain a personal advantage for himself, particularly if the advantage was at the expense of the outside shareholders. The price which Feldmann received for his shares included a 'premium' value which was dependent on the power to allocate the company's output particularly in a period of short supply. This power was effectively transferred to Wilport when Feldmann organized the resignation of the original board and replaced them with the Wilport nominees. On the other hand the defendants argued that the disputed transaction was merely a *bona fide* sale of a controlling number of shares with the rights and powers that naturally attach to these shares.

District Judge Hincks summed up the legal issues as follows:[17]

> On analysis it will be seen that the basic question in the case is one of law. In the state of the steel market as it existed on August 31, 1950, was the admitted power inherent in a control block of corporate stock to control the distribution of Newport's product and to select those who may become its customers a corporate asset as the plaintiffs contend, or was it something properly pertaining to the ownership of a control block of stock the value of which was necessarily and properly reflected in the value on the stock as the defendants contend?

District Court Judge Hincks, giving judgment for the defendants, held that the power to control distribution of a corporate product is

17 129 Fed Supp 183.

not a corporate asset, and the transfer of this power by a dominant shareholder and his associates did not amount to the conversion of corporate property, and there was no breach of fiduciary duty either to the company or the outside shareholders. Judge Hincks held that the power of a control block of shares to transfer management and hence the distribution of the company's output was:[18]

> . . . an attribute inseparably attaching to the stock which, if it has any effect on value, is an inseparable factor entering into the value of the control block.

The District Court of Connecticut found that the shares sold had a fair value as a control block of $20 per share. The Court also held that even if the value of the control block could have been separated from the power to control distribution of the company's products, there was not sufficient evidence to indicate what value the shares would have had if divorced from this power. Hence the plaintiffs failed to discharge the onus of proof by indicating what was the true value of the defendant's shares without this power.

The United States Court of Appeals, (Clark CJ and Frank J; Swan J dissenting) rejected the notion that the value of the shares could not be separated and held that the burden of proof as to the value should lie on the defendants, and remanded the case to the District Court with instruction to determine what part of the $20 per share should be allocated to the power to control the company's management and allocate the company's output. This amount or premium should then be shared by the defendants with the plaintiffs in proportion to their shareholding. An important difference between the United States Court of Appeals judgment and the *Regal Case* was that in this case it was held that the majority of the plaintiffs were entitled to recover individually, rather than the company, which is the normal beneficiary in a derivative suit and which often results as in the *Regal Case,* in an unexpected windfall for the purchasers of the company.

Clark CJ stated:[19]

> In the often-quoted words of Judge Cardozo: '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 sensi-

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18 Ibid 182.

19 219 Fed Rep 2d 176.

> tive, 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 individual loyalty by the "disintegrating erosion" of particular exceptions'. *Meinford v Salmon* (164 N.E. 545, 546). The actions of defendants in siphoning off for personal gain corporate advantages to be derived from a favourable market situation do not betoken the necessary undivided loyalty owed by the fiduciary to his principal.

The court held that there should be judgment for the plaintiffs and those whom they represented for any premium value shown, to the extent of their respective stock interests.

The case does not clarify the important issue as to whether the outside shareholders who had recently sold their shares were entitled to participate in the verdict, as in all probability many of them would not have joined in the plaintiffs' action on the assumption that any judgment would only benefit the corporation. As Richard W. Jennings points out,[20] the better procedure after remanding the case to the District Court would be for notice to be given to all shareholders in the company, at the date of the transaction challenged, of their right to join as plaintiffs and to participate in the probable recovery.

It is interesting to note that the corporation asset theory upon which the plaintiff relied in *Perlman v Feldmann* was first foreshadowed by A A Berle and G C Means in their seminal work, 'The Modern Corporation and Private Property' first published in 1932. The authors argue[21] that any premium paid for a majority block of stock is paid because the purchaser is buying 'control'. He is 'buying power and not stock'. Bearle and Means also argue that:

> The power going with 'control' is an asset which belongs only to the corporation, and that payment for that power if it goes anywhere, must go into the corporation treasury.

Thus the controlling shareholders can sell their shares for their ordinary value as investments, but the power to control the company is treated as corporate property for which they are accountable to the company.

However these views have attracted some opposition.[22]

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20 44 Calif Law Review 1, 5 (1956).

21 New York: The MacMillan Company, 243-44 (1932).

22 See *Sale of Corporate Control,* 19 University of Chicago Law Review 896 (1952); *Duties of Controlling Shareholders in Transferring Their Shares* 54 Harv LR 648 (1941).

Prior to *Perlman v Feldmann* it was generally agreed in the USA that a stockholder might dispose of his stock in such manner and at such a price as he could obtain, although it had long been recognized that the advantages of control had often meant that a higher price was paid for a controlling block. The United States courts had also for many years restricted the freedom of controlling shareholders to dispose of their interests when the sale was negligently or fraudulently made to persons who then looted the company.[23] Actual knowledge by the corporation controllers or vendors, that the purchasers intended to loot the company, was not necessary where the circumstances were sufficiently suspicious to have put reasonable vendors on enquiry as to the intentions of the purchasers. Another restriction on the freedom to transfer controlling interests was to be found in the fiduciary duty of directors and controlling shareholders not to intercept an opportunity properly belonging to the company. This duty may be violated in certain circumstances by sales of controlling blocks of stock.

Probably the clearest case for the implementation of the corporation opportunity doctrine is present when the eventual buyer of the controlling shares makes an offer to the corporation which is refused by the directors in order that they can negotiate the sale of their own controlling shares at a premium.[24] In the *Feldmann Case* a more difficult problem arose as there was no general offer made to the Newport company shareholders on the part of the purchasing syndicate.

Another example of when the United States courts will intervene at the instance of minority shareholders is when the minority are able to establish that the directors in selling their controlling shares have been guilty of what is described as a 'sale of office'. Such a sale is a breach of fiduciary duty which they owe to the company in their position of directors or officers. In one of the leading United States cases on this type of situation, *Benson v Braun*,[25] the New York Court of Appeals held that it is legitimate for those selling controlling shares to resign as directors and use their influence to bring about resignations by a majority of the board in order to facilitate the transfer of control of the company to the new board. Hence the mere fact that the directors receive an excessive sum for their shares when they agree to resign from the board is not sufficient evidence

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23 Insuranshares Corporation v Northern Fiscal Corporation 35 Fed Supp 22 and Gerdes v Reynolds 28 NYS 2d 622 (Sup Crt 1941).

24 Commonwealth Title Ins & Trust Company v Seltzer 227 Pa 410.

25 155 NYS 2d 622, 625.

of a 'sale of office'. In order to establish a 'sale of office' it is necessary for the plaintiffs to prove that a secret additional amount was paid in cash for the defendants' resignation from office as in *Bosworth v Allen*,[26] or that the defendants contrived the transfer of control of the board to the intending purchaser.[27] The test as laid down in the well known case of *Gerdes v Reynolds*[28] was:

> Is the price paid in reality a price paid for the stock, or is it in part at least a price paid for the resignation of the existing officers and director and the election of the buyer's nominees?

It need hardly be emphasised that the plaintiffs would frequently have a most difficult task to establish their case unless they had access to inside knowledge of the negotiations and dealings between the parties to the transaction which normally would not be available to them.

English and Australian Company law have no similar equitable principles applying to the 'sale of office' in these situations where the payment is made in the form of an excessive price for the directors' shares.

Sections 191, 192, 193 of the English *Companies Act of 1948,* and s.129 of the Australian *Uniform Companies Acts* prohibit certain payments to a director by way of compensation for loss of office or as a consideration for or in connection with his retirement from any such office, unles particulars with respect to the proposed payment have been disclosed to and approved by the company in general meeting.

The difficulty with these statutory provisions is that they will usually not apply when there is a transfer of control of the company, but no general offer is made to ordinary shareholders remaining in the company. As Anthony Boyle points out,[29] the Jenkins Committee in England made some worthwhile suggestions for the improvement of the English statutory provisions, but they did not deal with this type of case.[30] The Jenkins Committee recommended that section 191, 192 and 193 should be extended to cover payments to former directors and to directors of holding companies for loss of office in subsidiary

26 168 NY 157.

27 Porter v Healey 244 Pa 427.

28 28 NYS 2d 622, 653 (1941).

29 *The Sale of Controlling Shares* 13 International & Compartive Law Quarterly 185 (1964).

30 See Board of Trade *Report of the Company Law Committee* Cmnd 1749 paragraphs 99 (h) and (i) (1962).

companies. Also, 'the approval required by sections 191 and 192 should be by special resolution of the company and that required by s.193 by a corresponding majority of the members concerned'. Section 119 of the Australian *Corporations and Securities Industry Bill (1974)* seeks to prevent stock market manipulation of securities, while sections 123 and 124 of the same Bill prohibit dealings in securities by insiders and government employees. The requirements of s.123 are drawn from the US *Securities Exchange Act of 1934, s.16 (a)*. As it is still uncertain how this Bill will be altered by the Senate, it would not seem to be fruitful to examine these provisions in detail at this stage.

However it does seem certain that any new Australian legislation, whether Commonwealth or State, dealing with insider trading must borrow to a large extent from both US legislation and case law rather than from the traditional English sources.

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