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The Path of Fiduciary Law

David Kershaw *

Abstract: Contemporary accounts of corporate legal evolution view lawmakers as highly responsive to the economic interests of both pressure groups and markets. Through this lens law is understood to be the product of pressures exerted by managers, investors, institutional shareholders and the Federal Government, and the incentives of state lawmakers to accommodate the interests of these pressure groups. This lens dominates our current understanding of corporate legal evolution in the United States and is becoming highly influential in comparative accounts of corporate legal variation. This article sounds a note of objection. The article argues that the disciplinary pendulum has swung too far toward external accounts of legal evolution and too far away from internal accounts of legal change which view the path of law, at least in part, as the product of the internally generated constraints of the legal system – the relative autonomy of the law. To make this argument, the article considers the internal constraint of the conception of the corporation in 19th century US and UK corporate law and the evolution of self-dealing law in these two jurisdictions. It shows how two jurisdictions that started from the same legal proposition about self-dealing diverged rapidly as a result of the interaction of this proposition with profoundly different conceptions of the corporation. Contrary to the dominant account of the evolution of self-dealing law in the United States, the contemporary self-dealing rule is not the legally unexplained product of external market pressures but the logical and consistent product of the path of fiduciary law trodden through the corporate conception. The article shows that for contemporary corporate law a significant dose of inevitability was administered at the inception of general incorporation.

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INTRODUCTION

A discipline's theory of legal change and evolution provides its presumptive vantage point for understanding and assessing contemporary rules. For example, if the underlying theory of legal change understands law as an adaptation to the needs of its constituency of users, then the scholar will seek to account for how the law satisfies those needs, and the regulator or legislator will be wary of intervention. But if the theory of change identifies extraneous bias and distortion in the process of law making, then the vantage point of both scholar and law-maker will be critical of law's failure to fulfil its function and more reform orientated. A discipline's theory of historical change is therefore central to its assessment of the legitimacy and efficacy of existing rules and central to what the discipline does: what it views as the role of scholarship; and what it views as legitimate approaches to that scholarship.

Understanding the drivers of legal evolution is at the heart of contemporary corporate law scholarship. Over the past half century scholars have provided innovative and compelling accounts of why corporate law looks as it does today. These accounts share a theory of legal change which, in different guises, views legal change as the product of pressure exerted by the economic and financial needs and interests of the market place and its constituent players. It is an approach that has a close affinity with Marxist historiography which views superstructure as the direct product of 'material behaviour'.¹

This article argues that this dominant theory of legal change is partial and therefore inaccurate. It treats subsidiary drivers as primary drivers and pays scant regard to the primary driver. Following Holmes, American scholars have long been warned against treating the life of law as logic.² But in embracing Holmes' call for engagement with economics and statistics,³ the fact that a legal system may have certain logics that have a substantial impact on the path of legal change has been increasingly ignored by corporate scholarship. Today the 'legal' in mainstream 'corporate legal history' is disappearing. Without it, accounts of legal change are inaccurate, and the contemporary scholarly vantage point finds itself in the wrong place.

There are several layers of this economic understanding of historical change. The first and most readily accessible is the idea that lawmakers are responsive to instrumental economic imperatives. In this account law will adapt to ensure that it is responsive to the needs and interests of commerce, although in doing so it may

¹ In *The German Ideology*, Marx and Engels observe that: '[C]onceiving, thinking, and the intellectual relationships of men appear here as the direct result of their material behaviour. The same applies to intellectual production as manifested in a people's language of politics, law, morality, religion, metaphysics, etc'. L.H. Simon, *Karl Marx: Selected Writings* (Indianapolis and Cambridge: Hackett Publishing, 1994).

² O.W. Holmes, *The Common Law* (1881), 1.

³ O.W. Holmes, 'The Path of Law' (1897) 10 *Harvard Law Review* 457.

mistake the interests of individuals, such as managers, for the interests of commerce.⁴ A second, and dominant, economic account of corporate legal change for the past 40 years pivots around the horizontal state versus state competition for corporate charters,⁵ and the vertical pressures placed on state corporate law making as a result of the threat of Federal pre-emption of corporate law.⁶ Through these lenses law is the product of the economic incentives and pressures exerted by the players in the corporate chartering process – the state and its coffers, the Federal Government, the founders, the managers, the shareholders, the capital markets and the plaintiff's bar. Race to the bottom theorists view the managerial friendly nature of Delaware law as the product of the Delaware State's responsiveness to the interests of managers who control the re-incorporation decision. Race to the top theorists view corporate law as responsive to the economic imperative of maximising the value of the corporation's shares. Scholars that take a more nuanced view of the debate, such as Professor Bebchuk, argue that charter competition will generate pro-managerial rules in areas of corporate law, such as self-dealing and corporate opportunities, that are significantly re-distributive to managers, and pro-shareholder rules which maximise value where they are not.⁷ Other accounts of legal change and variation operate outside of the charter competition debate, but they do so with the same underlying understanding of legal change as the product of economic forces and pressures exerted by interest groups.⁸ For example, in recent important work Professors Armour and Skeel have argued that the divergence in the nature of takeover defence regulation in the US and the UK is the product of variation in the structure of corporate ownership in these countries, particularly the stronger presence of institutional investors in the UK in the late 1960s, who lobbied

⁴ See, generally, M.J. Horwitz, *The Transformation of American Law 1780-1860* (Cambridge: CUP, 1977) and *The Transformation of American Law 1870-1960: The Crisis of Legal Orthodoxy* (New York: OUP, 1992).

⁵ See W. Cary, 'Federalism and Corporate Law: Reflections Upon Delaware' (1974) 83 *Yale Law Journal* 663; D.R. Fischel, 'The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law' (1982) 76 *Northwestern University Law Review* 913; J.R. Macey and G.P. Miller, 'Toward an Interest-Group Theory of Delaware Corporate Law' (1987) 65 *Texas Law Review* 469 (1987); L.A. Bebchuk, 'Federalism and the Corporation: The Desirable Limits of State Competition in Corporate Law' (1992) 105(7) *Harvard Law Review* 1443; L.A. Bebchuk, A. Cohen, and A. Ferrell, 'Does the Evidence Favor State Competition in Corporate Law?' (2002) 90 *California Law Review* 1775; M.J. Roe, 'Delaware's Shrinking Half-Life' (2009) 62 *Stanford Law Review* 125.

⁶ See M.J. Roe, 'Delaware's Competition' (2003) 117 *Harvard Law Review* 588 and 'Delaware's Politics' (2005) 118 *Harvard Law Review* 2491.

⁷ See W.W. Bratton, 'Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-Five Years' (2000) 34 *Georgia Law Review* 447, 450-451, describing this position as the 'middle ground view of charter competition'; 'states pursued suboptimal policies of management accommodation respecting fiduciary rules and anti-takeover legislation'.

⁸ L.A. Bebchuk and M.J. Roe observe, for example, that '[i]nterest groups differ in their ability to mobilize and then exert pressure in favor of legal rules that favor them or against rules that disfavor them. The more resources and power a group has, the more influence the group will tend to have in the political process [...] the existing corporate ownership structures will affect the resources (and hence political influence) that various players will have and thus the rules that will be chosen'. 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 *Stanford Law Review* 127, 157.

forcefully to protect their economic interests.⁹ They argue further that the common law rules in both jurisdictions are similar as a result of repeat player litigation which pressurizes courts to take account of managerial interests.¹⁰

Through this lens of legal change the system of law becomes a black box in relation to which economic pressures are exerted to produce a legal product that comes out of the box. Through this lens, law as a relatively autonomous system does not play a role that could distort pressures, block some pressures, and facilitate others. Rather law, within the black box, simply becomes a mechanism of mediating multiple pressures and interests. Corporate law becomes a blank sheet of paper, and it is the economic fight over who gets to hold and control the pencil that determines the legal outcome.

Central to these accounts of legal change are certain disciplinary narratives that serve as examples or standard bearers of legal change as the outcome of economic pressures and incentives. An account of legal change based on economic incentives and pressures must of course provide examples of legal change that are clearly explained in such terms. US corporate law provides such examples although, perhaps surprisingly given the dominance of this economic understanding of legal change, not many of them. Most important in this regard is the general narrative of the decline of the disciplinary power of fiduciary duties,¹¹ and the more specific example of the evolution of the self-dealing standard from a strict standard, that rendered voidable any self-dealing transaction regardless of fairness, to a standard that required only fairness. Other important narratives involve the evolution of takeover defences, including both the adoption of state takeover statutes and the failure to provide Unocal proportionality review with any teeth.¹²

This article takes issue with this dominant economic understanding of legal change by challenging the widely accepted narrative about the evolution of US self-dealing law, and the related claim about the decline of American fiduciary standards. It does so through a close tracing of the evolution of self-dealing law in both the United Kingdom and the United States. UK and US self-dealing law begun by borrowing the same fiduciary principles from English trusts law to fill the gaps in their silent corporate codes, and for a brief period had the same UK case as the leading case. However, their laws rapidly diverged to provide starkly different fiduciary standards for directors. The mid-19th century common law rule in the UK was that a self-dealing transaction was voidable by the company in the

⁹ J. Armour and D.A. Skeel, Jr, 'Who Writes the Rules for Hostile Takeovers and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727.

¹⁰ See, further, H. Halbhuber and D. Kershaw, *The Power of Ideas in Corporate Law: Evidence from Takeovers* (on file with the authors 2011), taking issue with this interpretation of US and UK takeover law.

¹¹ For example, L.A. Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability' (2004) 52 *UCLA Law Review* 413, observing that the fiduciary 'sealant decayed during the twentieth century'.

¹² For an application of the framework of analysis adopted in this article to takeover law, see Halbhuber and Kershaw, n 10 above.

absence of *ex-ante* authorisation or *ex-post* ratification.¹³ The leading case, *Aberdeen Railway v Blaikie*,¹⁴ observed that ‘so strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into’. In the United States, in key States such as New Jersey or New York, the rule in the mid-to-late 19th century appeared to be identical. Indeed, the leading US cases of this period invariably relied upon, and often extensively quoted from *Aberdeen Railway*. Harold Marsh described the 1880s position in similar terms:

In 1880 it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction.¹⁵

Explaining the evolution of self-dealing law in the United States has long been viewed as a puzzle for US corporate scholars.¹⁶ In his 1966 article, *Are Directors Trustees*, Marsh describes the evolution of US self-dealing law in three stages. In 1880 the rule was as stated above; by 1910 the strict voidability rule had been replaced with a rule that allowed directors to enter into transactions with the corporation provided the transaction was fair and had been approved by a disinterested majority of directors; and by 1960 all that was required for a legitimate self-dealing transaction was that the transaction was fair. Marsh famously decried this shift away from the voidability rule. He accused the courts who presided over this shift as being ‘shamefaced’ and noted the courts’ wholesale failure to articulate the reasons for abandoning the voidability rule. By way of contrast, in 1880, 1910, 1960 and 1980 the position in the UK was unaltered from the strict voidability rule articulated in *Aberdeen Railway v Blaikie* in 1854.

How do we explain the apparent evolutionary dynamism of US corporate law and the evolutionary stasis of UK corporate law? Naturally, when legal starting points – the absence of regulation in either UK or US corporate codes, the shared sources of English fiduciary law from which corporate law in the US and UK borrowed, and the apparent identical initial interpretation of such borrowed legal goods – are the same, we look outside of the law and not within it to explain divergent paths. The widely held understanding of US self-dealing law, even without the comparativist’s gaze, has been to understand its evolution as an example of law’s responsiveness to economic forces and interest group pressure. Scholars have suggested that courts were captured by managerial interest group pressure or that courts became increasingly aware of the need for law to adjust to

¹³ See J. Edelman, ‘The Fiduciary Self-Dealing Rule’ in J. Glistler and P. Ridge (eds), *Fault Lines in Equity* (Hart Publishing: Oxford, forthcoming in 2011) arguing that self-dealing transactions are void.

¹⁴ (1854) Macq HI 461.

¹⁵ H. Marsh, ‘Are Directors Trustees: Conflicts of Interest and Morality’ (1966) 22 *Business Law* 35.

¹⁶ R. Clark, *Corporate Law* (Boston: Little Brown, 1986), 160, referring to the evolution of self-dealing law as a ‘historical puzzle’.

the instrumental economic needs of the market place: self-dealing transactions can provide significant benefits to companies, especially in small companies.¹⁷ Furthermore, this account of the evolution of self-dealing law is a perfect fit with US corporate law's primary contemporary narrative about the external drivers of legal change, namely the effects of state competition for corporate charters.

The juxtaposition of UK self-dealing law next to US self-dealing law ostensibly affirms this view of the drivers of the evolution of self-dealing law in the United States. It is often claimed that US judges adopt, and have long adopted, a more consequentialist style of legal reasoning which is necessarily more open to influence from the real economic world.¹⁸ If one were to place any contemporary UK corporate case next to its Delaware counterpart a reader would be immediately struck by the absence of consequentialist reasoning in the UK judgments and the absence of policy discussion as an acknowledged driver of legal outcomes. By contrast, the Delaware courts pride themselves on their connectedness to the needs and vocabulary of the market place and the understanding of the policy rationales that underpin legal rules.¹⁹ One might conclude therefore that the different paths of UK and US self-dealing law are explained by a much greater receptivity on the part of US courts, as compared to their UK counterparts, to the instrumental economic needs of the market place. Furthermore, the UK is not, and has never been, a jurisdiction that is subject to charter competition in any meaningful respect.²⁰ Accordingly, the different UK and US trajectories of self-dealing law fit well with a narrative that explains US legal evolution through the lens of the pro-managerial pressures on law-making in significantly redistributive areas.

But such accounts of legal change are too easy. Law does not respond to instrumental economic pressures by simply sacrificing its internal rules, principles, and structures to an identified economic need or a lobbyist's financial interests.

¹⁷ See *ibid.*, 160-166. See, for example, J. Cox, citing Marsh, observing that '[b]ecause conflicts of interests are endemic to the commercial setting that the corporation calls home, pragmatism prevailed over what was believed unsubstantiated fears of self-interested behavior. Courts seriously tempered their earlier approaches to conflict of interest transactions'. 'Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel' (2004) 48 *Villanova Law Review* 1077, 1079.

¹⁸ See, eg, M.J. Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (Sydney: Ashgate, 2001), 2, observing that 'the developments in case law emanating from the Delaware courts are marked by a conscious sense of consequence. Cases are not always decided as economists would like, but the courts recognize the importance of their decisions for corporate governance. By contrast [...] [English] courts retreated from a cautious pragmatism to a sometimes arid formalism'.

¹⁹ Compare for example two duty-of-care cases: in the UK *Re D'Jan* [1993] BCC 646 and in Delaware *In re Walt Disney Derivative Litigation* 907 A 2d 693 (Del Ch 2005).

²⁰ See G. Miller, 'Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England' (1998) 1 *Columbia Business Law Review* 52, arguing that corporate legal federalism and its absence in the UK is primary driver of legal difference in takeover law and derivative action regulation. See, generally, on the state of regulatory competition in Europe: W.W. Bratton, 'How Does Corporate Mobility Affect Law Making? A Comparative Analysis' in D. Prentice and A. Reisberg (eds), *Corporate Finance Law in The UK And EU* (Oxford: OUP, 2011); J. Armour, 'Who Should Make Corporate Law? EU Legislation versus Regulatory Competition' (2005) 58 *Current Legal Problems* 369.

Rather it engages with such needs and pressures through the existing rules, principles, and structures of the legal system. These systemic components contribute to, and are therefore determinative of, how law responds to these pressures: the path that law crafts through interaction with those pressures. US corporate law did not and cannot throw up its arms and say, 'This set of self-dealing rules do not respond to the needs of the market place; let's have a different set of rules.' It cannot say, 'We need to completely change the rule set to accommodate our primary constituency.' Legal changes and adjustments, even pursued by the most instrumental of lawmakers who themselves would like to rewrite the rule book, must benefit from a façade of legitimacy and must be proffered in ways that are consistent or explained by reference to existing internal rules, principles, and structures. If the legal historian finds that no reason is given for an apparently profound legal change such as the shift from voidability to fairness in self-dealing law, it is likely that the lawmakers who made the changes did not view the shift as profound at all, and we need to dig deeper to account not for legal change but continuity.

To explain the divergence of UK and US self-dealing law we need delve deeper into their apparently shared starting points.. Both jurisdictions started with a blank sheet of paper – there were no rules on self-dealing in the corporate code and no prior common law rules dealing with generally incorporated companies, which did not exist until the mid-19th century. Furthermore, both jurisdictions borrowed from the same source of legal ideas to address corporate self-dealing: fiduciary law contained within English trust law and agency law authorities. However, the background set of core systemic characteristics of US and UK corporate law, with which they translated these source materials into the corporate context, were not the same; they were profoundly different. Most importantly in this regard were the respective jurisdiction's divergent conceptions of the corporation.

In the UK a generally incorporated company, known as a registered company, was viewed conceptually as the continuation of what were known as unincorporated or deed of settlement companies. These were effectively large-scale partnerships, formed by using contract and trusts law, which were widely used prior to the availability of general incorporation. The general incorporated company was not viewed as a paradigm shift in the form of business organisation but merely as a means of addressing some of the practical difficulties associated with the unincorporated company. Following the introduction of general incorporation, the incorporated company continued to be perceived as the product of private partnership and enterprise. It followed therefore that the UK incorporated company was viewed from inception as the endogenous product of private contract, and, accordingly, the rules imposed on the company to regulate its governance were open to variation at the election of the shareholders. Importantly, the powers of the directors were also a function of this corporate contract. Stripped of the formal complications engendered by the creation of a separate legal entity, power in a UK company was understood to be delegated

directly from shareholders to directors, who *then* formed the board. This contractual conception of the governance of a UK company operated as the safety value for instrumental economic pressures in multiple contexts, including self-dealing, allowing directors and shareholders to mould governance rules to their preferences, thereby relieving the courts from the need to respond to these pressures and allowing, without consequence, inflexible rules to ossify.

In the United States general incorporation was viewed as an extension of statutory chartering. Each generally incorporated company was viewed as a product of legislative action; the state's creation and empowerment of an entity and *its* empowerment of a board of directors. This understanding of the corporation placed clear limits on the extent to which the parties themselves could change the rules: what stockholders had not given, they could not take away without the authority of the state to do so. Accordingly, responses to external pressure to allow self-dealing transactions had to come from within the law itself. However, US state courts did not respond by tearing up and re-writing the rules, rather they responded in different, internally consistent, and jurisdictionally-specific ways. The juxtaposition of UK and US self-dealing law enables us to see US self-dealing law in a clearer light. It allows us to see that the path of US self-dealing law from voidability to fairness is not illogical and unexplained and is not therefore open to crude economic forces accounts of legal change. On the contrary, the path to fairness is logical and consistent with the early 19th century fiduciary law and consistent with the options made available by the U.S conception of the corporation.

The analysis in this article does not directly address claims about the influence of charter competition on US corporate law, but it generates, as a by-product, a dose of scepticism about its relevance. Claims about horizontal competitive pressures on Delaware lawmakers have generally resisted providing a granular account of how the common law is changed by such pressures. This is hardly surprising as the nature of such effects means that one can rarely identify a single case or event to demonstrate increased managerial bias or lawmakers resisting managerial bias to ensure that the governance rules maximise value in the eyes of smart arbitrageurs. But it does mean that rules over time must gravitate to particular positions that support the claim. Importantly, this time period starts from the advent of the competition. If the change occurs prior to the starting gun, then charter competition is irrelevant. The timeline established by the analysis in this article does not support the claim of any significant charter competition effect in the self-dealing context because a strong case can be made that fairness review was established before the charter competition process was kick-started by New Jersey in 1889.²¹

²¹ Typically the starting point for charter competition is identified as 1889 when New Jersey enacted a statute allowing corporations to own stock in other corporations, or as of 1896 when New Jersey adopted what is often viewed as the first modern corporation code. However, see C.M. Yablon, 'The Historical

A short road map of the article: Part I sets forth an account of the conceptions of the corporation in the United Kingdom and the United States with particular regard to the extent to which corporate governance rules were deemed to be contractable. Part II sets forth the article's thesis through a detailed consideration of the evolution of self-dealing law in the United Kingdom and in the three most (historically) important US jurisdictions: New Jersey, New York, and Delaware. Part III concludes.

I THE CONCEPTION OF THE CORPORATION

A. THE UK: A CONTRACTUAL CONCEPTION OF THE COMPANY

Prior to the introduction of general incorporation, in the UK large-scale business activity was carried out through unincorporated associations or companies which, for legal purposes, were in effect large-scale partnerships. These unincorporated companies were legally constructed through an innovative combination of trust law and contract law. The assets of the company were vested in trustees and directors of the unincorporated company (who were typically different individuals than the trustees)²² who were appointed and empowered to manage and deploy those assets in accordance with a contract – the deed of settlement – entered into by all the ‘partners’/‘members’ in the unincorporated association. The directors’ powers over the unincorporated company’s assets were a direct function of the provisions set forth in this deed of settlement. These companies were often referred to as ‘deed of settlement companies.’

There were multiple practical problems associated with carrying out business through an unincorporated company, including, in particular, the difficulties involved in taking legal action in the company’s own name²³ and the problem of unlimited member liability which, although partially managed through contract, could never be fully excluded.²⁴ The UK legislature in the early 19th century was

Race Competition for Corporate Charters and the Rise and Decline of New Jersey 1880-1910’ (2007) 32 *Journal of Corporation Law* 323, arguing that the process started as early as 1880 although observing that: ‘In the decade from 1880 to 1889, there was not yet any public recognition that New Jersey, or any other state, had become a particularly popular state in which to incorporate, although there is evidence of a different perception among knowledgeable business professionals.’ 333. Arguably West Virginia tried the ‘charter mongering’ strategy first in 1888 but to little avail: See C. Grandy who argues that prior to 1890 New Jersey Corporate law was ‘focused on firms operating within the state’: *New Jersey and the Fiscal Origins of Modern American Corporation Law* (New York: Garland Publishing, 1993), 43. See also W.W. Bratton and J.A. McCahery, ‘The Equilibrium Content of Corporate Federalism’ (2006) 41 *Wake Forest Law Review* 619.

²² L.S. Sealy, ‘The Director as Trustee’ (1967) *Cambridge Law Journal* 83, 84.

²³ M. Lobban, ‘Corporate Identity and Limited Liability in France and England 1825-67’ 25 *Anglo-American Law Review* 397, 404.

²⁴ On the pre-general incorporation construction of an ‘entity’ through trust and contract see J. Getzler and M. Macnair, ‘The Firm as an Entity Before the Companies Acts’ in P. Brand et al (eds), *Adventures of the Law: Proceedings of the Sixteenth British Legal History Conference* (Dublin, Four Courts Press 2005).

clearly cognisant of these practical problems. Indeed, the introduction in the UK of general incorporation – known in the UK as incorporation by registration – through the Joint Stock Companies Act of 1844, which did not provide for limited liability,²⁵ can be viewed as one step in a continuum of legislative steps designed to incrementally address some of these practical problems. Accordingly, the broad availability of the corporate form through a simple form filling registration process was not viewed as an organisational paradigm shift – from partnership to separate legal entity – but rather as a means of addressing the practical problems of existing institutions.²⁶

The legislative steps prior to the Joint Stock Companies Act of 1844 included providing the Crown with the authority to grant letters patent to enable the unincorporated company to sue in the name of the company through a ‘public official’²⁷ and, thereafter, allowing banking companies to appoint such a ‘public official’ through a registration process.²⁸ For such unincorporated companies with an appointed ‘public official’ Lord Justice Lindley, the 19th century’s leading English company law scholar and senior judge, observed that they could ‘without any great inaccuracy be likened to a corporation.’²⁹

For scholars of Lord Lindley’s generation the term ‘company’ was the umbrella term applying to both unincorporated and incorporated companies which were, roughly speaking, viewed as different forms of partnership and which were, to a significant extent, subject to the same legal architecture of contract and trust law that governed a partnership. In his treatise on company law, which is tellingly entitled *A Treatise on the Law of Companies as a Branch of the Law of Partnerships*, he refers to companies incorporated by registration as ‘partnerships incorporated by registration’.³⁰ Francis Palmer, a leading 19th century commentator on company law, observed that the unincorporated company was

²⁵ Limited liability for companies incorporated by registration was not introduced until the Limited Liability Act of 1855.

²⁶ See Lord Cranworth in *Oakes v Turquand* L.R. 2 H.L., explaining that the companies acts were a response to the fact that ‘the ordinary provisions of the law of this country were ill adapted to the business of such bodies’. Gladstone on requesting leave from the House of Commons to move a bill on the Joint Stock Companies observed that the bill would ‘not change the course of the law, but rather accelerated it; because, in the present state of the law, Joint-Stock Companies had, under the pressure of absolute necessity, extorted, piecemeal, from the courts of law, a recognition of their distinct existence; and, without any strictly statutory title, they had become, to all intents and purposes, recognized creatures in the eye of the law’. HC Deb 02 April vol 73 cc 1754-8.

²⁷ 4 & 5 Wm. 4, c 94. N. Lindley, *A Treatise on the Law of Partnerships, Including its Application to Companies* (Chicago: Callaghan & Company, 1878), 9.

²⁸ Commencing in 1826 with The Banking Act 1826 (7 Geo. 4, c.46), enabling joint stock unincorporated banking companies to appoint a public officer in whose name the bank could sue and be sued.

²⁹ See *ibid.*, 2.

³⁰ See *ibid.*, 8. Note that this book involves the breaking out of the section on companies found originally in his *A Treatise On The Law of Partnerships, Including its Application to Companies*, n 27 above. The section in Hansard, the official publication of the Houses of Parliament, where permission is granted to bring the Joint Stock Companies Bill forward is sub-headed, *The Law of Partnership*, HC Deb 02 April 1844 Vol. 73 cc 1754-8.

the 'lineal ancestor of the ordinary company' formed under the Companies Acts.³¹ Companies, whether incorporated or unincorporated, were distinct from corporations. Corporations 'in the proper sense of the term' were the product of state action – through Crown charter or statutory charter.³²

This view of incorporated companies reflected the position encoded within the general incorporation legislation. In the 1844 Joint Stock Companies Act, the 'joint stock company,' which the Act requires are registered and incorporated, is defined to include 'every partnership whereof the capital is divided or agreed to be divided into shares, and so as to be transferable without the express consent of all the co-partners [...] and every partnership which at its formation or by subsequent admission [...] shall consist of more than 25 members'.³³ The 1844 Act required as a precondition to registration the production of a 'deed of settlement' signed by the shareholders just as an unincorporated company would be formed by the members signing a deed of settlement.³⁴ The 1844 Act provided, as was typical in unincorporated companies, that the deed of settlement contain a covenant on the part of the shareholders to observe the terms of the deed.³⁵ Section 11 of the 1862 Companies Act – an Act which consolidated the Acts regulating companies enacted between 1844 and 1856 and which is viewed as the UK's first major piece of companies legislation³⁶ – similarly provided that the memorandum of association³⁷ is a contract binding on the members and members inter se.³⁸ However, this provision did not provide that the company, in addition to the shareholders, was bound to observe the contract.³⁹ The failure to notice the legal entity is instructive: corporate personality was a means of addressing identified practical problems associated with the unincorporated company and was not intended to alter the legal relationships amongst those who invested in or carried

³¹ F.B. Palmer, *Company Law: A Practical Handbook for Lawyers & Business Men* (4th ed, 1902), 5.

³² N. Lindley, *A Treatise on the Law of Companies Considered as a Branch of the Law of Partnerships* (6th ed, 1902): 'corporations in the proper sense of the term [...] these must be created by royal charter or by Act of Parliament and to them the law of ordinary partnerships has little if any application'. See also *ibid* (5th ed), 8, 57, 102.

³³ Joint Stock Companies Act 1844, § 2, 7, 8 Victoria.

³⁴ *ibid*, § 3.

³⁵ *ibid*, § 7: 'And such deed must contain a covenant on the part of every shareholder, and a trustee on the part of every company, to perform the several engagements contained in the deed on the part of the shareholders.'

³⁶ Palmer, n 31 above, 1, referring to the 1862 Act as company law's 'Magna Carta'.

³⁷ 25 & 26 Victoria, Cap. 89. The 1862 Act replaced the deed of settlement with the memorandum of association and the articles of association. Prior to 2006, the Memorandum of association was the primary constitutional document akin to a Delaware corporation's certificate of incorporation. Today the memorandum of association is merely a formation document and the primary constitutional document is the articles of association – see §§8 and 17 Companies Act 2006.

³⁸ The 1862 Act, § 11 provided, 'It shall, when registered bind the company and the members thereof to the same extent as if each member had subscribed his name and affixed his seal thereto, and there were in the memorandum contained, on the part of himself, his heirs, executors and administrators, a covenant to observe all the conditions of such memorandum subject to the provisions of this Act.'

³⁹ Note that the courts, unsurprisingly, held that the company was also bound as if it had covenanted to observe the terms of the contract – *Wood v Odessa Waterworks Company* (1889) 42 Ch. 636.

out the business of the company, which were set forth in deed of settlement entered into by the shareholders.⁴⁰

The introduction of incorporation by registration did not simply involve legal conceptual continuity but also, for the business, chronological factual continuity. That is, the starting point for the business was not the creation of the corporate entity; rather business activity and the company were understood to be prior to incorporation. Hence the vocabulary of ‘registration’. Gladstone,⁴¹ requesting leave to move the Joint Stock Companies Bill in 1844, described the Bill’s objective as ‘for the registration of joint-stock companies and conferring on such companies certain privileges of corporate bodies’.⁴²

Through this dominant lens of factual and conceptual continuity, the English incorporated company was viewed predominantly as private: the product of endogenous business activity. The role of the state in creating the incorporated entity was side-lined. Accordingly, UK legislators and commentators in the 19th century did not envisage the corporate form as a concession⁴³ of the state, empowered by the state. In the UK there was no 19th century legal debate, as there was in the United States,⁴⁴ about whether or not a general corporate charter represented a contract between the corporation and the state; whether the corporate charter amounted to a legislative act. References to the relationship between the state and the corporation in leading 19th century UK corporate law texts are absent.⁴⁵

However, this dominant bias towards the private did not completely disregard the public nature of incorporation. Incorporation created a legal entity that benefited from limited liability, which was viewed as a privilege and not the statutory rubber stamping of something that could be achieved by contract.⁴⁶ It was understood that limited liability generated risks for the public and, in particular, for the creditors and that legal protections were therefore required. These protections were provided by restricting what incorporated companies could do through an unalterable memorandum of association – the primary constitutional document. This memorandum, which was not alterable at all until

⁴⁰ A similar provision is found today in § 33(1) of the Companies Act 2006, but one that treats the shareholders and the company as contractually bound.

⁴¹ In 1844 William Gladstone was a minister and President of the Board of Trade. He later served as Prime Minister four times between 1868 and 1894.

⁴² HC Deb 02 April vol 73 cc 1754-8.

⁴³ References to concession can at times be found particular when the interests of creditors are concerned. See *Asbury Railway Carriage Co. v Riche* [1874-80] All ER Rep Ext (2219).

⁴⁴ See, for example, S.D. Thompson, *On The Law of Private Corporations, Vol 1* (1895), 55-77.

⁴⁵ Lindley, n 32 above, and Palmer, n 31 above. The only context in which the idea of legislative authorisation is foregrounded in early English company law is in relation to the capacity of the company and acts that are ultra vires the company. See *Asbury Railway Carriage Co. v Riche*, n 43 above.

⁴⁶ On the adoption of limited liability in the UK, see M.-L. Djelic, ‘When Limited Liability Was (Still) An Issue: Conflicting Mobilisations in Nineteenth Century England’ (European Group for Organization Studies Working Paper, 2011).

1890 unless specifically permitted by the statute,⁴⁷ contained information, among others, about the company's business objects, its limited liability, its name, and its share capital.⁴⁸ The permissions and restrictions of the memorandum were viewed through a public lens. Indeed courts would sometimes refer to the memorandum in this context as a 'charter.'⁴⁹ However, these restrictions on contractibility⁵⁰ did not apply to the governance of the corporation which was left to the subsidiary constitutional document, the articles of association, which could be altered at any time by super majority shareholder resolution.⁵¹

With regard to corporate governance the continuity from the contractual underpinnings of the unincorporated company to the incorporated company was untrammelled. How directors were appointed and removed, when shareholder meetings could be called, the extent of the powers of the directors, and the directors' obligations to the company were subject to specification and variation by the corporate contract. Consider, for example, director power, removal of the directors, and duty of care liability waivers.

With regard to director power, the 1844 Act explicitly empowers the directors.⁵² However, directors' powers 'to conduct and manage the affairs of the company' are not provided directly by the statute but provided 'according to the provisions and [...] restrictions' of the Act and the corporate contract: the deed of settlement.⁵³ That is, the statute delegates board empowerment to the shareholder contract. The Companies Act 1862 went further than this and did not provide for director power at all.⁵⁴ Rather, as with an unincorporated deed of settlement company, the directors were empowered by the shareholders through the

⁴⁷ The Companies (Memorandum of Association Act) 1890 enabled the amendment of the memorandum with court approval for one of seven specified reasons. § 1(5). Prior to 1890 the memorandum could only be altered to increase capital, decrease capital in accordance with the Companies Act 1867, to subdivide its shares, or change its name.

⁴⁸ This meant that while capital could be raised, it could not be reduced, and any activity undertaken outside of its stated objects was void *ab initio*, *Ashbury Railways v Riche* (1875) L.R. 7 H.L. 653. The Companies Act 1867 allowed for court controlled capital reductions. See, generally, D. Kershaw, 'The Decline of Legal Capital: An Exploration of the Implications of Board Solvency-Based Capital Reductions' in A. Reisberg and D. Prentice (eds), *Corporate Finance in the UK and US* (Oxford: OUP, forthcoming in 2011).

⁴⁹ *Ashbury Railways v Riche*, *ibid*, 668.

⁵⁰ See Whincop, n 18 above, first using the term 'contractibility' to characterise the UK's approach to corporate law.

⁵¹ Lord Cairns, in *Ashbury Railways v Riche*, n 48 above, observed in this regard, 'With regard to the articles of association, those articles play a part subsidiary to the memorandum of association. They accept the memorandum of association as the charter of incorporation of the company, and so accepting it, the articles proceed to define the duties, the rights and the powers of the governing body as between themselves and the company at large, and the mode and form in which the business of the company is to be carried on, and the mode and form in which changes in the internal regulations of the company may from time to time be made.'

⁵² Joint Stock Companies Act 1844, § 27.

⁵³ *ibid*, § 23. It is noteworthy that the deed of settlement did not allow shareholders through the deed of settlement to retain powers of ordinary management.

⁵⁴ Model Articles issued through secondary legislation and known as 'Table A Articles' provided for the delegation of corporate power and authority to the board to manage and direct the company. In the absence of general or specific (in relation to particular articles) contrary intent on the formation of the company, such model articles would be adopted by the company.

company's constitution, a document which could only be altered by the members and, as contrasted with most US jurisdictions, in relation to which the board had no amendment veto.⁵⁵ Accordingly, for a UK incorporated company director power was not original but clearly delegated by the shareholders through the constitutional documents. Palmer's Company law observed that the 1862 Act 'leaves the members entirely free to determine how and by whom the business shall be managed.'⁵⁶ Note also that power, pursuant to the 1844 Act, and subsequent model articles of association, is delegated to the directors and not to the board of directors.

Accordingly, from the inception of incorporation by registration a UK incorporated company may have been created by a process of registration, but its ability to function through representative directors was dependent upon what powers the shareholders were willing to confer through contract. Contract was, and is, at the heart of the conception of the corporation in the UK and at the heart of board power. In *Ernest v Nichols*,⁵⁷ a case dealing with a company formed under the 1844 Act, counsel for the appellants who were challenging the legality of a sale of all the company's assets to a company controlled by the company's directors argued that 'directors are trustees for their shareholders and have no power whatever beyond what is given them by their deed of trust'. Agreeing with counsel, Lord Wensleydale held that the deed 'restrict[ed] and regulate[d] their authority'.⁵⁸

With regard to director removal, until the Companies Act 1947 there was no statutory provision dealing with the removal of directors.⁵⁹ Removal was dealt with by the corporate contract, which could be fashioned in any way that the shareholders determined, but once fashioned it would be enforced by the courts until amended by the shareholders. Nineteenth century courts made it clear that there was no inherent power of removal as an incident of the corporate entity; there was simply the corporate contract. 'You must look,' held Lord Justice Bowen in *Imperial Hydropathic Hotel Company v Hampson*, 'when you are considering the question of dismissal of a director, to see whether the articles of association have been complied with.'⁶⁰

Contractibility extended beyond director appointment and removal to all aspects of the directors' actions. Below we shall consider this in detail in the context of self-dealing. Even the duty of care was viewed as being legitimately contractible. It was common practice in UK companies until 1929⁶¹ to include duty of care liability waivers in the articles of association, similar to those that are

⁵⁵ See, for example, the General Corporation Act of New Jersey (revision of 1896), § 27, providing for board and shareholder approval.

⁵⁶ Palmer, n 31 above, 146.

⁵⁷ (1857) 6 HLC 401.

⁵⁸ 8 App. Cas (1882).

⁵⁹ Companies Act 1947, § 29m, subsequently consolidated into the Companies Act 1948, § 184.

⁶⁰ (1882) 23 Ch.D.1.

⁶¹ See *In re Brazilian Rubber Plantations* [1911] 1 Ch 425.

now permitted in Delaware pursuant to Section 102(b)(7) of the Delaware General Corporate Law. However, these waivers did not require statutory permission, but were found by the courts to be enforceable.⁶² The courts' determination that they were enforceable in the litigation arising out of a major insurance fraud resulted in the legislature amending the Companies Act to render such waivers void.⁶³ Statutory action was required to constrain the underpinning contractibility of UK company law.

B. THE UNITED STATES: A PUBLIC CONCEPTION OF THE CORPORATION

1. Incorporation as state and private action

Above we have seen that English company law viewed the incorporated company and its governance structure less as the product of public action but more as public gloss on existing private activity. This contrasted with the perception of the chartered or statutory company, which were corporations 'in the proper sense of the term'⁶⁴ and which clearly involved the state's direct top-down facilitation of public or private activity.

In contrast, in the United States the introduction of general corporation statutes was viewed as an extension of the power of states to grant corporate charters.⁶⁵ Although the granting of individual statutory charters was relatively commonplace for trading corporations,⁶⁶ at least when compared to the UK,⁶⁷ it was widely seen as a process infected by corruption, patronage and rent seeking.⁶⁸ General incorporation addressed such problems by effectively making statutory chartering available on compliance with prescribed formalities. When states began enacting general incorporation statutes from the mid-1800s,⁶⁹ these were viewed as a democratic extension of statutory chartering; a more readily assessable form of statutory chartering.⁷⁰ Accordingly, the legal conception of the specifically chartered corporation as a creature of legislative action, the statutory grant of a

⁶² *In re City Equitable Fire* [1925] Ch. 407.

⁶³ Companies Act 1929, § 129.

⁶⁴ Lindley, n 32 above, 8.

⁶⁵ See J.K. Angell and S. Ames, *A Treatise on the Law of Private Corporations Aggregate* (7th ed, 1861), ch II, treating statutory companies and generally incorporated companies as different exercises of state power.

⁶⁶ *ibid*, 47: 'In no country, indeed, have corporations been multiplied to so great an extent, as in our own; and the extent to which their institution has here been carried, may very properly be pronounced astonishing.'

⁶⁷ Angell and Ames, n 65 above, 41, observe, for example, that 'it has never been the policy in England, as in this country to adopt, as a practice the conferring of full and unqualified corporate privileges upon a body of men associated for the purposes of trade. Corporations have occasionally been permitted, in England, to engross some business to the exclusion of natural persons [...]'.⁶⁸

⁶⁸ M.J. Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1985) 88 *West Virginia Law Review* 175, 181; J.W. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* (Charlottesville: University Press of Virginia, 1970), 9.

⁶⁹ See the list of General incorporation statutes provided in Justice Brandies' judgment in *Liggett Co. v Lee* 288 U.S. 517 (1933). On the types of statute for the different industries see Thompson, n 44 above, 99-126.

⁷⁰ V. Morawetz, *The Law of Private Corporations* (1882), 17.

privilege or franchise,⁷¹ naturally applied to the generally incorporated company. In *State v Penn-Beaver Oil Co* Chief Justice Pennewill of the Delaware Supreme Court observed that ‘the defendant corporation was organised under the general incorporation law of the state, but its legal status would have been the same if it had been created by a special act of the legislature’.⁷² This conception is, of course, very well known. Every student of corporate law in the United States is familiar with Justice Marshall’s definition and conception of the corporation set forth in *Dartmouth College v Woodward*,⁷³ a case involving a specifically chartered company. ‘A corporation’ he held was ‘creature of law’, an ‘artificial being, invisible, intangible, existing only in contemplation of law. Being the mere creature of law, it possesses only those properties, which the charter of its creation confers upon it, either expressly or as incidental to its very existence’.

While there is much discussion in the US literature on whether the conception of the corporation described by Justice Marshall evolved and changed during the course of the 19th century,⁷⁴ what is clear is that the presence of the state as the creator of the corporation hardly recedes during this period. Writing in 1861 Angell and Ames distinguish a partnership from a corporation by noting that the latter involves confirmation of the coming together of property and labour by an ‘indispensible’ ‘special legislative authority’;⁷⁵ a corporation is ‘a body created by law composed of individuals’.⁷⁶ Writing in 1895 Seymour Thompson commences his analysis of ‘Creation by Special Charters’ by observing that ‘nothing less than sovereign power can create a corporation’.⁷⁷ He commences the subsequent section on general incorporation, ‘Organisation under General Laws’, by observing that ‘a corporation can only be created by or under authority of a sovereign power, which in this country is expressed in the Acts of the Legislature’.⁷⁸ For Cook, writing in 1898, ‘the state creates the corporation upon the application of individuals, who are called incorporators. The incorporators then organize the corporation.’⁷⁹ Even Victor Morawetz, who is viewed by some commentators as being at the vanguard of late 19th century attempts to portray the corporation as an aggregation of private actors with much in common with a partnership,⁸⁰ cannot avoid foregrounding the legislative act central to corporate

⁷¹ As Angell and Ames explain, the word ‘franchise’ is used by Blackstone ‘in its most extensive sense [to be] expressive of great political rights. It is in this sense that the word is applied by Blackstone, when defining a corporation, and not in the less general sense [...] sense of the exclusive exercise of some right’. n 65 above, citing W. Blackstone, *Commentaries On The Laws of England* (1769), 37.

⁷² 34 Del. 81 (1926).

⁷³ 17 U.S. 518 (1819).

⁷⁴ See Horwitz, n 68 above. See, generally, J.C. Coates IV, ‘State Takeover Statutes and Corporate Theory: The Revival of an Old Debate’ (1989) 64 *New York University Law Review* 806.

⁷⁵ Angell and Ames, n 65 above, 32.

⁷⁶ *ibid*, 1.

⁷⁷ n 44 above, 31.

⁷⁸ *ibid*, 127.

⁷⁹ W. Cook, *A Treatise on the Law of Corporations Having Capital Stock* (4th ed, 1898), 6.

⁸⁰ Horwitz, n 68 above, citing Morawetz in support of the proposition that ‘up until the 1880s there was a strong tendency to analyze corporation law not very differently from the partnership’. Note that as

creation. For Morawetz a corporation is formed only ‘when authorised by an Act of the legislature’ and supports this position with a quotation from Cowen J in *Thomas v Dakin* on the distinction between a partnership and a corporation:⁸¹

The difference consists in this: the former are authorised by the general law among natural persons exercising their ordinary powers; the latter by a special authority, usually if not necessarily emanating from the legislature conferring privileges.

As a consequence of viewing general incorporation as a logical extension of statutory chartering, the charter of a generally incorporated company was viewed both as a legislative act – even though some of the terms of the charter, pursuant to the Act, are filled in by the by the incorporators – and as a compact or contract between the state and the corporation. Angell and Ames observed in this regard ‘that private corporations are created by an act of the legislature, which, in connection with its acceptance is regarded as a *compact*, and one which, so long as the body corporate faithfully observes, the legislature is constitutionally restrained from impairing’.⁸² In the Missouri case of *O’Brien v Cummings*,⁸³ the Court observed that ‘the law and the articles of association become, as it were, the compact between the state and the association, and this constitutes the charter of the body politic’. The New Jersey Court of Chancery in *Ellerman v Chicago Junction Railways & Union Stock Yards Co.*⁸⁴ held that:

The constitution providing that ‘the legislature shall pass general laws under which corporations may be organized, and corporate powers of every nature obtained,’ and the General Corporation Act being, as it now stands, passed in obedience to the mandate of the constitution, the certificate required by that Act becomes the charter of the company, and *the equivalent of the former special act of the legislature* (emphasis supplied).

The prominent presence of the state does not, of course, crowd out the idea of the corporation as the aggregation of business and investor interests and participants, which is a central component of the conception of the American generally incorporated corporation. This aggregate component of the corporation is present in the early pre-general incorporation case law and is hard-wired into the earliest of general incorporation statutes. In the 1841 New York case of *The Bank*

addressed in the next section, if at the heart of partnership is contract, the US corporation was not understood in partnership terms in the 19th century. Note also that Morawetz’s view was not widely held by other commentators. Ames writing an extremely complementary review of the second edition of Morawetz’s text observed that ‘we should be glad to see some modification of his fundamental conception of the nature of the corporation’. (1887) 1 *Harvard Law Review* 110.

⁸¹ 22 Wend. 9. (1839). Morawetz, n 70 above, 8.

⁸² Angell and Ames, n 65 above, 22.

⁸³ 13 Mo. App. 197 (1883).

⁸⁴ 49 N.J. Eq. 217 (1891).

of *Watertown v The Assessors of the Village of Watertown* the court held that ‘a corporation aggregate is a collection of individuals united in one body under a grant, securing a succession of members without changing the identity of the body, and constituting the members one artificial person capable of transacting business of some kind like a natural person’. Section 1 of the New York Act *Authorising the Formation of Corporation for Manufacturing, Mining and Mechanical and Chemical Purposes* of 1848 provides that ‘any three or more persons may *form themselves into* a corporation in the manner specified and required in and by the Act’ (emphasis supplied).⁸⁵ But for commentators of this period aggregate is always enveloped in state action. Consider Thompson Seymour’s *Commentaries on the Law of Private Corporations* in this regard:

The most usual conception of a corporation is that it is a collection of natural persons, joined together by their voluntary action or by legal compulsion, by or *under the authority of an act of the legislature*, to accomplish some purpose, pecuniary ideal, or governmental, *authorised by the legislature*, under a scheme of organisation and by methods thereby *prescribed or permitted* (emphasis supplied).

The fact that the corporation is in some notable respect the product of state action is trivial if not banal within US corporate legal discourse. But, comparatively, when juxtaposed next to the legal conception of the UK company, this focus on the role of the state is shown to be a distinctive aspect of the conception of the US corporation. In the United States the corporation is a different creature than it is in the United Kingdom: in the US, a private entity that is firmly contained within the orbit of public creation; in the UK an endogenous private association assisted by the state provision of entity status in order to address some of the practical difficulties associated with unincorporated business activity. Accordingly, in contrast to the UK in the US there is neither general incorporation statutes nor in any 19th century commentaries any sense of organisational continuity resulting from the incorporation of large-scale unincorporated business activity. Nor is there any sense of regulatory continuity with the legal rules and structures governing such unincorporated entities.

2. *Non-contractibility*

Some commentators have argued that early corporate law in the United States was heavily influenced by partnership law. This is incorrect. At its heart partnership law is rooted in contract: the provision of default rules that may be contractually

⁸⁵ A provision that bears a close resemblance to the UK Companies Acts association clause. See, for example, the Companies Act 1862, § 6: ‘Any seven or more persons associated for any lawful purpose may, by subscribing their names to a memorandum of association [...] form an incorporated company with or without unlimited liability.’

varied by the members.⁸⁶ Yet the contractibility of US corporate law in the 19th century was significantly attenuated. Of course, the by-laws of the corporation, which provided for ‘the government of [the corporations] members and officers in the management of its affairs’, delegated significant rule-making authority to shareholders, and in some instances directors. However, the by-laws were a subordinate constitutional document responsible primarily for regulating the procedural aspects of corporate activity.⁸⁷ Corporation statutes made it clear that to the extent to which the constitution was capable of addressing the core issues of the power and authority of the board and the obligations of the directors, they must be addressed through the certificate and only to the extent permitted by the statute. Governance was not, as it was in the UK, left to contract.

Arguably, this stance follows logically, in both the US and the UK, from the allocation of corporate power to the board. In the UK corporate power is located with the shareholders and its distribution left to the shareholder contract. It follows then that the rules relating to the exercise of that power should similarly be subject to the same contract. In the United States board power was addressed in the statute.⁸⁸ The statute created and empowered the corporation and the board, and it necessarily followed that only the statute could permit variation of the power distribution and the rules associated with the exercise of power. Typically statutes provided for variation. However, the courts policed the power of variation very restrictively, in many instances striking down attempted contractual variation of governance rules.

The reasons why courts refused to allow contractibility in relation to certain governance rules, and the reasons why market participants appear to have been less aggressive than their UK counterparts⁸⁹ in attempting to contract around the prevailing rules, are rooted in the idea that the corporation’s structure and the power and obligations of the board are the product of public / state action and therefore cannot be amended without the explicit permission of the state. In the

⁸⁶ N. Lindley, *A Treatise on the Law of Partnership* (5th ed, 1888), 2, observing that ‘[p]artnership, although often called a contract, is in truth the result of a contract; the relation which subsists between persons who have agreed to share the profits of some business’ in UK partnership law. C. Bates, *The Law of Partnership* (1888), 2, observing that ‘[p]artnership is a contract relation [...] an agreement of partnership, like any other contract must be founded on a consideration either of mutual promises or contributions’ in US partnership law.

⁸⁷ The General Corporation Law of New Jersey 1896, § 1(4).

⁸⁸ For example, the New York Act to Authorize the Formation of Companies for Manufacturing Purposes 1848, § 3 provided that ‘the stock property and concerns of such company shall be managed by not less than three, not more than thirteen, trustees’. In New York, The Act to Provide For the Organization and Regulation of Certain Business Corporations of 1875 [as amended as of 1881], § 10 provided that ‘[t]he business of every corporation shall be managed by a board of directors’. In New Jersey The Act Concerning Corporations in the State of New Jersey [as amended as of 1892], § 16 provided that ‘the business of every such company, shall be managed and conducted by the directors’. The New Jersey Corporation Act of 1896, § 12 provided that ‘the business of every corporation shall be managed by its directors’. In *Plaguemines Tropical Fruit Co. v Buck* N.J. Eq. 219 (1893), the court observed that ‘the board of directors is the legal executive as such, not only in practice and on principle, but by the statute’.

⁸⁹ This conclusion is based on the limited number of cases addressing the contractibility of core governance rules such as variation of, or liability waivers for breach of, fiduciary duties.

New Jersey case of *Andenried v East Coast Milling Co*,⁹⁰ the Chancery Court considered the East Coast Milling Company's charter amendment which purported to opt-out of the 'eminently wise and just' common law rule requiring the board to take action through collective, real-time board action rather than allowing a decision to be taken by each director giving separate written consent.⁹¹ The starting point for the Court was the New Jersey Corporation Act and the extent to which it could be interpreted to allow such adjustments: to what extent had the New Jersey Corporation Act granted the incorporators who had amended the charter 'the power to legislate'?

The New Jersey Corporation Act, as revised in 1896 and amended in 1898, contained a provision, which today is found in the same form in section 102(b)(1) of today's Delaware General Corporation Law, providing that the certificate could contain provisions 'creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders [...] provided such provision be not inconsistent with this Act'.⁹² The words 'creating' and 'defining' were added in 1898, prior to which, by implication, an amendment that did anything but limit powers of the corporation and the directors was not authorised by the statute.⁹³ A literal reading of this provision would suggest that a charter provision providing for written board resolutions could clearly fall within the regulation of the powers of the corporation and the directors. However, the court in *Andenried* rejected such a broad reading, and held, narrowly, that the provision allows variation of the powers of the corporation, not the method of exercising the power which 'must conform to settled legal principles'. Any ability to contract out of such important principles must, according to the court, be expressly authorised by the legislature and was 'not to be inferred from ambiguous expressions'. For the New Jersey Chancery Court these rules belonged to a structure of governance provided by the legislature designed to enable the corporation to function but also to protect the public interest implicated by incorporation. The fundamental building blocks of this structure are accordingly only alterable by the shareholders with the

⁹⁰ 68 NJ Eq 450 (1904).

⁹¹ The court cited Clark and Marshall, *Corporations* 2074, § 677, and *First Nat. BK of Ft. Scott v Drake*, 35 Kan. 564.

⁹² New Jersey Corporation Act [as amended, 1898], § 8(VII). A similar provision was introduced into the New York Business Corporation Law and enabled amendments to the certificate which limited the powers of directors provided that such amendment 'does not exempt [the directors] from any obligation or from the performance of any duty imposed by law'. New York Business Corporation Law, amended by the 1892 Act to amend the business corporation law, § 2(9).

⁹³ The words 'creating' and 'defining' were added by amendments to the 1896 Act passed in 1898. See J.D. Dill, *Private Companies Under the General Corporation Act of New Jersey* (New Jersey: treatise, 2nd ed, 1899), 21, describing the provision as 'one of the most important provisions of the Corporation Act' and observing that it carried 'to its logical result the principle laid down in *Ellerman v. Chicago Junc. Rys., & Co.* 49 N.J. Eq. 217, that the certificate of incorporation is equivalent to a special act of the legislature' and amounts to a 'delegation to [incorporators] of the law making power of the legislature'. Provisions providing for the limitation of the powers of the corporation and the directors were introduced in New Jersey in 1889 and in New York in 1892, prior to which, by implication in relation to the powers of the corporation and the directors the certificate was not amendable at all.

legislature's explicit authorisation to do so. Vice Chancellor Bergen in *Audenried* put this position as follows:

The proposition that the stockholders, in assenting to this provision in the articles of association, waived the advantage and protection they would enjoy under the common law and our Corporation Act, does not meet the case. Stockholders may waive an advantage, but *they cannot by waiver ordain a method of corporate action which the law does not recognize*, nor dispense with the aid of a board of directors as a means of corporate action. Such a course is not sanctioned by our law, and is inconsistent with the twelfth section of our Act, which requires that 'the business of every corporation shall be managed by its directors.' *But we ought not to confine the consideration of this question to the relationship existing between the stockholders and the directors.* The business of the state is to a large extent carried on by corporations, and their transactions directly and vitally affect the interests of all the people. *In committing the transaction of business so generally to corporations, the Legislature may be presumed to have provided for, and recognized deliberative meetings of directors as a safeguard to the public interest,* which presumption ought not to be overthrown by a forced construction of the Act. The *fundamental idea* of a business corporation involves an advantage coming from the aggregation of wisdom, knowledge, and business foresight which results from bringing a large number of stockholders and directors into a common enterprise. It is their knowledge and wisdom combined, acting as a unit, that gives efficiency and safety to the corporate management. I am satisfied that the section of this charter now under consideration is contrary to the provisions of our Corporation Act, and that there is no express or implied authority conferred thereby which will allow a corporation to determine, in its articles of association, that its board of directors may avoid the performance of their duties in the manner required by the word and spirit of our act and the well-settled law on that subject. To permit it would ingraft upon the law a vicious and dangerous power, and in *the absence of express legislative authority* I am unwilling to sanction it (emphasis supplied).⁹⁴

Audenried shows that the state's interests are necessary considerations when assessing the extent to which incorporators and shareholders can mould the governance structure of the corporation as set forth in the charter, the statute and the existing body of common law and equitable rules – 'the settled legal principles' – applicable to the company. While no attempt is made to define or enumerate the non-variable rules falling under the umbrella of 'settled legal principle', it is clear from the case law that the core rules and obligations associated with the exercise of corporate power and the office of a director fall within this category. These rules are part and parcel of the legislative creation of the corporation. Corbin writing in 1892, in his annotated text on the New Jersey

⁹⁴ *Audenried v East Coast Milling Co*, n 90 above.

Corporation Act observes, for example, that ‘duties required of an incorporated company are in the nature of conditions annexed to the grant of the franchise’⁹⁵ Writers and judges in this period would have willingly extended this observation to the duties of directors as well as of corporations.⁹⁶

To be clear, it is not that such core rules are not variable at all but that they are variable *only* pursuant to an enabling permission set forth in the Corporation Law and *only* where, in the absence of the explicit authorisation of the legislature to do so, any variation pursuant to such permission does not vitiate a core governance rule and any protection it grants. Consider for example the Delaware case of *State v Penn-Beaver Oil Co.*,⁹⁷ where a stockholder was denied access to inspect the corporation’s books and records based upon a provision in the charter which modified the stockholder’s common law inspection rights. The starting point for Chief Justice Pennewill of the Delaware Supreme Court, similar to the New Jersey Chancery Court in *Audenried*, was that such a provision would only be legitimate if authorised by the state through the Delaware General Corporation Law because if it was ‘it would be as effective as if the legislature had granted it by direct and special act’. The portal for answering this question was whether such a provision fell within the same enabling provision considered in *Audenried*, namely the power to create, define, and limit the powers of the corporation and the directors provided that such provisions were not contrary to the law of the state.⁹⁸ The court held that had a power of variation been applicable to this common law rule then the court would have expected the legislature to have granted this power explicitly. However, the legislature had not done so, and indeed ‘it probably would have been difficult, if not impossible, to induce the legislature to grant such a power’. Accordingly, the charter provision was invalid.

Subsequent Delaware decisions have arguably struck a more lenient tone. In *Sterling v Mayflower Hotel Corp.*,⁹⁹ for example, the Delaware Supreme court approved a charter provision permitting interested directors to count in a quorum. For this court, the contractibility of common law rules was permitted by the variation provision; the limits of this contractibility being set by statutory enactment or ‘a public policy settled by the common law or implicit in the General Corporation Law itself’. ‘Public policy’ acts here as an opaque receptacle into which a court can place the corporate legal rules that it deems sufficiently important to be non-contractible. Importantly, it was clear in *Sterling*, as in other cases where charter provisions address self-dealing transactions,¹⁰⁰ the fundamental regulatory protections which Delaware law applies to self-dealing

⁹⁵ W.H. Corbin, *The Act Concerning Corporations in the State of New Jersey* (New Jersey: F.D. Linn & Co., 1892), 8 fn (t).

⁹⁶ See *Whalen v Hudson* 170 N.Y.S. 855 (1918) for an example of the invalidation of a self-dealing opt-out.

⁹⁷ 34 Del. 81 (1926).

⁹⁸ Delaware General Corporation Law (as of 1926), § 5.

⁹⁹ 33 Del. Ch. 293 (1952).

¹⁰⁰ *Helfman v American Light and Traction Company* 121 N.J. Eq. 1 (1936).

transactions, namely at this time fairness review, cannot be removed through charter provision.

With regard to the directors' powers and obligations, a closely related strand of argument, which curtails the scope for contractual variation of such powers and obligations, is the view that the organs of the corporation – the board and the shareholder meeting – are the product of state action. and as such, power to vary the obligations owed by directors and to relieve directors of liability for breach of those obligations cannot be exercised by the shareholder body. Only the state acting through the legislature or through the courts can alter the obligations or provide relief from liability for breach. We see this clearly articulated in *New York Dock Company v McCollum*,¹⁰¹ where the Official Referee, in holding that a director was not entitled to indemnification for his litigation expenses, observes that the director 'derives his powers and authority neither from the stockholders nor from the corporation. His status is sui generis. His office *is a creature of the law.*' As such, drawing on an earlier New York case involving a municipal corporation, a right to indemnification is unavailable because the risk assumed by the director is 'exactly like the risk assumed by an officer of a municipal corporation' and, citing *Matter of Chapman v City of New York*,¹⁰² 'when a citizen accepts a public office, he assumes the risk of defending himself against unfounded accusations at his own expense.' Accordingly, indemnification could only be granted by 'judicial sanction' (state action) based 'upon equitable considerations' (by implication,¹⁰³ regardless of any indemnification provision in the charter). It follows from this analysis that any attempt to provide for indemnification for breach, or indeed waiver of liability for breach, requires an enabling provision in the Statute: the state must permit indemnification or variation. And indeed, as is well known such legislative provisions have represented some of the most important amendments to corporate codes over the past century.¹⁰⁴

When we turn to 19th century corporate texts what is striking for a UK company lawyer is the absence of serious discussion about the scope for the shareholders to vary the governance structure and the obligations of directors through contract. Discussions about charter amendment are typically taken up with discussions about the scope for the state to amend the charter and the conditions which determine the validity of such amendments.¹⁰⁵ For US corporate legal discourse and corporate lawyers in the 19th century the contractibility of core governance rules amounted to a legal non-sequitur. It made no sense within the state-based conception of the corporation. As we shall see in Part II of this article,

¹⁰¹ 16 N.Y.S. 2d 844 (1939).

¹⁰² 168 N.Y. 80. (1901).

¹⁰³ By implication because there was no charter amendment in this case.

¹⁰⁴ See amendments to the Delaware General Corporation Law allowing corporations to provide for director indemnification. See, generally, S. Arshat and W.K. Stapleton, 'Delaware's New General Corporation Law: Substantive Changes' (1967) 23 *Business Law* 75, 77-80; and the amendment to the Delaware General Corporation Law, § 102(b)(7), providing for duty of care liability waivers, now set forth in Del. Code Ann.tit § 102(b)(7) (1986).

¹⁰⁵ See, for example, H.O. Taylor, *The Law of Private Corporations* (Philadelphia: Kay & Brother, 3rd ed, 1894), 407-507.

both in the case law and the commentary there is significant legal borrowing and transplantation from UK case law addressing issues arising from what were in many respects for both jurisdictions *sui generis* legal institutions. However, when borrowing the English case law, US law filters out the contractarian milieu of UK company law: the substantive legal rules travel; their contractibility does not.

US commentators have argued that different conceptions of the corporation dominated the understanding of the corporate enterprise at different points during the 19th century, commencing with a move from a state empowerment entity theory, to a partnership based theory of the corporation between the early 1880s and the turn of the century, which in turn is replaced by an organic ‘real entity’ theory of the corporation.¹⁰⁶ Although such conceptual evolution may – and the article takes no position on this – have been operable in the public, political and constitutional legal debates about the corporation in the 19th century and early 20th century, it is not a stage theory of the conception of the corporation which makes sense of the law’s internal- or self-conception of the corporation which maintains a consistent commitment to the state empowerment conception of the corporation. One only has to juxtapose the US corporate texts that are said by some commentators¹⁰⁷ to represent the high-water mark of the 19th century’s partnership conception of the US corporation next to Lindley’s *Treatise on Company Law as a branch of the Law of Partnerships* to realise that the central contractual component of partnership was missing from the US conception.

II THE FORMATION OF CORPORATE SELF-DEALING LAW

In the 19th century, both in the United States and the United Kingdom, directors of corporations were readily viewed as, or at least labelled, trustees of the corporation. Like trustees, directors performed a representative function. Indeed in many early US general incorporation statutes directors were referred to as ‘trustees’.¹⁰⁸ This analogy to the trustee enabled the transplantation of fiduciary law to fill in the gaps left by general incorporation statutes in relation to the expectations and duties of directors.

When any rules are borrowed to address a problem of first impression, across subject areas or across jurisdictions, the context and background of the legal ‘transplantator’ will affect the types of rules that are borrowed, those that are left behind, and the ways in which the borrowed rules are interpreted and explored. Here we are concerned with a central aspect of the systemically provided background of 19th century corporate lawyers: their conception of the corporation

¹⁰⁶ Horwitz, n 68 above; Coates, n 74 above.

¹⁰⁷ *ibid.*

¹⁰⁸ New York Act to Authorize the Formation of Companies for Manufacturing Purposes 1848, § 3.

and of corporate power. We ask how do the distinctive conceptual backgrounds of UK and US lawyers inform the process of transplanting fiduciary law rules to address corporate self-dealing? How did this background inform 19th lawyers' attempts, as well as their perception of the need, to tailor fiduciary law to the corporation in a way that was responsive to the instrumental economic needs of market participants?

A. THE EVOLUTION OF SELF-DEALING LAW IN THE UNITED KINGDOM

1. *Directors as trustees*

19th century English company law naturally looked to trusts law to regulate the behaviour of directors of both unincorporated and incorporated companies. Directors were viewed as 'in some sense trustees'.¹⁰⁹ As Professor Sealy has observed, it is often assumed that the application of trustee duties to directors of companies incorporated by registration flowed from the application of trust law obligations to deed of settlement companies whose directors literally were trustees, because a deed of settlement company was a legal construction made up of trusts law and contract. However, Sealy has shown that this is incorrect. In most instances the directors of deed of settlement companies, in relation to whom corporate law borrowed from trust law, were different individuals than the trustees. For Sealy the application of trusts law doctrine to directors of unincorporated and incorporated companies alike followed logically from the nature of directorial role: quite simply they were trusted by the shareholders to act on behalf of the company; *entrusted* with the management of the company's assets.¹¹⁰

For the first companies incorporated by registration under the Joint Stock Company Act of 1844 it was unnecessary to borrow from trusts law to address self-dealing contracts as the Act addressed these transactions directly. Section 29 of the 1844 Act disabled a conflicted director from acting in relation to such transactions and, reflecting the trust law position we shall discuss below, rendered such transactions unenforceable without shareholder approval. However, by the

¹⁰⁹ *Charitable Corporation v Sutton* (1742) 2 Atk 400. See Palmer, n 31 above, 147, observing that that 'it is impossible to dispute the proposition that [directors] are in some sense trustees, that proposition having been established by a long series of cases' [emphasis added]. See also *Forest of Dean & Co* (1879) 10 CD 450 – see, generally, Palmer, n 31 above, 148. The labelling of directors as trustees took two different guises: the first was simply to call them trustees; the second, and clearly more accurate, approach was to identify them as trust-like or, in the English context, as quasi-trustees. Courts were aware that the analogy was a general one. Consider, for example, Lord Justice Bowen's dicta in *Imperial Hydropathic Hotel Company v Hampson* (1882) 23 Ch.D. 1: 'When persons who are directors of a company are from time to time spoken of by Judges as agents, trustees, or managing partners of the company, it is essential to recollect that such expressions are used not as exhaustive of the powers or responsibilities of those persons, but only as indicating useful points of view from which they may for the moment and for the particular purpose be considered [...] It is not meant that they belong to the category, but that it is useful for the purpose of the moment to observe that they fall *pro tanto* within the principles which govern that particular class.'

¹¹⁰ In *York Rail. Co. v Hudson* (1853) 16 Beav. 485, Romilly MR held that 'the directors are persons selected to manage the affairs of the company for the benefit of the shareholders. It is an office of trust which, if they undertake, it is their duty to perform fully and entirely'.

Joint Stock Companies Act of 1856 this provision had disappeared from the Act, leaving the regulation of self-dealing transactions to rely on the court's adaptation of fiduciary law to the company.

For whom the directors of an incorporated company were trustees or had trustee-like responsibilities, and to whom they owed their obligations of trust, were questions with which English company law struggled somewhat in the 19th century. Today UK company lawyers will readily inform you that directors are appointed by the company through the shareholders acting in general meeting, and it follows that the directors' duties of loyalty and care are owed to the company not to the shareholders. But this was less clear to 19th century company law. Logically obligations are owed by a 'trustee' to the person who empowers you to act and to any other person who the person who empowers you to act directs you to act on behalf of. In *Charitable Corporation v Sutton*,¹¹¹ a case involving a chartered corporation, Lord Hardwicke, the Lord Chancellor, put it as follows: '[Directors]¹¹² are most properly agents of those who employ them in this trust, and who empower them to direct [and] superintend the affairs of the corporation.' This view was the basis for his conclusion that the 'foundation' of the director's 'charge' 'was of a mixed nature: It partakes of the nature of a public office, as it arises from the charter of the Crown.' Applying this logic, it would follow that in a UK company which is incorporated by registration, as the directors are empowered by the shareholder body through the corporate contract, the obligation of trust is owed to shareholders, unless the shareholders direct that it is owed to someone else. In this regard, Lindley observed:

It is part of the contract into which the members of a company enter, that the management of its concern shall be confided *to a few chosen individuals*. But whilst this contract limits the right of each member to interfere in the conduct of its affairs [...] it, if possible, increases the obligations of the directors to observe good faith *toward the great body of shareholders* to attend diligently to their interests and to act within the limits of *the authority conferred on them*. Directors are not only agents, but to a certain extent trustees. Their position, however, is very different from ordinary trustees, whose primary duty is to preserve the trust property and not to risk it. Directors have to carry on business and this necessarily involves risk. The duty of directors to shareholders is so to conduct the business of the company, as to obtain for the benefit of the shareholders the greatest advantages that can be obtained consistently with *the trust reposed in them by the shareholders* and with honesty to other people; and although it is true that the directors have more power, both for good and for evil, than is possessed by the shareholders individually, still that power is limited and accompanied by at trust, and is to be exercised bona

¹¹¹ n 109 above.

¹¹² The case deals with the 'committee men' of the company.

*fide for the purposes for which it was given, and in the manner contemplated by those who gave it [Emphasis supplied].*¹¹³

For Lindley the obligation or expectation of ‘trust’ imposed on directors arises as a result of the shareholders empowering the directors to act on their behalf. Note also the very personal nature of the transfer of power from the shareholders, not to the company or to the ‘board’ but to ‘a few chosen individuals’. The company as an entity is not present in this discussion of director power. The bilateral relationship between trustee and beneficiary was thereby easily grafted on to the director and the shareholder.

An early and important example of borrowing from trust law was the self-dealing case of *Aberdeen Railway Company v Blaikie*, a case which is also of considerable importance in 19th century US corporate law. In *Aberdeen Railway v Blaikie*, the Aberdeen Railway Company, a chartered not a registered company,¹¹⁴ purchased railway chairs for train tracks from a partnership called Blaikie Brothers. Mr Blaikie, one of the partners in Blaikie Brothers, was also a director and chairman in the company. The company repudiated the contract claiming that the self-dealing nature of the contract rendered it unenforceable. The House of Lords agreed, holding that the contract was unenforceable regardless of whether or not it was fair to the company. Lord Cranworth, the Lord Chancellor held that:

It is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into. It obviously is, or may be, impossible to demonstrate how far in any particular case the terms of such a contract have been the best for the cestui que trust which it was impossible to obtain. It may sometimes happen that the terms on which a trustee has dealt or attempted to deal with the estate or interests of those for whom he is a trustee have been as good as could have been obtained from any other person; they may even at the time have been better. But still so inflexible is the rule that no inquiry on that subject is permitted [...]

¹¹³ Lindley, n 27 above, 364.

¹¹⁴ In this context, although commentators noted the important conceptual differences between chartered and registered companies (see text to nn 30-32 above), the limited number of chartered commercial companies came to be treated by 19th century courts within the same partnership / contractual paradigm as registered companies. This is unsurprising given that the constitution of chartered companies was set forth in the Companies Clauses Consolidation Act 1845, an act heavily influenced by prevailing arrangements in deed of settlement companies, and which in turn operated as a prototype for the model Table A Articles.

The English authorities on this subject are numerous and uniform [...] ¹¹⁵The inability to contract depends not on the subject-matter of the agreement, but on the fiduciary character of the contracting party.

In *Aberdeen Railway* there are two distinct legal considerations invoked by self-dealing transactions. The first is the duty of loyalty – to avoid putting oneself in a position where duty to the company and personal interest conflict or possibly conflict – an obligation that would be breached only by the self-dealing director. The second is a restriction on the directors’ authority to manage the company, applicable to the authority of *all* directors: the powers delegated to directors are limited by the fiduciary relationship and cannot be deployed to enter into a self-dealing contract. Lord Cranworth refers to the ‘inability to contract’. Counsel for the partnership argued that even though Mr Blaikie was conflicted and participated in the decision to enter into the contract he was but one of several directors who were not conflicted and therefore the contract should be enforceable. Lord Cranworth rejected this claim through the lens of duty holding that ‘it was Mr Blaikie’s duty to give to his co-directors, and through them to the company, the full benefit of all the knowledge and skill which he could bring to bear on the subject’.¹¹⁶ He could, in the alternative, have held that the directors were not authorised to enter into such a transaction given the ‘fiduciary character of the contracting party’.¹¹⁷

The judgment reads as an absolute prohibition on self-dealing. However, it was clear from the trusts authorities relied upon by the court that the informed consent of the cestui que trust, and by analogy the shareholders, could authorise a self-dealing transaction or validate a voidable agreement.¹¹⁸ These self-dealing trust authorities are based upon a contractual theory of authority that views the strict standard as a default rule. The trustees have no authority to enter into a self-dealing transaction unless such authority is explicitly provided by the settler or the beneficiaries.¹¹⁹ That is, the general grant of authority to exercise trust powers is

¹¹⁵ Citing: *Keech v Sandford* Sel. Cas. Ch. 61 (1726); *Whelpdale v Cookson* 1 Ves. Sen. 9 (1741); and noting that ‘the whole subject was considered by Lord Eldon on a great variety of occasions. It is sufficient to refer to what fell from that very able and learned judge in *Ex parte James* Ves. 337 (1803)’.

¹¹⁶ A detailed discussion of the relationship between this holding and the understanding of director power in an English company is deferred to the section on the evolution of New York self-dealing law. See text to nn 208-214 below.

¹¹⁷ More recently, Millett LJ in *Ingram v IRC* [1997] 4 ALL ER 395, 426 observed that ‘a trustee’s power of sale does not authorise the trustee to sell the trust property except to someone with whom he can deal at arm’s length’.

¹¹⁸ See *Ex parte Lacey* 6 Ves. 625 (1802); *Ex parte James*, n 115 above.

¹¹⁹ See *Ex parte James* 8 Ves. Jun. 338 (1802), where Lord Eldon LC observed that ‘the rule is that a trustee shall not become a purchaser, until he enters into a fair contract that he may become a purchaser, with those interested [...] It is a question therefore of prudence [...] whether [the beneficiaries] will permit him to buy’; *Donnes v Grazebrook* [1814-23] All ER Rep 300, per Lord Eldon LC: ‘he continues to be a trustee he cannot, without *the express authority of his cestui que trust*, have anything to do with the trust property as a purchaser. In order to make the sale in the present case a valid transaction, it is, therefore, incumbent on Mr Grazebrook to show that he had *such an authority to enable him to become a purchaser at that sale*’ (emphasis supplied).

qualified and does not extend to self-dealing transactions. In *Benson v Heathborn*, an 1838 self-dealing case involving an unincorporated company, the court put it as follows:

I apprehend that, *without any special provision for the purpose*, it was by law an implied and inherent term in the engagement [of the directors] that they should not make any other profit to themselves of that trust or employment, and should not acquire to themselves, while they remained directors, an interest adverse to their duty (emphasis supplied).¹²⁰

2. Contracting out of fiduciary rules

Companies aware of the potential benefits of entering into self-dealing contracts that were fair to the company, yet also aware of the pitfalls and administrative burdens involved in obtaining shareholder approval for those contracts, responded to the application of these strict rules of equity to companies by contractually amending their application. Typically, companies in their articles of association adopted a variant of the standard constitutional terms imposed on chartered companies which provided that a director's office would be vacated if he became directly or indirectly interested in the contract.¹²¹ The contractual variant provided that the office would only be vacated if the director failed to disclose the contract. By implication such disclosed contracts were enforceable, and the self-dealing directors were not liable to account for any profits they made from the transaction. The question for the courts was therefore whether the demanding obligation of loyalty and the restrictions on authority set forth in *Aberdeen Railway* could be contractually varied. As is clear from the above analysis the view that they could be varied is wholly consistent with the contractual conception of an English company as well as, more specifically, with the contractual theory of authority which underpins both director and trustee power.

In the leading case of *Imperial Mercantile Credit Association v Coleman*,¹²² a director of the plaintiff company purchased debentures at a five per cent discount and sold them to the company at a one and a half per cent discount. The default by the issuer of the debentures resulted in the collapse of the company. The liquidator sued the directors to account for profits made from the self-dealing contract. However, the company had a provision in the articles similar to the constitutional amendment described above. In reaching his conclusion that the director was not required to account for the profits, Lord Hatherley LC sitting in the Court of Appeal was clearly cognisant of the economic policy considerations that support making the rules on self-dealing contracts less restrictive:

The principle [set forth in *Aberdeen Railway*] is so firmly established that I should be extremely sorry to say anything which would in the slightest decree

¹²⁰ 1 Y. & C.C.C. 325 (1842).

¹²¹ Companies Clauses Consolidation Act 1845, § 86.

¹²² L.R. 6 Ch. App. 588 (1871).

impeach it [...] However, the question then remains, whether the company cannot stipulate that this is a benefit of which they do not desire to avail themselves, and if they are competent so to stipulate, whether they may not think that in large financial matters of this description it is better to have directors who may advance the interests of the company by their connection, and by the part which they themselves take in large money dealings, than to have persons who would have no share in such transactions as those in which the company is concerned.¹²³

Lord Hatherley held that the provision in the articles amounted to an enforceable contractual variation of the equitable rule and, as the director had disclosed his interest, he was entitled to keep the profit.¹²⁴ His deference to a contractual conception of the corporation is explicit and forthright. Following on from the above quotation he observes:

It is not for me to say which was the wiser or better course of the two, nor do I think that this Court professes to lay down rules for the guidance of men who are adult, and can manage and deal with their own interests. It would be a violent assumption if anything of that kind were attempted. It must be left to such persons to form their own contracts and engagements, and this Court has only to sit here and construe them, and also to lay down certain general rules for the protection of persons who may not have been aware of what the consequences would be of entrusting their property to the management of others where nothing is expressed as to the implied arrangement.

By viewing the strict fiduciary rules as default rules that could be amended by the corporate contract the instrumental economic need to facilitate contracts between corporations and directors is addressed while leaving the strict standard in place in its purity, untouched by that instrumental economic pressure. Indeed it was clear that the type of contractual variation set forth in *Imperial Mercantile* – disclosure and disinterested director approval – was just one example of the ways that the shareholder body could address self-dealing contracts. They could, quite legitimately, have simply said that the board had authority to enter into such contracts and such contracts would then have been enforceable without disclosure.¹²⁵ This combination of trust law’s fiduciary standards and contractual

¹²³ Counsel for the defendant director submitted that ‘this company, like other similar companies, chose directors who could bring them business, and the company were willing, for the sake of getting that business, to waive the ordinary rules as to directors’.

¹²⁴ Note that the House of Lords (LR 6 HL 189) reversed the Court of Appeal, but only on the basis that the director’s disclosure was insufficient to comply with the provision in the articles. It did not challenge Lord Hatherley’s conclusion that contractual variation was permissible.

¹²⁵ Writing in 1902 Palmer, n 31 above, 159, observes that ‘these are the rules prima facie applicable to such transactions, but a company is at liberty to waive the benefit of those rules, and to allow a director to make a contract, or to be interested in a contract, with the company and regulations [the articles] very

variation left the courts on the side lines with no role to play apart from determining whether there had been compliance with the stipulation in the articles. There was no need for the courts to explore whether fiduciary law could provide a more flexible standard, as companies and shareholders were empowered to provide flexibility themselves.

3. *Detaching contractibility*

Until 1980 UK company law's self-dealing landscape could be accurately and comprehensively summarised by reference to *Aberdeen Railway* and *Imperial Mercantile*. However, although the contractual underpinnings of both the company and fiduciary law provided a swift and simple response to the instrumental economic need for directors to do business with the company, in the long run this resulted in arguably sub-optimal regulation of self-dealing transactions in the UK. The recurring regulatory diagnosis in the UK in relation to directors' duties, typically brought into focus by a corporate crisis or scandal, has been: (i) that company law, formed prior to the separation of ownership and control, assumes that shareholders are active participants in the corporate contract when in reality due to collective action problems and rational apathy they are not; (ii) shareholders need to be protected from the power imbalance created by these collective action problems which managers can exploit by facilitating their company's opt-out of the strict legal standards that hold managers to account; and (iii) it follows therefore that the existing substantive rule should be made a mandatory rule. That is, the UK's repeat regulatory move in response to crisis has been to remove contractibility.¹²⁶ But it has typically done so without any awareness that the substantive legal rules, which are then rendered mandatory, have been formed in the context of contractibility and may have been otherwise *but for* contractibility. This is the lesson which we shall see that the United States provides for the United Kingdom.

Today, UK company law's self-dealing regulation requires shareholder approval where the transaction value is the lower of £100,000 or 10 per cent of the company's value.¹²⁷ Such transactions are known as 'substantial property transactions'. These rules, introduced in 1980 following a corporate scandal,¹²⁸ are mandatory rules. All shareholders, including interested shareholders, can vote. However, if the company is listed on the London Stock Exchange then in relation to non-*de minimis* transactions (0.25 per cent of the company's capitalisation) it is subject to the additional regulation set forth in the United Kingdom Listing Authority's Listing Rules,¹²⁹ which require a disinterested shareholder vote.¹³⁰

commonly make provision accordingly'. See also *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 QB 606.

¹²⁶ Consider, for example, the duty of care and liability waivers. See text to nn 61-63 above.

¹²⁷ Companies Act 2006, § 190-195.

¹²⁸ See 'Substantial Fraud Alleged at L&C' (30 January 1976) *The Times*, 23.

¹²⁹ United Kingdom Listing Authority, Listing Rule 10. Until October 2009 these rules were mandatory for UK companies. Since 2009 UK companies may elect for a 'standard listing' in contrast to a 'Premium Listing' to which such rules do not apply. Most UK listing companies have a premium listing.

This article's central submission is that in order to understand the path of self-dealing law in the UK and the US closer attention needs to be played to the legal drivers of adaption of fiduciary law to commercial concerns. Clearly, as the cases evidence, in both jurisdictions adaption took place in a context where lawmakers were aware of, or irritated by, instrumental economic pressures. It may be the case that the benign aspects of such pressures were over-weighted and that such pressures really represented managerial rent-seeking. However, if such justifications for taking into account these needs and interests are at all benign then the UK's decision to keep the standard while removing its twin of contractibility is cause for concern. The US's experience, particular the trajectory of New Jersey law addressed below, suggests that the UK self-dealing standard would have been different but for such contractibility.

B. THE EVOLUTION OF SELF-DEALING LAW IN THE UNITED STATES

Writing in 1960, Harold Marsh in his seminal article, 'Are Directors' Trustees',¹³¹ articulated a compelling three-stage narrative about the evolution of self-dealing law in the United States. He showed how in the first stage in the wake of the introduction of general incorporation, self-dealing law rendered any self-dealing transaction voidable by the corporation or any shareholder without regard to the actual fairness of the transaction. Commentators in 1880, he observes, would have been able 'with confidence' to have stated that this was the general rule. By 1910, however, the rule had changed to provide that self-dealing transactions were enforceable if fair and approved by disinterested directors. By 1960, according to Marsh, the disinterested director approval requirement had dropped away, and it could be said, as it could be said today:

With some assurance that that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder whether there was a disinterested majority of the board or not, but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.¹³²

Marsh argues that the transition from voidability to disinterested director approval plus fairness and then to fairness alone, is unexplained in policy terms by the

¹³⁰ For transactions below the substantial property transactions threshold, or for listed companies that are *de-minimis*, the contemporary regime requires disclosure in order to be able to keep the benefit of the transaction without obtaining shareholder approval, but in keeping the UK company law's underlying bias in favour of contractibility, it leaves it open to companies to craft other regulatory solutions – Companies Act 2006, § 177.

¹³¹ Marsh, n 15 above.

¹³² *ibid*, 43.

cases. The first transition, he submits, takes place without any attempt to address the strong policy factors articulated in the circa 1880 cases to the effect that if a director is placed in a position in which personal interest is in conflict with corporate interest, then ‘in the majority of cases duty would be overborne in the struggle’.¹³³ Marsh argues that ‘one searches in vain in the decided cases for a reasoned defence of this change in legal philosophy, or for the slightest attempts to refute the powerful arguments which had been made in favour of the previous rule’.

Although Marsh’s view of the evolution of self-dealing regulation is widely accepted in the US corporate legal debate, it is not correct.¹³⁴ This article is not the first to suggest this. In important articles in the 1990s,¹³⁵ Professor Beveridge argued that Marsh’s account was incorrect and that fairness considerations were central to US self-dealing law much earlier than Marsh had identified. However, his views have failed to generate significant traction in the academy and have been either rejected,¹³⁶ relegated to a qualifying footnote to Marsh’s established position,¹³⁷ or forgotten.¹³⁸ The case made by Beveridge is in essence correct but not sufficiently compelling to dislodge the considerable disciplinary investment in

¹³³ *Wardell v Union Pacific R.R. Co.* 103 U.S. 651 (1880).

¹³⁴ Clark, n 16 above, 160-166. See all the articles cited in nn 137 and 138 below, which adopt Marsh’s view. These articles represent only a fraction of the articles that adopt Marsh’s view.

¹³⁵ N.P. Beveridge, Jr, ‘The Corporate Director’s Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction’ (1992) 41 *DePaul Law Review* 655, and ‘Interested Director Contracts at Common Law: Validation Under the Doctrine of Constructive Fraud’ (1999) 33 *Loy. L.A. L. Rev.* 97.

¹³⁶ There is minimal direct assessment of Professor Beveridge’s claim. Those that consider it in more depth have rejected it. In W.L. Cary and M. Eisenberg, *Cases and Materials on Corporations* (New York: Foundation Press, 7th ed, 1995), the claim is considered and rejected. 650-651. In the 8th edition there is no consideration of Beveridge’s position. See also V. Brudney, ‘Contract and Fiduciary Duty in Corporate Law’ (1997) 38 *Bclr* 595, adopting Marsh’s view, but citing Beveridge and noting that ‘[w]hether or not that implementation was as extensively invoked in restraining corporate management and controllers as Marsh suggested, there is no doubt that it was pervasive, particularly in industrial states’; and P. Mcginty, ‘The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism’ (1997) 46 *Emory Law Journal* 163.

¹³⁷ C.R. Taylor, ‘The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little Fear and What Might be Done about It’ (2006) 85 *Or. L. Rev.* 993, viewing Marsh’s position as ‘widely accepted’ although, citing Beveridge, ‘not free from doubt’; J.H. Langbein, ‘Questioning The Trust Duty of Loyalty: Sole Interest or Best Interest’ (2005) 114 *Yale Law Journal* 929, 958-959; J. Velasco, ‘Structural Bias and the Need for Substantive Review’ (2004) 82 *Wash. U. L. Q.* 821, 836; R.M. Jones, ‘Rethinking Corporate Federalism in the Era of Corporate Reform’ (2004) 29 *Journal of Corporation Law* 625, 648; *Solomon v Armstrong*, 747 A.2d 1098, 1115 n.48 (del. Ch.1999), noting that ‘Marsh’s characterization is most likely still viable’.

¹³⁸ L.E. Strine, et al, ‘Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law’ (2010) 98 *Geo. L.J.* 629; D.M. Ibrahim, ‘Individual or Collective Liability for Corporate Directors?’ (2008) 93 *Iowa L. Rev.* 929; E.W. Hecker, Jr, ‘Fiduciary Duties in Business Entities’ (2006) 54 *U. Kan. L. Rev.* 975; D.A. Skeel, ‘Icarus and American Corporate Regulation’ (2005) 61 *Bus. Law.* 155; D.W. Deal, ‘Director’s Vulnerability to Breach of Fiduciary Duty Claims for Compensation Decisions: Where Have We Been, Where Are We Now?’ (2005) 30 *Okla. City U. L. Rev.* 311, 321-322; J.G. Hill, ‘Regulatory Responses to Global Corporate Scandals’ (available on <www.ssrn.com>); Cunningham, n 11 above, citing Marsh for the observation that the fiduciary ‘sealant decayed during the twentieth century’; J.C. Coffee, ‘Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms’ (2004) 84 *B. U. L. Rev.* 301, 334; J.C. Coffee, Jr, ‘The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control’ (2001) 111 *Yale L. J.* 1; Cox, n 17 above, 1079; E. Rock and M. Wachter, ‘Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants’ (2002) 96 *NW. U. L. Rev.* 651, 668; *Solomon v Armstrong*, n 137 above.

Marsh's position, which fits perfectly with both the contemporary article of faith that fiduciary standards have progressively declined since the introduction of general incorporation,¹³⁹ as well as with the dominant and compelling narrative that charter competition drives managerial friendly solutions in areas of corporate law that have the potential to be significantly redistributive to managers.

The starting point for the key 19th century US jurisdictions was in many respects identical to that of the United Kingdom. Directors of companies were viewed as trustees and indeed were often referred to as 'trustees' in general incorporation statutes.¹⁴⁰ Early 19th century cases in the Supreme Court and in individual state courts readily relied upon this analogy, in some instances relying on the English chartered corporation case of *Charitable Corporation v Sutton*.¹⁴¹ This analogy naturally led to the application and translation of fiduciary law principles addressing relationships between trustee, trust, and beneficiary. Indeed, in many of the early corporate self-dealing cases we see the application of the same English trust cases, as well as US state trust cases that were directly based upon such cases, that formed the bedrock of the UK's self-dealing law analysed above. We also see direct reliance on some of the key UK cases which translated English trust law principles into the company context, in particular *Aberdeen Railway v Blaikie*.¹⁴² This initial step in US regulation of self-dealing appears wholly consistent with the first stage of Marsh's account of the development of this area of the law: there was indeed a strong strand of authority established in the 1860 and 1870s and affirmed in multiple cases thereafter – in some jurisdictions until as late as the 1940s – articulating a position which was, or at least can be read as being, effectively identical to the position taken in *Aberdeen Railway v Blaikie*.

Fairness review is presented by Marsh as an unexplained legal change of direction from the morally upstanding starting point of the voidability standard. This section argues that this view is based upon a partial view of the English and US fiduciary law authorities that were available for borrowing to regulate director conduct. In fact, US corporate law sampled more broadly from the English fiduciary law pool than did UK corporate jurisprudence and in doing so created multiple paths towards fairness review. In two respects 18th and 19th century non-corporate fiduciary doctrine contained a fairness based approach to self-dealing contracts. The first approach involved what this article shall call remedial fairness. Where contracts have been performed and it is no longer possible to unravel the contract, the law must unpick the transaction to determine the remedy that the trustee or the corporation should receive. In such circumstances the

¹³⁹ See n 11 above.

¹⁴⁰ See n 108 above.

¹⁴¹ n 107 above.

¹⁴² *Benson v Heathorn*, n 120 above, is also referred to in several cases, for example: *Wardell v Union Pac. R. Co* 103 US 651 (1880); *Hoffman Steel Coal Co. v Cumberland Coal & Iron Co.* 16 Md. 456 (1960); *Cumberland Coal & Iron Co. v Parish* 42 Md. 598 (1875); *Hoyle v Plattsburgh & M.R. Co.* 9 Sickels 314 (1873); *Globe Wollen Co. v Utica Gas & Electric Co.* 151 A.D. 184.

equitable remedy would be an accounting for profits. But what amounts to a profit? If a widget is sold by the director to the corporation, is profit anything in excess of cost or anything in excess of a market return? If it is a service that has been consumed by the corporation, is profit anything paid to the director or anything in excess of a market price for the service? If law's answer is 'market return', then a strict rule of voidability becomes a fairness standard in relation to executed contracts.

The second channel to fairness review contained within fiduciary law is dependent on how trust, trustee, and beneficiary are translated into the corporate context of corporation, board, director, and shareholder. As we have seen in the UK context, and will see again below, corporate law borrowed from trust law's approach to self-dealing which provides for the voidability of such transactions regardless of their fairness (subject to the remedial fairness approach noted above). Through this lens the board of directors are the trustees, and entering in a transaction with the corporation is analogous to entering into a transaction with the trust. However, the corporation does not fit perfectly with the trust analogy. The corporation (through the shareholder meeting) appoints the directors, and the directors act on behalf of the corporation not the shareholders. A transaction between the director and the corporation could also therefore be analogised to a transaction between a trustee (in his personal capacity) and the beneficiary, or a transaction between an agent and his principal or between an attorney and his client, with the corporation as the active beneficiary or client. As the corporation is incapable of acting for itself (without the assistance of the board), this analogy would require the director to play no role in the board's decision to enter into the contract. Transactions between trustees and beneficiaries or between attorney and client were treated warily by English and US courts in the 18th and 19th century; however, they did not attract the strict voidability rule that was applicable to a self-dealing transactions between trust and trustee; rather they were subject to fairness-like (both fair process and fair price) regulation. The concern about conflict in this context was less acute: the trustee or beneficiary was not acting on both sides of the transaction although he was well placed to exert undue and inappropriate influence on the transaction. Accordingly, a different fiduciary analogy would open the door to fiduciary law's existing fairness approach.

This section will demonstrate that the story of fairness and strictness in US self-dealing regulation is not about one being replaced by the other in the 19th century – the chronological acceptance of fairness coupled with the silent rejection of policy position underpinning the strict rule. Rather the story of fairness and strictness in 19th century US corporate law, in the 1880s and before, is the story of their mutual presence. The interesting question therefore is not, as is suggested by Marsh: where did fairness review come from, and how did it come to replace the strict voidability rule? It was there and available at the inception of US corporate law's regulation of self-dealing when it elected to borrow from other fiduciary contexts. The interesting question is rather: what was it about US corporate law that enabled its development in, as we shall see below, a very short time frame,

whereas in the UK, *where in theory it was equally available*, it was not developed at all? In this section it is argued that the conception of the US corporation and its understanding of corporate power opened the door to fiduciary law borrowing more widely than the UK conception of the company allowed for; and where the path of fiduciary law's fairness standard was not taken by state courts, the limitations on contractibility for the US corporation drove litigants and courts to explore remedial fairness in a way that was unnecessary in the United Kingdom.

To consider this argument in more depth this section will consider the development of the law in the 19th century's most important US corporate law jurisdictions: New Jersey and New York. We will then turn to Delaware. Nineteenth and early twentieth century commentaries on corporate law devote significant attention to self-dealing. They typically do so, however, with limited regard to the jurisdictional specificity of each state's corporate law.¹⁴³ This is also characteristic of responses to Beveridge's critique of Marsh.¹⁴⁴ However, 19th century US corporate law is characterised by a strong sense of jurisdictional specificity. This jurisdictional specificity generates different paths of legal evolution and in the self-dealing context different paths towards fairness review. In this context, taking a 'US corporate law' viewpoint has the effect of exacerbating an already highly complex body of law, generating a sense of legal chaos and indeterminacy when in fact within the key jurisdictions the complexity is far less chaotic and the law far more path-dependent than commentators have acknowledged.

1. *New Jersey*

a. *The remedial implications of a strict standard*

Writing in 1861,¹⁴⁵ Angell and Ames observed that 'though the member of the corporation be also one of the trustees of the corporation, it would seem that this would not incapacitate him from contracting with it but he may recover against the corporation for his services rendered under a contract with the other trustees, in a case where there is no evidence of such gross impartiality in the contract as amounts to fraud'. In this statement two of the three regulatory strategies deployed in self-dealing law in the United States can be identified: first, self-dealing contracts are valid and enforceable provided that the self-dealing director does not act for the company in entering into the contract – the contract must be made 'with the other trustees'; and second, the contract must be fair to the corporation to be enforceable – articulated through the more demanding language of 'gross impartiality' and 'fraud'. Angell and Ames cite three Vermont cases in support of this proposition, two of which dealt with religious corporations

¹⁴³ See Thompson, n 44 above.

¹⁴⁴ See Cary and Eisenberg, n 136 above, 651, referring to cases from Alabama, California, Connecticut, New Jersey, New York, and Maryland in response to Beveridge.

¹⁴⁵ Angell and Ames, n 65 above, 200.

incorporated to build meeting houses, the third with a school district.¹⁴⁶ The early New Jersey Chancery case of *Stratton v Allen*¹⁴⁷ relies directly on this passage in *Angell & Ames* in holding that:

The mere fact that the creditor was a director of the company, does not render the transaction fraudulent. There is nothing which forbids either the members or directors of a corporation to make contracts with it, like any other individual; and when the contract is made, the director stands, as to the contract, in the relation of a stranger to the corporation.

Stratton v Allen suggests, contrary to Marsh's view, that a disinterested director and fairness standard was established long before the 20th century. Professor Beveridge in his critique of Marsh's claim relies upon Angell and Ames's position and the cases to which they refer.¹⁴⁸ In fact this approach found limited traction in the development of New Jersey corporate law with a very limited number of later cases that relied on this aspect of the case. Although it was affirmed in the 1878 case of *Franklin Fire Insurance Company v Martin*¹⁴⁹ by the New Jersey Court of Errors and Appeals and, also in 1879, was relied upon at first instance in the important case of *Gardner v Butler*,¹⁵⁰ its influence assessed in terms of citations disappeared thereafter.

The real story of New Jersey self-dealing regulation does not start with Angell & Ames and *Stratton v Allen* but with the case of *Stewart v Lehigh Valley Co.*,¹⁵¹ an important case relied on by Harold Marsh to demonstrate the state of the law in first of his three stages. In this 1875 case, which considered a challenged self-dealing transaction involving a director of a state-chartered canal company, the Court of Errors and Appeals viewed the board as trustees for the company and directly imported into New Jersey law English corporate and trusts law principles governing self-dealing transactions. In a familiar passage the court held as follows:

The position thus assumed by the plaintiff rests upon the broad principle that [...] so insidious are the promptings of selfishness and so great is the danger, that it will over-ride duty when brought into conflict with it, that sound policy requires that such contracts should not be enforced or regarded [...] I have come to the conviction that the true legal rule is, that such a contract is not

¹⁴⁶ *Geer v 10th School District in Richmond* 6 Vt. 76 (1834) (applying a good faith standard); *Sanyer v Methodist Episcopal Society in Royalton* 18 Vt. 405 (1846) (affirming Geer); *Rogers v Universalist Society* 19 Vt. 187 (1847) (whilst upholding the contract observing that '[p]artiality, in any given case, so gross as to amount to fraud, will, when sustained, necessarily defeat the contract'.

¹⁴⁷ 16 N.J. Eq. 229 (1863).

¹⁴⁸ Beveridge, Jr, 'The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction', n 135 above, 660-661, and 'Interested Director Contracts at Common Law: Validation under the Doctrine of Constructive Fraud', n 135 above.

¹⁴⁹ 40 N.J.L. 568 (1878).

¹⁵⁰ The case is also cited in the Court of Errors and Appeal's judgment in *Gardner v Butler* 30 N.J. Eq. 702 (1879).

¹⁵¹ 38 N.J.L. 505 (1875).

void, but voidable, to be avoided at the option of the *cestui que trust*, exercised within a reasonable time. I can see no further safe modification or relaxation of the principle than this. A director of a corporation may have rights not arising out of express contract – such as the right [...] to have money which he has loaned it repaid to him; but where the right is one which must stand, if at all, upon an express contract, and which does not arise by operation or implication of law, then he shall not hold it against the will of his *cestui que trust*; for in the very bargain which gave rise to it, in which he should have kept in view the interest of that *cestui que trust*, there intervened before his eyes the opposing interest of himself. The vice which inheres in the judgment of a judge in his own cause, contaminates the contract; the mind of the director or trustee is the forum in which he and his *cestui que trust* are urging their rival claims, and when his opposing litigant appeals from the judgment there pronounced, that judgment must fall. It matters not that the contract seems a fair one. Fraud is too cunning and evasive for courts to establish a rule that invites its presence.

The claim made by the defendant that the conflict was dissolved if the interested director abstains from the decision was rejected by the court.

Nor is it proper for one of a board of directors to support his contract with his company, upon the ground that he abstained from participating as director in the negotiations for and final adoption of the bargain by his co-directors, the very words in which he asserts his right declare his wrong; he ought to have participated.

The court cites the leading English self-dealing case of *Aberdeen Railway v Blaikie* and the New York corporate law cases of *Butts v Wood*¹⁵² and *Gardener v Ogden*,¹⁵³ which both rely upon *Aberdeen Railway*, and the trust authorities upon which *Aberdeen Railway* rests.¹⁵⁴ The court also cites the influential 1816 New York trust case *Davoue v Fanning* which imported the same line of English trusts cases into New York trusts law.¹⁵⁵ Indeed the structure of the judgment is almost identical to

¹⁵² 10 Tiffany 317 (1867).

¹⁵³ 22 N.Y. 337 (1860).

¹⁵⁴ The English trusts cases relied upon in *Aberdeen Railway v Blaikie*, n 14 above, and directly in *Butts v Wood*, n 152 above, and *Gardner v Ogden*, include *Keech v Sanford* (1726) Sel Cas Ch 61, and *Whelpdale v Cookson* (1747) 1 Ves Sen 9.

¹⁵⁵ 2 Johns.Ch. 252 (1816). The New York Chancery Court in *Davoue v Fanning*, 2 Johns.Ch. 252 (1816), laid particular emphasis on the House of Lords case, *York Buildings Co. v Mackenzie* (1795) 8 Bro Parl Cas 42, a case dealing with an insolvent chartered company which is also cited in *Stewart v Lehigh Valley Co.*, n 151 above. The court in *Davoue*'s summary of the judgment in *York Buildings* bears a close resemblance to the language deployed in *Stewart v Lehigh*, for example: 'That he who is intrusted with the interest of others, cannot be allowed to make the business an object to himself, because, from the frailty of nature, one who has power will be too readily seized with the inclination to serve his own interest at the expense of those for whom he is intrusted.'

Aberdeen Railway: a focus on conflicts, a rejection of fairness, and a rejection of board composition as a means of mitigating the conflict because as a director you are required to serve and not abstain.

Stewart v Lehigh Valley Co. served as a leading reference point for New Jersey self-dealing law for another 60 years. For example, in 1920 in *Busch v Riddle*,¹⁵⁶ the Court of Errors and Appeals referred to the doctrine set forth in *Stewart v Lehigh* as having been ‘uniformly recognized and repeatedly enforced in this state’. In 1939, citing *Stewart v Lehigh* the Court of Errors and Appeals observed that ‘the complainant was charged with knowledge of the well established principle of law affecting corporations in contracting with their officers, which is that such contracts are voidable at the instance of the corporation, its stockholders or creditors’.¹⁵⁷

However the strict rule articulated in *Stewart v Lehigh* is only one part of the New Jersey self-dealing story; it represents one of two strands of self-dealing jurisprudence that co-reside, and indeed complement each other. Importantly, these strands have more or less identical starting points. The second strand of jurisprudence commences in 1878 with *Gardner v Butler*,¹⁵⁸ a judgment given three years after *Stewart v Lehigh Valley Co.* It is in this strand of cases that the strains generated by the need to facilitate transactions between directors and the company without obtaining ex-ante shareholder approval are laid bare, and the seeds of the contemporary fairness solution are planted.

In *Gardner v Butler* a corporation formed by statutory charter entered into an agreement with a partnership in which its managing director and several other directors were partners. The effect of the agreement was to outsource the company’s paper trading business for a commission of six per cent of gross sales. The board resolution entering into the transaction was ‘carried’ by the votes of the self-dealing directors with only one disinterested director present. At first instance the New Jersey Court of Chancery observed that such ‘arrangements made by paper manufacturing companies with their directors are by no means unusual’ and upheld the arrangement.¹⁵⁹ The validity of the arrangement at first instance was

¹⁵⁶ 92 N.J. Eq. 265 (1920). See also *Voorhees v Nixon* 72 N.J. Eq. 791 (1907): ‘It must be regarded as the settled policy of the law of this state that express contracts between a corporation and one of its directors are voidable at the instance of the corporation.’; *General Inv. Co. v American Hide & Leather Co.* 97 N.J. Eq. 214 (1925): ‘[I]t is established in *Stewart v. Lehigh Valley R. R. Co.*, that courts will not inquire whether a contract such as this seems a fair one. “Fraud is too cunning and evasive for courts to establish a rule that invites its presence.” The same case and the many authorities there cited are also an answer to the protestation that the director took no part in the negotiations under attack.’

¹⁵⁷ *Wiencke v Branch-Bridge Realty Corporation* 125 N.J. Eq. 135 (1939).

¹⁵⁸ n 150 above.

¹⁵⁹ Judicial awareness of market practice and needs that we see in this case is found more explicitly in subsequent cases. Consider for example, *Robotham v Prudential Ins. Co. of America* 64 N.J. Eq. 673, where the Court of Chancery considering the rule in *Stewart v Lehigh*, n 151 above, in the context of cross directorships observes, ‘Theoretical rules have to give way to practical necessities of business [...] common directors abound, and common directors are better than dummies.’ In *Stephany v Marsden* N.J. Eq. 90 (1908) the court observes in applying *Stewart v Lehigh Valley Co.*, n 151 above, that: ‘I have observed a tendency of recent years, arising largely from the extensive and complex dealings and relations of modern trading corporations, to relax this rule; the tendency being, as I have observed it, to inaugurate the modified doctrine that such contracts should not be deemed voidable at the mere option of the

based on three intersecting rationales: First, following *Stratton v Allen* that a director stands in relation to the company as a stranger when he transacts with the company; secondly, that if the rule in *Stewart v Lehigh Valley Co.* applies the director is still entitled to reasonable compensation – a rationale developed in greater depth by the Court of Errors and Appeals; and thirdly, as an outcrop of the first and second rationales and the instrumental benefits of self-dealing contracts, that whilst *Stewart v Lehigh* may set forth the general rule it is subject to exceptions in equity:

When the *cestui que trust* comes into equity to avoid the contract, even, it is reasonable that he should be required to show, as a ground for the action of the court, something more adverse to the contract than the mere fact that it was made with a director; for if it shall, as in the case in hand, appear, not only to be *fair and just*, but actually more advantageous to the company than any which could be made with a stranger, why should it be set aside to the detriment of the company? (emphasis supplied)

Justice Van Syckle, giving judgment for the Court of Errors and Appeals, affirmed the Chancellor’s holding at first instance and does so in a way that lays a clear track from the strict rule in *Stewart v Lehigh Valley Co.* to fairness review. The Court strongly affirms the strict approach in *Stewart v Lehigh Valley Co.* as ‘well settled law’. It then proceeds, following the lead of the Chancellor’s second rationale, to explore the remedial implications of the rule: what happens if a director enters into a contract to provide services or to sell assets to the company, and the services have been provided or the assets consumed. In such circumstances what, if anything, is the company entitled to, and what does it mean to require the director to account for any profits he has made from the executed voidable transaction? To explore this issue the court relies on the facts of *Aberdeen Railway v Blaikie* as a hypothetical. The Court asks what would have happened in *Aberdeen Railway* if the railway’s chairs had been delivered and accepted:

I apprehend it would not have been held, in any court, that the company could have retained the property and have refused to pay for it – not the contract price, but what it *was reasonably worth* [...] It may be safely asserted that no authority can be found which will permit a corporate body to retain property conveyed to it by a director, or to receive services which he was not bound to render as a director, without paying him a *fair* equivalent [...] *The same principle must apply, whether it is property conveyed or services rendered to the company.* The cupidity and avarice of the trustee is guarded against by giving the *cestui que trust* the right to repudiate the contract at all times, where it is

corporation, but that the burden should be imposed upon these seeking to enforce or support such a contract to clearly establish its fairness.’

executory, and to allow simply a just remuneration, without reference to the contract price, where it is executed. The trustee thus derives no advantage from his breach of duty, and the company can suffer no detriment from his service in their behalf (emphasis supplied).¹⁶⁰

Applying this logic the court concluded that:

The case resolves itself, then, into this question: Have the directors, whose action is the subject of controversy, retained for their services more than they are *justly and reasonably* entitled to? The burden is on them to show what they reasonably deserve to have, and no unjust exaction will be permitted (emphasis supplied).¹⁶¹

In reaching this conclusion the court directly applies the holding in *Stewart v Lehigh Valley Co.* that such contracts are voidable without regard to fairness and cannot be enforced by the breaching director. However, when the court gets to the question of remedies then fairness – understood as it is today as arm’s-length contracting – enters through the back door. The effect of the *Gardner v Butler* approach is that for any executed self-dealing transactions the *Stewart v Lehigh* substantive standard is dissolved into a remedial fairness standard: because no one will bring an action to invalidate the contract, and where an action is brought the court will take no action, unless the terms of the contract are unfair. As the terms of the service contract in *Gardner* were fair, the self-dealing directors were not liable to account for any profit. Importantly, as the Court of Errors and Appeals observes, this approach applies beyond the compensation / operational services context of this case and applies ‘whether it is property conveyed or services rendered’. Note also that the court in *Gardner* makes a distinction between executory and non-executory contracts rather than a distinction between, on the one hand, executory and executed but rescindable contracts and, on the other, executed but non-rescindable contracts.¹⁶² Many executed self-dealing transactions could in theory be voided and be unwound. By relying on the executory / executed distinction more space was created for a remedial fairness approach as it included executed but rescindable transactions.¹⁶³

In support of this position the Court of Errors and Appeals in *Gardner v Butler* relies on another English case, *Great Luxembourg Railway v Magnay*,¹⁶⁴ where the court held that ‘when it is said that he cannot make any profit by the

¹⁶⁰ *Aberdeen Railway v Blaikie*, n 14 above.

¹⁶¹ *ibid.*

¹⁶² As the transaction is voidable according to the strict rule, an executed transaction could, where possible be unwound. This would not be possible where the service has been provided, or the product consumed or integrated in the company’s activities.

¹⁶³ See, for example, *Oliver v Rabway Ice Co.* 64 N.J. Eq. 596 (1903), where the court refused to unwind a share buy-back from the directors, comparing the shares to the railway chairs in *Aberdeen Railway v Blaikie*, n 14 above, had they been used.

¹⁶⁴ 25 Beay. 586 (1858). For more recent engagement with this question see *Warman v Dwyer* (1995) 128 ALR 201.

transaction, it is not meant that he is not to have the proper value of property which is actually taken by the company'. It is of interest in this regard that in the United Kingdom this case has not to date been cited for this holding. English courts have not explored these remedial issues in the context of corporate self-dealing transactions, although had they done so the likely outcome, following *Great Luxembourg Railway*, would have been identical. English law did not need to push the remedial implications of the strict voidability rule because contracting out quickly became standard practice and, as we have seen, was sanctioned by the courts as the logical extension of the conception of the corporation based on contract. This enabled English law to perform quickly the necessary adjustment to the economic reality of widespread unapproved self-dealing – an option, which as explained in Part I, and is considered further below, was unavailable in New Jersey.

It is important to stress that while *Gardner v Butler* lays the first stones on New Jersey's path to fairness review it does so in a way that is wholly consistent with *Stewart v Lehigh Valley Co.* Indeed in some cases *Gardner* is, correctly, cited alongside *Stewart v Lehigh* in support of the strict approach.¹⁶⁵ The evolution of the *Gardner v Butler* approach toward fairness does not, therefore, require a break with or an explicit rejection of the strict approach – which would require what Marsh never found, namely, a policy account explaining the shift in approach and the rejection of the policy underlying the strict approach. The shift to a substantive fairness standard merely requires the recognition that from a liability perspective there is no difference between a strict rule coupled with remedial fairness standard and a substantive fairness standard.

Many of the subsequent cases which follow *Gardner v Butler* addressed managerial compensation issues. In this context, some courts quickly left the niceties of the relationship between the standard applicable to the transaction and the remedial consequences thereof behind and came to state the substantive standard applicable to these self-dealing transactions in substantive fairness terms. In *Fougeray v Cord*,¹⁶⁶ in 1892 the Court of Chancery observes that 'the [directors] are entitled to what their services are reasonably worth, and no more'. In *Davis v Davis Co.*,¹⁶⁷ in 1902 the burden, the Court of Chancery holds, is on the directors to show that 'what they have done merit payment'. Subsequent New Jersey Courts applied the *Gardner v Butler* approach beyond the compensation / services context. In *Oliver v Rahway Ice. Co.*, a 1903 case involving a stock repurchase from directors of the company, Vice Chancellor Stevens extends the application of the *Gardner v Butler* approach beyond services to property,¹⁶⁸ with direct reference to Justice Van

¹⁶⁵ See, for example, *Hodge v United States Steel Corp.* 64 N.J. Eq. 807 (1903); *Baumohl v Goldstein* 95 N.J. Eq. 597 (1924).

¹⁶⁶ 50 N.J. Eq (1892).

¹⁶⁷ 63 N.J. Eq. 572. (1903).

¹⁶⁸ On the view of stock as upon 'the footing of other property', see *Berger v United States Steel Corporation* 63 N.J. Eq. 809.

Syckle's analysis of *Aberdeen Railway* considered above. The court held that the 'company must pay [for the shares] not the contract price but what at the time of the sale it was reasonably worth'.¹⁶⁹ In *Marr v Marr*,¹⁷⁰ the Court of Chancery explicitly extended the *Gardner v Butler* approach to loans to the company. Consistently with *Gardner* they observe that any entitlement of a contracting party to 'reasonable compensation' or for the return of the loan (including one must assume reasonable interest) is not based on the self-dealing contract itself but arises by operation of law. It is noteworthy with regard to loans that *Stewart v Lehigh Valley* itself suggested such an approach: ' [A] director of a corporation may have rights not arising out of express contract – such as the right [...] to have money which he has loaned it repaid to him.' In *Stephany v Marsden* in 1908,¹⁷¹ although the Court does not cite *Gardner v Butler*, it applies the identical structure of analysis: the affirmation of *Stewart v Lehigh Valley Co.*¹⁷² coupled with a remedial fairness standard:

Where property has been conveyed to a corporation by a director of the corporation, while the contract under which the conveyance has been made may be avoided by the corporation, it will be the duty of a court of equity to restore to the party who made the conveyance such property or values as he has parted with and as have passed to the corporation.

In *Tooker v National Sugar Refining Co. of New Jersey*,¹⁷³ a case involving a contract to sell to the corporation stock purchased by a director, the court: first, affirmed the holding in *Stewart v Lehigh Valley Co.* that the conflicted director's recusal from the meeting that resolved to enter into the self-dealing contract did not validate the contract; indeed it amounted to a 'breach of trust'; and second, observed that the transaction 'would also have been voidable under the rule of *Gardner v. Butler* which denies to a director the right to bargain gain with his company for a price in excess of the real value of the thing sold'. *Tooker* is particularly interesting as an example of how remedial fairness overreaches to become the substantive standard. Pursuant to the *Stewart v Lehigh* and *Gardner v Butler* approach the transaction is voidable, but if it has been executed then the director is entitled to his fair due for the service or the property. Remedial fairness review follows as the courts will not unwind an executed transaction. But in *Tooker*, applying *Gardner v Butler*, voidability becomes a function of the fairness of the transaction.

¹⁶⁹ n 163 above.

¹⁷⁰ 72 N.J. Eq. 797 (1907).

¹⁷¹ 75 N.J. Eq. 90 (1908).

¹⁷² The Court in *Stephany v Marsden*, n 159 above, observes: '[T]he general rule, as I have briefly defined it, as established by our Court of Appeals, cannot be said to have been in any way relaxed by that court since it was there first stated in the case of *Stewart v. Lehigh Valley Railroad Company*, 38 N. J. Law, 505, and it has since been by that court so repeatedly approved and recognized that I must regard it as a fixed part of the jurisprudence of this state.'

¹⁷³ 80 N.J. Eq. 305 (1912).

Aside from *Gardner v Butler*, there are other separate, apparently stand-alone, early strands of fairness review. *Stratton v Allen* has already been mentioned. Another short strand of case law commenced in 1886 with *Wilkinson v Bauerle*,¹⁷⁴ which involved the sale of the whole company to a director, which certain creditors of the company claimed had deprived them of their right to recover amounts owed to them. The Court of Errors and Appeals held that it was for the director to bear the burden of proving that he was acting in good faith and that ‘the sale produced the full value of the property’, and if not the creditors could ‘compel them to account for the full value of the property’. However, the subsequent reception of this case was primarily confined to the question of whether directors could divert property to themselves to the detriment of creditors and, although a limited number of cases drew upon *Wilkinson* to support a fairness review approach,¹⁷⁵ they never developed any head of steam. The starting point for fairness review in New Jersey is clearly *Gardner v Butler*.

The fairness approach contained in *Gardner v Butler* – ten years prior to the 1889 starting gun for regulatory competition¹⁷⁶ – and the coexistence of *Stewart v Lehigh Valley Co.* and *Gardner v Butler* represent a direct and powerful challenge to Marsh’s consensus position. The later cases are arguably also somewhat consistent with Marsh’s position as he argues that by 1910 the prevalent approach involved a combination of majority disinterested (or non-participating interested director) board approval plus fairness review. However, although we clearly see remedial fairness in the cases in this period the disinterested director / non-participating director condition is a regulatory bystander in New Jersey case law. In *Gardner v Butler* there was majority of interested directors who participated in the board decision, and in only a few of the subsequent cases, either before 1910 or thereafter, is a majority of disinterested directors identified as a relevant factor, and in several of those cases the key issue is less the legitimacy of the transaction and more the directors’ ability to vote and be counted in the quorum.¹⁷⁷ From 1878 to 1960 New Jersey law is best characterised as involving the consistent application of a strict voidability / no fairness substantive standard with a fairness remedial standard. The disinterested director requirement did not disappear in New Jersey because it was never there. This is unsurprising. The leading voidability case of

¹⁷⁴ 41 N.J. Eq. 635 (1886).

¹⁷⁵ See, for example, *Barry v Moeller* N.J. Eq. 483 (1904); *Mitchell v United Box Board & Paper* 72 N.J. Eq. 580 (1907).

¹⁷⁶ n 21 above.

¹⁷⁷ *Metropolitan Telephone & Telegraph Co. v Domestic Telegraph & Telephone Co.* 44 N.J. Eq. 568 (1888), referring to *Stock Co. v Railroad Co.* 34 Ohio St. 450, and suggesting that two companies with overlapping interested directors could enter into a contract where those directors are in the minority, and also holding that an interested director is incapable of acting and counting for the board quorum. Subsequent New Jersey authority has cited *Metropolitan* for the latter holding – see, for example, *Hill Dredging Corp. v Risley* 18 N.J. 501 (1955); *Robotham v Prudential Inc. Co. of America* 64 N.J. Eq. 673 (1903) (suggesting less onerous rules where the interlocking directors in two companies were in the minority – but also suggesting that where a director participates on both sides of the transaction, fairness review is applicable and that the role of the director in taking the decision may affect who bore the burden of proving fairness).

Stewart v Lehigh explicitly rejected the disinterested board / non-participating director approach, and the fairness standard was a remedial standard that was not connected to the nature of board approval. We shall see below, by way of contrast, that the non-participating director was central to New York self-dealing law which involved a very different path to a fairness standard and which was function of the interested director's non-participation.

New Jersey's contemporary common law fairness position is the product of the courts recognising that a strict standard plus a remedial fairness approach are the functional equivalent of a fairness standard. The New Jersey courts, however, took a considerable period of time to make this functional connection. It was not until 1961 in *Abeles v Adams Engineering Co. Inc.*¹⁷⁸ that the New Jersey Supreme court set forth the substantive standard without regard to the presumption of voidability: '[A] contract between a corporation and one of its directors, made without approval of the stockholders, is not enforceable by the director unless it is honest, fair and reasonable.' The cases cited in support of this statement of the law include two 1950s New Jersey cases, *Eliasberg v Standard Oil Co.*¹⁷⁹ and *Hill Dredging Corp. v Risley*.¹⁸⁰ *Eliasberg* and *Hill Dredging* both operate formally within the *Gardner v Butler* strict substantive rule / remedial fairness approach, but the strict rule is set forth as a perfunctory prohibition which if not observed results in fairness review.¹⁸¹ Interestingly, *Eliasberg* relies upon the then recent Delaware jurisprudence providing for a substantive fairness standard.¹⁸²

Why, one might ask did it take so long to convert the fairness remedial standard into the substantive standard? Arguably this is because it amounted merely to a functional tidying-up of the case law. Given the reference in *Eliasberg* to the Delaware cases, considered below, it also seems plausible that this move to a substantive fairness standard involved convergence to the approach taken by the, at this time firmly established, market leader in corporate law. Importantly though, if regulatory competition was the driver of this shift to an explicit fairness standard in New Jersey it is not, as outlined above, one of substantive consequence.

b. Barriers to contractual solutions

That the seeds of fairness review are found in the very early cases is unsurprising. The courts in the US and the UK were both clearly aware of the instrumental

¹⁷⁸ *Abeles v Adams Engineering Co. Inc.* 35 N.J. 411 (1961).

¹⁷⁹ 23 N.J. Super 431 (1952).

¹⁸⁰ n 177 above.

¹⁸¹ Both *Eliasberg v Standard Oil Co.*, n 179 above, and *Hill Dredging Corp. v Risley*, n 180 above, rely on *U.S. Steel Corp. v Hodge* 64 N.J. Eq. 90, which clearly affirms *Stewart v Lehigh Valley Co.*, n 151 above. In *Eliasberg*, having stated the voidability rule, the court observes that: 'Where there is no stockholders' approval of a contract or proposal in which a director has a personal interest, the burden is upon the director to completely justify the transaction.' The court in *Hill Dredging* cites this statement with approval. The court states the strict rule that the transaction cannot be entered into without shareholder approval, but if it is entered into without approval then, quoting *Eliasberg* favourably, and citing *Stephany v Marsden*, n 159 above, 'The burden is on the director to completely justify the transaction.' See also *Daloiso v Peninsula Land Co.* 127 A.2d 885 (1956).

¹⁸² *Gottlieb v Heyden Chemical Corp.* A.2d 595 (Del.Ch. 1951), paras 5-7; *Kerbs v California Eastern Airways, Inc.* 90 2d 652 (Del. Sup Ct. 1952).

economic pressures to facilitate some self-dealing contracts. However, from an identical starting point – the application of the English corporate and trusts authorities on self-dealing – very different paths to facilitating and regulating self-dealing contracts in the UK and New Jersey were taken. The UK’s contractual conception of the corporation allowed market players to fashion their own remedy to the barriers created by the strict voidability rules. The courts in New Jersey generated an internal response as the external contractual one deployed in the UK was not available. It is noteworthy that although *Aberdeen Railway v Blaikie* plays such a central part in the development of New Jersey self-dealing law, there is no reference in New Jersey case law to the leading UK contractibility case of *Imperial Mercantile Credit Association v Coleman*.¹⁸³

Although it appears that New Jersey corporations and shareholders may have adopted contractual opt-outs from the strict rule in their constitutional documents,¹⁸⁴ it is unclear at what point in time this practice commenced,¹⁸⁵ and we need to distinguish their adoption from their effectiveness.¹⁸⁶ As discussed in Part I of this article, US, and in particular the New Jersey courts, imposed significant constraints on contractibility. Prior to 1889 contractual amendment of a director’s powers and obligations was arguably not available at all; thereafter although variation was explicitly permitted by the statute it was closely policed and restricted. Such constraints were a function of the view that general incorporation was an extension of statutory chartering and that, accordingly: the state created the corporation; the charter could be viewed as a legislative act; and contractibility was a function of the state permitting contractibility which, where the governance rule in question was viewed as important (‘a settled legal principle’), it needed to do so explicitly. Although, as was observed in Part I, we see increasing flexibility in relation to contractibility during the course of the 20th century, it seems highly unlikely that the earlier cases would have been receptive to contracting out of the voidability principle which was clearly viewed as a ‘settled legal principle’¹⁸⁷ well

¹⁸³ L.R. 6 Ch. App. 58 (1871). In no state is *Imperial Mercantile* cited to support contractibility. There are a limited number of non-New Jersey references to the House of Lords judgment, n 124 above, in this case which addressed the question of what amounted to adequate disclosure and a couple of non-New Jersey cases which refer to Lord Hatherley’s judgment for other reasons. There is one New Hampshire case, *Ashuelot R.R.Co. v Elliot* 57 N.H. 397, and one New York case, *Metropolitan Elevated RW Co. v Manhattan RW. Co.* 11 Daly 373, that refer to Lord Hatherley’s judgment in *Imperial Mercantile Association* in relation to self-dealing but as support for the strict voidability rule and not in relation to contractibility.

¹⁸⁴ Marsh, n 15 above, 45-46, gives a personal account of the drafting of these provisions when he was a law firm associate. An example of contracting out language is provided in W.M. Fletcher, *Corporation Forms and Precedents* (2nd ed, 1928), §§ 1031-1032.

¹⁸⁵ There are only very few cases which consider contractual opting out of the strict rule which date from the 1930s. This suggests that such provisions were very rare until later in the 20th century. The discussion and invalidation of such an opt-out in the New York case of *Whalen v Hudson*, n 96 above (refers to an opt-out as ‘this most unusual provision’), and citing H. Broom, *Legal Maxims* (Philadelphia: T. & J.W. Johnson & Co., 8th ed, 1882), 289 (that ‘unusual clauses always excite suspicion’).

¹⁸⁶ See W.J. Carney, ‘The ALI’s Corporate Governance Project: The Death of Property Rights’ (1993) 61 *Geo. Wash L. Rev.* 898, relying on Marsh and assuming adoption equals effectiveness.

¹⁸⁷ On the inability to contract out of ‘settled legal principles’ without explicit authority to do so, see *Audenried v East Coast Milling Co.*, n 90 above.

into the twentieth century.¹⁸⁸ Juxtaposing the evolution of UK self-dealing regulation with that of New Jersey, which in historical perspective is the United States' most important corporate law jurisdiction, we see that the path of self-dealing law is, in a significant respect, a function of the conception of the corporation.

2. *New York*

a. Channels of fiduciary law

Alongside *Stewart v Lehigh Valley Co*, the New York case of *Munson v Syracuse*,¹⁸⁹ decided in the fall of 1886, is the standard bearer of the strict approach to self-dealing providing for the automatic voidability of the transaction.¹⁹⁰ *Munson* involved a petition for specific performance of an executory contract between the company and its director. Judge Andrews, for the Court of Appeals of New York, held that self-dealing contracts are 'repugnant to the great rule of law which invalidates all contracts made by a trustee or fiduciary, in which he is personally interested at the election of the party he represents'. The judgment cites and follows the holding in *Aberdeen Railway v Blaikie*. Accordingly, the court 'does not stop to inquire whether the contract or the transaction was fair or unfair', nor did it matter that he was only one of ten participating directors and that the others were disinterested: 'The law cannot accurately measure the influence of a trustee with his associates.' Earlier, if less celebrated, examples of the New York courts expressing similar sentiments include: the Court of Appeals judgments in *Barnes v Brown*¹⁹¹ and *Butts v Wood*¹⁹² and the New York Supreme Court's decision in *Cumberland Coal & Iron Company v Sherman*,¹⁹³ applying Maryland law, all of which rely upon *Aberdeen Railway*.

One way of telling the story of self-dealing law in New York, and of problematising Marsh's stage theory, is to juxtapose the strict approach taken in *Munson* next to alternative, and apparently contradictory, approaches found in the case law during this period. Indeed there are several early New York cases which suggest, or explicitly adopt, a fairness approach to self-dealing. For example, in *Gamble v Water*,¹⁹⁴ in 1890, a case that admittedly is not directly on point as it involves shareholder ratification of a self-dealing transaction between the director and the company, the court is concerned to assess the 'fair value to the company

¹⁸⁸ That some limited contractibility in relation to the voidability rule is suggested by *Hodge v United States Steel Corp.*, n 165 above, which approved of a by-law amendment clarifying that self-dealing ratified by a majority of the outstanding shares would be treated as if ratified by all shareholders, addressing any concerns that a unanimous vote would be required for ratification. Note that this does not alter the legal principle simply the procedural mode of approval. See *Whalen v Hudson*, n 96 above, for an explicit invalidation of contracting-out under New York law.

¹⁸⁹ *Munson v Syracuse, G. & C. Ry. Co.* 58 Sickels 58.

¹⁹⁰ Marsh, n 15 above, 37.

¹⁹¹ 35 Sickels 527 (1880).

¹⁹² n 152 above.

¹⁹³ 30 Barb. 553 (1859).

¹⁹⁴ 123 N.Y. 91 (1890).

of the property purchased'. Shortly after *Gamble v Water* in *Sage v Culver*,¹⁹⁵ decided in 1895, the New York Court of Appeals held that 'when it appears that the trustee or officer has violated the moral obligation to refrain from placing himself in relations which ordinarily produce a conflict between self-interest and integrity, there is, in equity, a presumption against the transaction, which he is required to explain'. To 'explain' it the court provided that the director must 'show that [the transaction] was fair, and that no undue influence has been taken by him of his position, for his own advantage or the advantage of some other corporation in which he has an interest'. *Sage v Culver* is probably the most important of all New York self-dealing cases because, as detailed below, it was relied upon in multiple subsequent cases resulting ultimately in the clear adoption of the fairness standard.

However, an account of New York self-dealing law that involves identifying a strand of strict self-dealing cases and a separate and distinctive strand of fairness-based cases misses the key point about the source and evolution of New York self-dealing law. As does a story that attempts to fit these strands of case law into sequential chronological boxes. The real story of New York self-dealing law is how English trust and fiduciary law – clearly adopted by the New York courts in the early 18th century – with their bilateral relationships of trustee and beneficiary and attorney and client, are translated into the tri-lateral context of the corporation, the board of directors, and the stockholders. From this vantage point *Munson* is consistent with *Sage*, and fairness review fits with the strict voidability rule.

English 18th and 19th century trust and fiduciary law made a distinction, which it continues to make today, between regulating the exercise of delegated power and regulating influence.¹⁹⁶ In relation to the exercise of delegated power, it provided that a fiduciary cannot exercise that power in a way that benefits herself. One outcrop of this rule was that she could not therefore enter into a contract with herself. Although in theory the courts could have attempted to factually assess whether or not the contract represented a loyal, indeed self-sacrificing, exercise of power by the fiduciary, the courts of equity in the 18th and 19th centuries expressed reservations about the reliability of evidence to make this determination and the ability of the courts to assess this evidence.¹⁹⁷ Given such evidentiary obstacles the courts elected to protect the fiduciary relationship by prohibiting the transactions, regardless of whether or not they were good for the trust. Accordingly, a trustee was prohibited from entering into a contract in her personal capacity to buy trust assets without the unanimous consent of the beneficiaries. The most famous statement of the law in this regard was made in

¹⁹⁵ 147 N.Y. 241 (1896).

¹⁹⁶ J.C. Shepherd, *Law of Fiduciaries* (Toronto: Carswell, 1981), observing at 156 that 'the basic theoretical distinction between dealings with the 'corpus' and dealings with the 'beneficiary' is that in the former the fiduciary's power is one of control, while in the latter his power is one of influence'.

¹⁹⁷ *Ex Parte James*, 8 Ves. Jun. 338 (1803) ; *Ex Parte Lacey*, n 118 above.

1803 by Lord Eldon in *Ex Parte Lacey* where he said that the rule 'is not that a trustee cannot buy from a *cestui que trust*, but that he shall not buy from himself'.

The courts of equity took a less demanding approach to dealings between the fiduciary and his charge, for example, dealings between a trustee and a beneficiary unrelated to the trust assets or between attorney and client. Equity would also countenance a transaction with trust assets where, to use Lord Eldon's words, the fiduciary 'shakes off the obligation, that attaches upon him as trustee'. Although such arrangements were subject to the 'most guarded jealousy', they were not prohibited without regard to the terms of the arrangement. This distinction makes sense: in the former context the fiduciary wields power on both sides of the transaction; in the latter she does not exercise power for the counterparty to the transaction. Although the pre-existing relationship may enable her to exercise significant influence over the counterparty, the conflict is less acute than when she sits on both sides of a transaction. Here the regulatory objective is to ensure that the terms of the transaction are not the product of undue or self-serving influence by the fiduciary. Lord Eldon's jurisprudence is again central to setting out the English courts' approach. In *Gibson v Jeyes*,¹⁹⁸ an 1802 case brought against a financial advisor by the estate of the advisee, Lord Eldon observed:

Whenever, however, the relations between the contracting parties appear to be of such a character as to render it certain that they do not deal on terms of equality but that either on the one side from superior knowledge of the matter derived from a fiduciary relation, or from overmastering influence, or on the other from weakness, dependence, or trust justifiably reposed, unfair advantage in a transaction is rendered probable, there the burden is shifted, the transaction is presumed void, and it is incumbent upon the stronger party to show affirmatively that no deception was practiced, no undue influence was used, and that all was fair, open, voluntary and well understood.

In the 1833 case of *Hunter v Atkins*¹⁹⁹ the Lord Chancellor, Lord Brougham outlined the standard applicable to such relationships as follows:

There are certain relations known to law as attorney, guardian, trustee. If a person standing in these relations to client, ward, *cestui que trust*, takes a gift, or makes a bargain, the proof lies upon him that he has dealt with the other party [...] exactly as a stranger would have done, taking no advantage of his influence or knowledge, putting the other party on his guard, bringing everything to his knowledge which he himself knew.²⁰⁰

¹⁹⁸ 6 Ves. 266 (1802).

¹⁹⁹ (1834) Cooper T. Brougham 464.

²⁰⁰ 47 E.R. 166 (1834). Applying this rule to the purchase by the trustee of property from the beneficiary, see *Thomson v Eastwood* (1877) 2 App. Cas. 215, per Lord Cairns L.C.: 'If challenged in proper time, Equity will examine into it, will examine the value that was paid by the trustee, and will throw upon the trust the onus of proving that he gave full value and that all information was laid before the *cestui que trust* when it was sold.'

New York fiduciary law in the mid to late-19th century clearly adopted English law's distinction between power and influence as well as the *Ex parte Lacey* and *Gibson v Jeyes* applicable standards. In the New York Court of Appeals case of *Cowee v Cornell*²⁰¹ decided in 1878, the court in considering the validity of an agreement between a deceased grandfather and his grandson, without attribution or citation, quoted verbatim the above extract from *Gibson v Jeyes* and observed further that:

This doctrine is well settled²⁰² [...] The principle referred to it must be remembered is distinct from that absolutely forbidding a purchase by a trustee or agent for his own benefit of the subject of a trust, and charging it when so purchased with the trust. That amounts to an incapacity in the fiduciary to purchase of himself. He cannot act for himself at all however fairly or innocently in any dealing as to which he has duties as trustee or agent. The reason of this rule is subjective. It removes from the trustee, *with the power*, all temptation to commit any breach of trust for his own benefit. But the principle with which we are now concerned does not absolutely forbid the dealing, but it presumes it unfair and fraudulent unless the contrary is affirmatively shown (emphasis supplied).

At the heart of the problem of how to regulate self-dealing contracts between corporations and their directors is the determination of whether the contract in question involves the exercise of power or of influence by the self-dealing director. Following the structure of 19th century fiduciary law, if the transaction involves the exercise of power, then it is subject to the strict structural loyalty-based approach that prohibits such transactions regardless of actual loyalty and renders them voidable at the corporation's or its shareholders' election. If the transaction involves influence, then the standard is a fairness standard. The fiduciary influence standard is referred to in some of the cases, primarily the non-corporate cases, as a doctrine of 'constructive fraud'.²⁰³

²⁰¹ 75 N.Y. 91 (1878).

²⁰² The Court cites 'Hunt, *J. Nesbit v. Lockman*, 34 N. Y., 167; Story's Eq. Jur., § 311; *Sears v. Shafer*, 2 Seld., 268; *Huguenin v. Basely*, 13 Ves., 105; S. C., 14 Id., 273; S. C., 15 Id., 180; *Wright v. Proud*, 13 Id., 138; *Harris v. Tremenheere*, 15 Id., 40; *Edwards v. Myrick*, 2 Hare, 60; *Hunter v. Atkins*, 3 My. & K., 113'; for other cases articulating the influence fairness standard see Andrews J in the Court of Appeals. The same judge who decided *Munson v Syracuse*, n 189 above, in *Whitehead v Kennedy* 24 Sickels 462 (1877) (citing *Gibson v Jeyes*, n 198 above); and the Court of Appeal's judgment in *Fisher v Bishop* 63 Sickels 25 (1888), holding that 'fiduciary relations exist, and there has been a confidence reposed which invests the person trusted with an advantage in treating with the person so confiding. *Freelove v. Cole*, 41 Barb. 318, affirmed 41 N. Y. 619; *Ford v. Harrington*, 16 N. Y. 285. When this relation is shown to exist, it imposes the burden of proof upon the person taking securities, or making contracts inuring to his benefit, to show that the transaction is just and fair, and that he has derived no unfair advantage from his fiduciary relation' (citing *Gibson v Jeyes*, n 198 above).

²⁰³ See, for example: *Metropolitan El. Ry. Co. v Manhattan El. Ry. Co* 14 Abb. N. Cas. 103 (1884); *Cowee v Cornell* 10 Sickels 91 (1878); *Butler v Prentiss* 12 E.H. Smith 49 (1899); *Rosevear v Sullivan* 62 N.Y.S. 447 (1900); *Ten Eyck v Craig* 17 Sickels 406 (1875).

There are two difficulties involved in translating these standards from trusts and other non-corporate fiduciary relations to the corporation. First, following the creation of the trust, the trust involves a bilateral relationship between trustee and beneficiary. The corporation involves a tri-lateral relationship between corporation as an entity and its constituent parts or organs of the board and the shareholder meeting. This transplantation of the fiduciary standards from a bilateral to the trilateral relationship creates the following problem: is the corporation the trust, or is it the beneficiary? Secondly, the relationship of trustee to trust assets and trust power is not easily transplantable to the corporate context. The trustee holds legal title to the trust's assets. A transaction with trust property is therefore not legally possible without the trustee's involvement. A director of the corporation does not hold legal title to the corporation's assets which is, of course, vested in the corporation itself. Furthermore, although directors may be fiduciaries of the corporation, it is the directors acting collectively, as a board, not the individual directors, that possess and wield corporate power,²⁰⁴ and it is possible for the board to wield power without the actual participation of a director who wishes to enter into a contract with the company. If the director participates in the board decision to enter into the self-dealing contract, then power is wielded, the director sits on both sides of the transaction, and the corporation, in the trust analogy, is the trust. However, if the director does not participate in the transaction, then power is not wielded, although influence maybe, and the corporation looks more like the beneficiary than the trust.

Early UK authority dealing with unincorporated companies suggested that the 'paralysing' of the director's role to enable self-dealing arrangements was not possible.²⁰⁵ The issue was placed partially in play in *Aberdeen Railway v Blaikie* where the court considered whether the fact that Blaikie 'was one of a body of directors' made any difference to the applicable standard. The court rejected this position observing that it was the director's duty to give the company the full benefit of his knowledge and skill. Of course, although in the minority, Blaikie had exercised power so the court was not faced with the situation where the director had abstained or had not attended the meeting. This holding was subsequently interpreted more broadly in *Imperial Mercantile Credit Association v Coleman*,²⁰⁶ as a general prohibition on any director entering into a transaction, regardless of whether he participated in the decision or not, as the company had 'a right to the entire services of the director, and to the advice of every director in giving his opinion upon matters brought before the board'. Accordingly, English courts refused to allow directors to dissociate themselves from power, to in Lord Eldon's words 'shake off the obligation,' just as a trustee could not divulge himself of power without revoking his trusteeship. This rendered a self-dealing transaction a transaction which always involved the exercise of director power, regardless of

²⁰⁴ Of course individual directors wield power delegated to them by the board of directors.

²⁰⁵ *Benson v Heathorn*, n 120 above.

²⁰⁶ n 122 above.

formal voting participation. The fiduciary influence standard was thereby sidestepped.

This UK approach is consistent with the 19th century UK conception of the incorporated company that was partially blind towards the entity; where the real participants, as in its ‘predecessor’ unincorporated company, were the trustee directors and shareholders. That is, the UK incorporated company was viewed bilaterally and therefore it was easier to view a director's relationship to corporate power in the same way as a trustee's individual relationship to trust power. Consider Lindley on board power and the analogy between trust and company:

The property of the company may not be legally vested in the directors [DK- as it would be if it were a trust], but it is practically under their control; and they are bound to employ it for the purposes for which it was *entrusted to them*. So the powers which the directors have, eg., of calling meetings, electing members of their own board, allotting, transferring and forfeiting shares, making calls, etc., etc., *are reposed in them* in order that such powers may be bona fide exercised for the benefit of the company as a whole; and any exercise of such powers for other purposes is a breach of trust and will be treated accordingly (emphasis supplied).²⁰⁷

Note that Lindley refers to powers ‘which the directors have’. In a deed of settlement / unincorporated company corporate power was delegated to the directors of the company and not, in the first instance, to a board of directors or a ‘court of directors’. In a deed of settlement company there is no entity or body or organ of that entity, but only individual persons to whom power is delegated. While the deed of settlement would typically provide for the collective exercise of that power, the power itself resided in each of the directors themselves. This required therefore that the deed of settlement provide that when some directors were not present that the ‘court of directors’ could act and would ‘have all the powers and authorities vested in the directors for the time being, *as if all were present*’ (emphasis supplied).²⁰⁸ That is, the court of directors brought together the power vested in each of the individual directors in order for that power to be exercised collectively. Consistently with this approach the delegation of power to directors in an incorporated UK company has never typically been to a board of directors, but rather to ‘the directors’.²⁰⁹ This is also why English courts

²⁰⁷ Lindley, n 27 above.

²⁰⁸ *Benson v Heathorn*, n 120 above.

²⁰⁹ For example, default constitution – the Table A articles – issued pursuant to the Companies Act 1862 provides that the ‘business of the company shall be managed by the directors, who may pay all expenses incurred in getting up and registering the company, and may exercise all the powers of the company’. Although the term ‘board of directors’ is used elsewhere in the articles, it is not used in relation to the empowerment of directors or the procedures which they have to follow to exercise power. For example, ‘The directors may delegate any of *their* powers to committees consisting of such member or members of their body as they think fit.’ Article 68 (emphasis supplied). The Aberdeen Railway Company was a

sometimes refer to corporate powers as ‘fiduciary powers’: powers entrusted to fiduciaries, to be exercised in accordance with their fiduciary duties.²¹⁰ Director power was something directors had as a result of being a director and not as a result of attending and participating in the board meeting. Accordingly, English law’s answer to the question posed by the House of Lords in *Aberdeen Railway* as to whether the director was ‘acting in the case now before us’ is that participation is irrelevant because when the board makes a decision the powers held by all the directors is exercised. As power is necessarily exercised the applicable fiduciary standard is the strict voidability standard, even for the non-participating self-dealing director.

In contrast, in a New York corporation power resided not in the directors individually with a mandate to act collectively but in the board of directors itself. The New York general incorporation statute for manufacturing companies, as amended as of 1860, provided that the ‘stock, property and concerns of such company shall be managed by not less than three, nor more than thirteen trustees’. The Revised statutes of 1861 provided for quorum requirements in relation to the exercise of power by the trustees and that ‘every decision by a majority of the persons duly assembled as a board, shall be valid as a corporate act’. Writing in 1882 Victor Morowetz observed that ‘the active management and direction of the affairs of a trading corporation are ordinarily vested in a board of directors or trustees’.²¹¹ By 1892 the New York General Corporation Law provided that ‘the affairs of every corporation shall be managed by its board of directors [and that] the act of a majority of the directors present at the meeting at which the quorum is present shall be the act of the board of directors.’²¹² Power in a 19th century New York corporation did not reside in the directors themselves but in the board of directors, which was empowered to exercise corporate power in the absence of less than a majority of the directors. Directors who did not attend a board meeting at which a decision was made did not exercise corporate power. As Paul Ames put it writing in 1887: a director ‘may be deemed to be relieved of any trust relation to the stockholders, except in so far as his own individual action may affect the complete exercise of the power lodged in the whole board’.²¹³ Logically, therefore, the fiduciary standard applicable to such a non-participating director in a self-dealing transaction would be the *Gibson v Jeyes* influence standard, ie, a fairness standard, and where he did participate it would be the stricter *Ex Parte Lacey* power standard. Because of the understanding of director empowerment in a UK company this distinction was not available to UK company law, whereas it was logical and arguably correct in the New York context. This understanding of

chartered company, and its constitution was provided by the Companies Clauses Consolidation Act 1845 which also empowers the directors, rather than the board of directors. § 90.

²¹⁰ *In re National Provincial Marine Insurance Company* (1870) L.R. 5 Ch.App. 559; *In re Coalport China Company* [1895] 2 Ch.404; *In re Cawley & Co.* (1889) 42 Ch.D. 209.

²¹¹ Morowetz, n 70 above, 229.

²¹² The General Corporate Law 1892, § 29.

²¹³ P. Ames, ‘May a Director Deal with His Corporation’ (1887-1888) 1 *Columbia Law Review* 193, 193.

board power opened a channel through which the established fiduciary influence standard could flow into corporate law.²¹⁴

To be clear, I am not suggesting a determinate relationship between New York corporate law's understanding of board power and application of the fiduciary influence standard. Rather, this understanding of board and director empowerment created an opening – a crack in the structure of analysis that drove UK law – which provided one means of being responsive to the instrumental economic pressures to enable self-dealing. Small disconnects in an argumentative structure can drive different legal paths, but, of course, they may not do so. Indeed, the New Jersey courts, dealing with corporations with effectively identical understandings of board power to their New York counterparts,²¹⁵ did not take this opening and adopted the UK's approach to director participation, holding that the strict voidability rule was applicable even in the absence of director participation. The early decisions of the Courts of Maryland took the same position. However, even in these jurisdictions where the influence standard was rejected the tension between influence and power existed in a way that it did not in UK corporate law. For example, in 1861, the Maryland Court of Appeals in *Cumberland Coal v Sherman*,²¹⁶ following the UK cases of *Aberdeen Blaikie* and *Benson v Heathorn*, considered and rejected the influence standard. However, in 1875 in *Cumberland v Parish*,²¹⁷ the Maryland Court of Appeals having reiterated the same position then incongruously held that the question of voidability hinged on an influence standard: whether 'reasonable use has been made of [the] confidence'. Nor is the claim here that the New York courts were completely closed to the adoption of the UK and New Jersey position. Indeed in a limited number of cases, which themselves had no impact on the trajectory of New York law, the New York courts, relying on *Cumberland Coal v Sherman*, adopted a position that does not depend upon director participation.²¹⁸ Rather the claim made here, and argued

²¹⁴ Beveridge argues that this standard was the general by the mid-1870s US self-dealing fiduciary standard, citing the trusts case book: J.W. Perry, *A Treatise on the Law of Trusts and Trustees* (Boston: Little, Brown, 2nd ed, 1874), 248-249. We show below how this standard percolated through New York self-dealing law. This standard did not play a role in New Jersey self-dealing law.

²¹⁵ Arguably it is noteworthy for this argument that early New Jersey Corporation statutes did not refer to a board, but rather empowered directors directly. See J.J. Treacy and J. Milton, *The General Corporation of New Jersey (Revision of 1896)* (New Jersey: Hudson Print Co., 1921), including all supplements and amendments thereto, to the end of the legislative session of 1921 (1921). However, the New Jersey courts were clearly of the view that the board and not individual directors were empowered. See, for example: *Titus v Cairo and Fulton R.R. Co.*, 37 N.J.L. 98 (1874), observing that 'the authority of corporate bodies are within the exclusive control of the board of directors, from whom authority to dispose of their assets must be derived'.

²¹⁶ n 193 above.

²¹⁷ n 142 above.

²¹⁸ In *Hoyle v Plattsburgh & MR Co.*, n 142 above, 'nor is it possible to limit the duty of a director of a corporation, in this respect, to the time while he is acting as a director under any special delegation of power, or is in attendance at meetings of the board'. Surprisingly, this case is typically cited alongside other authorities supporting the view that the strict standard was dependent on participation – see, for example: *Globe Woolen Co. v Utica Gas & Electric Co.* 75 Misc. 539 (1912), n 142 above, citing *Hoyle v Plattsburgh & MR Co.*, for the proposition that 'if a director enters into a contract between himself and his

below, is that in working out how to regulate self-dealing transactions the dominant view in New York from the 1860s to the 1890s bought into fiduciary law's distinction between power and influence, a distinction made available by the understanding of board and corporate power in a New York corporation.

Importantly, Harold Marsh, and commentators who have adopted Marsh's position, were aware of this influence strand of fiduciary law and the analogy of the corporation to the beneficiary. However, it is viewed as both a marginal and unpersuasive ex-post technical justification; a cover for the unspoken drivers of legal change.²¹⁹ Compounding the sense that this justification was outside of the mainstream legal position Marsh cites only one 1902 Texas case in support. Indeed he suggests that is the only case that made this connection.²²⁰ However, in New York the influence strand of fiduciary law is neither marginal nor an ex-post explanation of legal change. It arises, together with the voidability standard, as a result of the courts' attempts, prior to 1880 and thereafter, to transplant fiduciary law to the context of the US corporation. The courts did not, unsurprisingly, see it as necessary to 'explain' the application of a fairness standard because to them it did not represent a change in the law.

b. Participating directors and the influence standard

Many of the early New York cases involved directors who participated in the decision to enter into the self-dealing transaction. As they exercised power the strict *Ex Parte Lacey* standard set forth in *Aberdeen Blaikie* is applicable. But in New York one cannot extrapolate from these cases to a generally applicable voidability standard. On the contrary the early cases held up as the standard bearers of the strict standard take pains to stress the participation of the director in the board decision. Underpinning the court's focus on participation is, it is submitted, an awareness that the applicable standard depends upon whether power is exercised or merely influence exerted. In *Butt v Woods*, for example, the Court stresses the participation of the defendant in the approved transaction.²²¹ In *Munson v Syracuse* there is a pervasive focus on the participation of the director in approving the transaction. The Court observed that 'the contract bound the corporation to purchase, and Munson, as one of the directors, *participated in the action* of the corporation in assuming the obligation'; he was 'one of ten directors who voted in favour of the contract'. The court observed further that: 'the law cannot measure the influence of a trustee on his associates [...] in an action by the trustee in his

corporation, and assumes to act for both, his contract is voidable'; *Metropolitan Elevated RW Co. v Manhattan RW Co.*, n 183 above: 'I think, therefore, that the undoubted rule of law in this state is, that every contract entered into by a director with his corporation may be avoided by the corporation within a reasonable time, irrespective of the merits of the contract itself'; *Merrill v United Box Board & Paper* 143 A.D. 833 (1911).

²¹⁹ Marsh, n 15 above, 40, noting that 'the only explanation which seems to have been given for this change in position was the technical one [...]'. Professor Clark observes, '[A]t most they made technical, analogical arguments'. n 16 above, 161.

²²⁰ Marsh, n 15 above, 40, refers to 'the only explanation that seems to have been given' and then quotes 'the Texas court': *Tenison v Patton* 95 Tex 284, at 292-93 (1902).

²²¹ See also *Barnes v Brown*, n 191 above: 'He could not act as trustee and for himself at the same time.'

private capacity to enforce the contract, *in the making of which he participated*. and that a strict rule ‘weakens the temptation to dishonesty [in] all transactions in which they assume *the dual characteristics of principal and representative*’ (emphasis supplied). Although the judgment has nothing to say about the applicable standard when the director abstains or recuses himself from the board’s decision, it operates within the dual power / influence fiduciary paradigm. Indeed, in litigation related to *Munson v Syracuse* the Court of Appeals in *Munson v Magee*²²² stressed that Munson’s role in acting for the corporation was central to the voidability decision:

The post-*Munson* and *Butt* cases that adopt a strict voidability approach to the facts of the case are relatively few in number. Those that do involve a director who participates in the decision. In these cases the courts identify such participation. For example, in *Koster v Pain*,²²³ the Court of Appeals observed that: ‘as in the case of every other trustee or agent, no director can, *in acting on behalf of the corporation*, reserve or secure to himself any advantage or benefit’ (emphasis supplied).²²⁴

Although the power / influence dichotomy silently structures the most important and influential early cases, in the 1880s only one New York case explicitly toys with the fiduciary influence fairness standard. This is the case of *Rudd v Robinson*, an 1889 Supreme Court decision, where the court juxtaposes a strict voidability rule with the influence standard, voiding certain transactions and subjecting others

²²² 15 E.h. Smith 182 (1899): “The contract of September 14, 1875, was executed by Munson, Case, and Gowen as individuals, owning and controlling the bonds of the Sodus Bay companies, and then by the Sodus Bay & Corning Railroad Company, by Munson, its president. No other officer or person executed the contract on behalf of the railroad corporation. It was therefore a case where Munson, as an individual, stood in the attitude of selling as owner, and purchasing as the president of the corporation, and this, as Judge Andrews says, the law will not sanction.”

²²³ 58 N.Y.S. 865 (1899).

²²⁴ *Merrill v United Box Board & Paper*, n 218 above (relying on *Munson v Syracuse*, n 189 above, and observing that ‘plaintiff voted to approve his own contract’); *Miller v Crown Perfumery* 109 N.Y.S. 760, (1908): ‘this principle flows logically from the fiduciary relation which exists between an officer of a corporation and the corporation, which prohibits such officer from voting to himself the property or assets of the corporation, or from taking part in any matter affecting his personal interests’, citing *Butts v Wood*, n 152 above; and *Barnes v Brown*, n 191 above; *Jacobson v Brooklyn Lumber Co.* 22 Bedell 152 (1906), citing both *Butts v Wood*, n 152 above, and *Munson v Syracuse*, n 189 above, for the proposition that ‘the courts in this state have frequently asserted the void ability of acts and votes of corporate officers, when they are affected by private interests’. *Strobel v Brownell* 16 Misc 567 (1895) (distinguishing *Munson v Syracuse*, n 189 above, on the basis that at the time the contract was made, Munson was a director of the purchasing corporation, and took part in making the contract upon which the action was brought); *Barr v New York, L.E. & W.R. Co* 80 Sickels 263 (1891) (distinguishing *Munson v Syracuse*, n 189 above, on the basis that it involved ‘the vice that a director of the defendant corporation was a party to it, and participated in the action of the corporation in assuming the obligation’); *Beers v New York Life Ins. Co.* 66 Hun 75 (1892) (observing that ‘a director is at liberty to make a contract with his corporation, so long as he does not, while acting in his own interest, on the one side, also act, on the other, in the capacity of trustee, so that his interest and his duty might conflict’).

– involving loans – to the influence standard.²²⁵ Absence of explicit consideration of this standard in the 1880s could be read as the absence of the standard. This is not correct. When placed within the context of this fiduciary power / influence paradigm we can see that the early strict decisions themselves operated within this paradigm and thereby accepted a role for a fairness standard for self-dealing transactions even though on the facts of those cases, *as power was exercised*, the voidability standard applied.

Responding to Beveridge's observation that in many of the voidability cases the director participated in the transaction,²²⁶ Cary and Eisenberg argue that, although this may be correct, 'the opinions did not limit the rule to such cases'. Indeed, in the absence of the above fiduciary context a literal reading of the cases would identify no explicit limit. But with this context we can see that voidability was connected to power, which explains the courts' focus on participation, and that fairness would have been applicable had power not been exercised.

This fiduciary paradigm also enables us to explain the apparent disconnect between the cases and leading New York commentators in this period. Professor Beveridge, in support of his argument that fairness review was established very early in US self-dealing law, cites Victor Morawetz, a New York attorney,²²⁷ who in 1880 opined that 'there is no impropriety in a contract between a director and the corporation, if the latter is represented by other agents'. In the 1886 edition of his book Morawetz observes that a quorate board is empowered to act on behalf of the company and provided the agent (the director) does not participate then the transaction is sound. However, 'even if [the corporation] is represented by a majority of the board, [the transaction] will always be scrutinised by the courts with strictness, and will be set aside at the suit of the corporation, upon proof of the slightest unfairness or imposition practised upon it'.²²⁸ In rejecting Beveridge's arguments Cary and Eisenberg argue that the commentators in this period go further than the majority of the cases.²²⁹ But they do not. Although one does not find a New York case in the 1880s that explicitly states the law in the terms outlined by Morawetz, he understood *Butts* and *Munson* to be articulations of the existing power / influence fiduciary position which was consistent with his statement. As Morawetz observed: '[I]he principle acted upon in these cases is a

²²⁵ Following *Twin Lick Oil Co. v Marbury* 91 U.S. 587. cf *Hoyle v Plattsburgh and Montreal Railroad Company*, n 142 above, following *Benson v Heathorn*, n 120 above, suggesting that such disability was not possible; although the director in this case participated in the decision to auction corporate assets.

²²⁶ Beveridge, n 135 above observes that 'if we examine the cases cited by Professor Marsh in support of his assertion that interested director contracts were voidable in spite of fairness, we shall see that the cases were actually concerned with transactions in which the interested director was active in representing both sides of the deal'. Beveridge does not proceed to explain this in terms of the background fiduciary standards.

²²⁷ Morawetz joined the well-known New York corporate law firm, Cravath, in 1887. See R.T. Swaine, *The Cravath Firm and Its Predecessors: 1818-1947, Vol 3* (New York: Ad Press, 2007), 381.

²²⁸ Morawetz's second edition was reviewed by Professor Ames in the *Harvard Law Review* where he referred to it as 'the best treatise on the subject of corporations'. (1887) 1 *Harv. L. Rev.* 109.

²²⁹ Cary and Eisenberg, n 136 above, 651: 'the strongest support for this argument comes from a few cases and the leading treatises of the time'; 'a clear majority of the cases support Marsh'.

general principle of the law of agency.²³⁰ Accordingly, fairness review in New York does not, as Marsh demanded, need to be justified as a departure from the strict voidability rule and the policies underpinning such a rule. It represents to 19th century New York lawyers an available stream of fiduciary doctrine that sits alongside the voidability rule and whose applicability is dependent on the role of the director in relation to the transaction in question.

c. Entrenching fairness review

It is in the 1890s that the influence doctrine comes to the fore in New York. The Court of Appeals decision in *Sage v Culver* which, as noted above, adopted an explicit fairness-based approach rooted in the fiduciary influence standard.²³¹ The court in *Sage* cites, but does not discuss, *Gibson v Jeyes* and *Cowee v Cornell* as authority for the fairness standard. For *Sage v Culver* fairness review is a product of the courts viewing self-dealing through equity's lens of influence and not of power. However, it is true that the rigour of equity's distinction between power and influence is not always maintained in this and subsequent cases that adopt the influence standard. The court in *Sage* does not appear to limit its holding to the non-participating director. Accordingly, if *Sage* represents a moment of legal change it is not one that moves from voidability to fairness, but one that arguably commences the disconnection of the influence standard from the absence of the exercise of directorial power.

The source of fairness review in *Sage v Culver* is readily traceable to the fiduciary influence doctrine. However, multiple other New York cases in the 1880s and 1890s which also took the view that self-dealing contracts were permissible subject to fairness review are not so clearly traceable to the fiduciary influence doctrine. Nevertheless, most of those cases fit within the non-power paradigm. The implication that these approaches were influenced or formed by that paradigm is irresistible. For example, in 1880 the New York Court of Appeals in *Van Brunt* held that the ability of officers of a railroad company to enter into contracts with the corporation 'cannot be seriously questioned' provided that 'no special advantage accrued to the defendant from the contract, and as there is no proof of any fraud'. In *Gamble v Water*, referred to above, the Court of Appeals

²³⁰ V. Morawetz, *A Treatise on The Law of Corporations* (Boston: Little, Brown, 1886), 485, para 518. See also H. Taylor, *The Law of Private Corporations* (Philadelphia: Kay & Brother, 1888), a text with strong New York influences (Taylor was a member of the New York Bar). Although Taylor does not state the rule as clearly as Morawetz, his analysis is structured by participation: 'A director or other corporate officer can *on behalf of corporation* make with himself no contract that will bind the corporation. Accordingly a resolution of the board of trustees of a corporation carried by the casting vote of the president ratifying an unauthorised act of his, in which he was personally interested is void.' 580.

²³¹ *Sage v Culver*, n 195 above, is a central but largely forgotten case for US commentators. The case only attracts seven citations from a Westlaw Journals and Review's search, only one of which considers *Sage v Culver* in the text of the article: C.M. Dickinson, 'Interested Directors of New York Corporation and the Burden of Proof' (1988) *Colum. Bus. L. Rev.* 91, 95-97. See also Beveridge, n 135 above, citing but not considering the case in detail, and L.B. Homer, 'The Status of the Fairness Test under Section 713 of the New York Business Corporation Law' (1976) 76 *Colum. L. Rev.* 1156.

applied a non-participating director / fairness standard. In *Strobel v Brownell* in 1895, distinguishing *Munson* because of the absence of the exercise of power and following *Gamble v Water*, the New York Supreme Court held that:

Every such contract made by a director of a company with a corporation is looked at with suspicion, and if the transaction is attacked the burden is upon the agent of the corporation, who has contracted with it, to show that it was honest and fair in all its parts, and that he has made no more profit out of the contract than any other person might properly have made.

Identifying evolutionary shifts in legal doctrine and attributing time periods within which they took place is a precarious task. The selection of a date immediately exposes the author to counterclaim based on an alternative set of cases. The common law is typically very obliging as there are many cases and many mistakes. What this section has attempted to demonstrate is that the cases from *Butt v Woods* to *Sage v Culver* represent not change but continuity underpinned by longstanding fiduciary doctrine. This period of continuity continues well into the 20th century. For example, the first instance judgment of *Dauids v Dauids* in 1909 appears initially to take a firm power-based voidability approach to allegedly excessive officer salaries but then, possibly influenced by a factual counterclaim that the directors had abstained from taking part in the decision, suggests that the applicable standard is a *Sage* fairness-based approach placing the burden on the directors to prove fairness, which in this case they failed to do.²³² In *Globe Woolen Co. v Utica Gas & Electric*, a 1918 case, the trial court upheld an executory contract between corporations with common directors. The court distinguished the automatic voidability rules applicable where the director acts, citing *Butt v Woods* and *Munson v Syracuse*, from the situation, citing *Strobell v Brownell* and *Gamble v Queens*, where the director does not participate. The Court held that provided ‘there being no fraud, conspiracy, bad faith or concealment, a valid contract may be made between a corporation and one of its directors.’ On appeal, Judge Cardozo in the Court of Appeals reversed the New York Supreme Court’s ruling but in so doing applied the same legal framework as the first instance court. The Court of Appeals held that the strict rule in *Munson* did not apply as the director had not participated in the decision but observed that ‘a dominating influence may be exerted in other ways than by a vote’. Accordingly, the Court held that:

There was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other (*Sage v. Culver; Dauids v. Dauids*). At least, a finding that there was this relation has evidence to sustain it. A trustee may not cling to contracts thus won, unless their terms are fair and just.

²³² See also *Carr v Kimball* 153 A.D. 825 (1912), for a similarly degree of schizophrenia about the relationship between power and the applicable standard, citing *Dauids v Dauids*, 120 N.Y.S. 350 (1909), and *Sage v Culver*, n 195 above.

The Court of Appeals invalidated the contracts as the ‘unfairness is startling’. Although *Globe* represents a clear reassertion of the power / influence framework, it represents a high watermark in this regard. Post-1920, although there are cases that firmly assert the power / influence framework rendering transactions voidable simply because of the exercise of power,²³³ the *Sage v Culver* fairness standard together with a disregard for the distinction between power and influence comes to dominate.²³⁴ In some instances reference to *Sage v Culver* is left behind; its influence based fairness standard detached from the case itself. This is seen most clearly in the first instance judgment in *La Vin v La Vin*,²³⁵ and the per curiam affirmation by the Court of Appeals,²³⁶ a decision which Marsh describes as ‘shamefaced’ for failing to address what he views as a departure from the strict rule.²³⁷ However, commonly *Sage* is cited as authority for a fairness-based standard which applies regardless of director participation in the board decision.²³⁸ *Munson v Syracuse* is not forgotten during this transition to fairness review,²³⁹ regardless of participation, but at worst it is cited in support of the general fairness standard,²⁴⁰ and at best as support for the position that the distribution of the burden of proof is dependent upon whether the director participated.²⁴¹

This is the unexplained shift in New York case law which Marsh rightly identifies: from non-participating / non-power-wielding director and fairness to just fairness regardless of whether power or just influence is exercised. It is not unexplained in common law evolutionary terms because *Sage v Culver* itself, a Court of Appeals case, appeared to ignore fiduciary law’s prerequisite of non-participation and thereby offered a platform for a fairness-only approach – a platform that the courts readily adopted by following the ‘rule stated in *Sage v Culver*’.²⁴² But this shift is unexplained, indeed inexplicable, in policy terms, for it

²³³ There are very few of these cases: *Hanben v Morris* 161 Misc 174 (1936).

²³⁴ See *Schall v Althaus* 208 A.D. 103 (1924); *Cleary v Oppenheimer* 154 Misc. 158 (1934); *Blaustein v Pan American Petroleum & Transport* 174 Misc. 601 (1940), all of which quote extensively from *Sage v Culver*, n 195 above.

²³⁵ *La Vin v La Vin* 283 A.D. 809 (1954).

²³⁶ *La Vin v La Vin* 305 N.Y. 598 (1953).

²³⁷ Marsh, n 15 above, 41.

²³⁸ *Schall v Althaus*, n 234 above; *Everett v Phillips* 288 N.Y. 227 (1942) (the Court of Appeals held that the dual position of directors did render the transaction void but subjected it to fairness review); *Bayer v Beran* 49 N.Y.S. 2d 2 (1944); *Stearns v Dudley* 76 N.Y.S. 2d 106 (1947); *In re Meyer’s Estate* 119 N.Y.S. 2d 737 (1953) (fairness review applicable when a director is ‘serving two masters’); *Wohl v Miller* 5 A.D.2d 126 (1958) (explicitly connecting actual participation to fairness review); *Foley v D’Agostino* 248 N.Y.S. 2d 121 (1964); *Kaminsky v Kahn* 259 N.Y.S. 2d 716 (1965); *Strax v Murray Hill Mews Owners Corp.* 809 N.Y.S. 2d 759 (2005).

²³⁹ *Munson v Syracuse*, n 189 above, is regularly cited in the non-corporate context of trusts and wills. For example: *In re Grace’s Estate* 247 N.Y.S. 2d 695 (1964); *In re Dickson’s Estate* 237 N.Y.S. 2d 572 (1963). There are very few post-*Globe Wollen Co. v Utica Gas & Electric Co.*, n 142 above / *Munson v Syracuse*, n 189 above, cites in corporate cases.

²⁴⁰ *Strax*, n 238 above, citing *Sage v Culver*, n 195 above, and *Munson v Syracuse*, n 189 above, as authorities for fairness review.

²⁴¹ *Hazgard v Chase Nat. Bank of City of New York* 159 Misc 57 (1936).

²⁴² *Blaustein v Pan American Petroleum & Transport*, n 234 above; *Cleary v Oppenheimer*, n 234 above.

was clearly not necessary to adjust to the instrumental economic need for self-dealing. As discussed in Part I of this article, in the UK where companies and shareholders had complete contractual freedom to fashion self-dealing rules they typically elected for a disinterested director mechanism, the failure to comply with which would attract the strict voidability rule. Perhaps then regulatory competition or the effects of repeat player litigation by management – or more accurately persistently similar claims made by different managers – has some explanatory power here. However, the repeat player litigation claim appears unpersuasive when one considers the parties and the courts and judges which decided these cases. In none of the cases cited during this transitional period does the same defendant or the same judge appear twice. Nor are self-dealing defendants archetypal repeat players:²⁴³ company resources could not be deployed to defend these actions; indemnification to the extent provided for was at this time of doubtful legality;²⁴⁴ and the plaintiffs appeared to be well resourced as typically they were either significant shareholders suing derivatively or liquidators. Regulatory competition as an explanatory factor is dented by the fact that *Sage v Culver*, as early as 1895, appeared to ignore the power / influence distinction, as well as by the fact that in several of the 20th century cases where fairness is adopted and the distinction is ignored the decision itself does not favour management, suggesting that those judges were not receptive to the claims that New York law needed to adjust in favour of managers in order to attract re-incorporations.²⁴⁵ A persuasive explanation is not available. But one cannot disregard an explanation that discounts politics, pressure groups, and rational responses of law-makers to those pressures and sees legal change as the result of a fair pinch of incompetence in reading the cases and applying the common law method.

3. *Delaware's borrowed goods*

What is striking about Delaware self-dealing case law is the lack of it. Delaware has no place in the first two stages of Marsh's evolution of self-dealing cases because there are no cases. Marsh refers to no Delaware cases before 1948.²⁴⁶ What is truly remarkable about Delaware is that it became the leading corporate law state with very little common law. Indeed, if one was to take 1920 as a cut-off point it would be very difficult to say anything at all about the effects of charter competition on corporate law by reference to Delaware law, as there was close to nothing in several key areas of corporate law that one could say was Delaware law – the statute was borrowed directly from New Jersey, and there were hardly any

²⁴³ M. Galanter, 'Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change' (1974) 9 *Law and Society Rev.* 1.

²⁴⁴ See text to nn 101-104 above.

²⁴⁵ See for example *Seball v Althaus*, n 234 above; *Stearns v Dudley*, n 238 above. Other cases, of course, would fit in the race to the bottom paradigm: see for example *Everett v Phillips*, n 238 above, or *Bayer v Beran*, n 238 above.

²⁴⁶ Citing *Blisb v Thompson Automatic Arms Corp.* 30 Del. Ch. 538, 64 A.2d 581 (Sup. Ct. 1948), in relation to the discussion of whether an interested director could be counted for the purpose of determining whether the board is quorate. The earlier Federal case of *Hand v Missouri-Kansas Pipe Line Co.* 54 F. Sup. 649 (D.Del. 1944), is cited in relation to board expenses in a proxy fight.

important Delaware cases. The lack of authority clearly creates open space for judges to carve-out solutions that are tailored to its primary constituencies. However, when placed in the context of the above analysis of New Jersey and New York self-dealing law, we see clearly that Delaware self-dealing law is rooted in the approaches formed in other states. It borrows from and brings together those approaches. In doing so it asserts its independence through only limited citation of its neighbours' cases upon which Delaware law rests.

Delaware law on self-dealing commences in the 1920s with the important case of *Caball v Lofland*²⁴⁷. In this case, both the Chancery Court and the Supreme Court of Delaware invalidated the payment of remuneration and the issuance of shares to a corporation's directors. Both courts rely on *Du Pont v Du Pont*, a Delaware District Court case applying New Jersey law, which observed, without citing authority, that 'if [the director] acts for himself in matters where his interest conflicts with his duty, the law holds the transaction constructively fraudulent and voidable at the election of the corporation'.²⁴⁸ The language of constructive fraud echoes the power / influence fiduciary dichotomy which was so influential in New York, although whereas the term is usually used to refer to the regulation of influence,²⁴⁹ here, unusually, it is connected to the exercise of power.²⁵⁰ Following this statement the Chancery Court then proceeds to rely on the New Jersey case of *Gardner v Butler* to understand the application of this rule. It extracts two principles from *Gardner*: a disinterested director principle and a fairness principle. In *Gardner* the board resolution was passed by a majority of interested directors. As observed above, *Gardner* followed *Stewart v Lehigh Valley Co.*, which viewed interested director non-participation as irrelevant. Nevertheless, for the Chancery Court in *Caball* the facts of *Gardner* serve as the basis for its holding that majority interested director participation renders the transaction constructively fraudulent and therefore voidable. The judgment does not articulate the standard of review for transactions that are approved by a majority of disinterested directors, although the language of constructive fraud implies fairness review. Secondly, it observes that *Gardner* provides that although the contract cannot stand if voided, the director-counterparty to the contract is entitled to his due as it 'would be manifestly inequitable to deny the trustee a fair equivalent therefore'.²⁵¹

²⁴⁷ 12 Del. Ch. 299 (1921).

²⁴⁸ *Du Pont v Du Pont* 242 F.98 (1917). The judge in *Du Pont* cites no authorities for this proposition.

²⁴⁹ For example, in *Cowee v Cornell*, n 203 above, citing among others the UK case of *Hunter v Atkins* 3 My. & K, 113 (1833), the court observed in defining constructive fraud that: 'Whenever, however, the relations between the contracting parties appear to be of such a character as to render it certain that they do not deal on terms of equality but that either on the one side from superior knowledge of the matter derived from a fiduciary relation, or from overmastering influence, or on the other from weakness, dependence, or trust justifiably reposed, unfair advantage in a transaction is rendered probable, there the burden is shifted, the transaction is presumed void, and it is incumbent upon the stronger party to show affirmatively that no deception was practiced, no undue influence was used, and that all was fair, open, voluntary and well understood.'

²⁵⁰ See n 203 above.

²⁵¹ Quoting directly from *Gardner v Butler*, n 150 above.

The Supreme Court of Delaware's judgment in *Caball*²⁵² focuses on the effects of director participation in approving the self-dealing contract and affirms the invalidity of the self-dealing transactions as constructive fraud. The court does not explore the standard applicable to a self-dealing transaction with a non-participating director. However, once again the focus on participation and the language, if not the precise use, of constructive fraud suggests that the influence fiduciary fairness standard would be applicable to such transactions. Unlike the Chancery Court the Supreme Court does not explore *Gardner* remedial fairness. Nor does the court refer to authority on self-dealing law apart from *Du Pont v Du Pont*, although it does affirm that the authorities considered by the Chancery Court were the leading authorities.

Caball brings together remedial fairness and the fiduciary influence standard. It arguably applies a fairness standard whether or not the directors participated in approving the transaction: if the director did not participate then it suggests that the fiduciary influence fairness standard applies; where the director participates remedial fairness applies. Thirty years later in *Gottlieb v Heyden Chemical Corp*,²⁵³ the court, citing only the Supreme Court's judgment in *Caball*,²⁵⁴ sets forth the general proposition that, where the majority of directors are interested, 'the burden is upon the directors to prove not only that the transaction was in good faith, but also that its intrinsic fairness will withstand the most searching and objective analysis'.

Delaware itself makes no substantive legal contribution to the development of fairness review. This work was done in New Jersey and New York in the mid to late-19th century. From an analysis of the limited amount of Delaware self-dealing case law we see that Delaware self-dealing law in the early 20th century was in effect a blank sheet of paper, and Delaware judges got to choose from the approaches and precedent of leading jurisdictions. Perhaps this vantage point enabled Delaware to cut through the complexity to see that a remedial fairness standard renders other approaches – a strict voidability rule or a participation-based fiduciary fairness standard – functionally irrelevant. But Delaware courts did not alter the nature of the legal standard, whose pro-managerial bias was encoded long before Delaware gained corporate legal significance. Of course, this tells us nothing about the application of the standard, or the procedural rules that structure its application. There is much room to manoeuvre within 'fairness'. And much room to attract managers with a signalled favourable approach to application and procedure.

²⁵² *Lofland v Caball* 13 Del.Ch. 384 (1922).

²⁵³ 33 Del.Ch.82.

²⁵⁴ *Lofland v Caball*, n 252 above, as the only case cited; the court also cited William Fletcher, *Cyclopedia of the Law of Private Corporations, Vol 3* (US: Callaghan, 1917), s 921.

III CONCLUSION

If we posit two approaches to self-dealing law – a strict voidability approach that enables the company to invalidate any self-dealing transaction and an approach based upon fairness as measured by a market benchmark – and asked managers to select their preferred form of regulation, it is highly probable that managers would prefer the latter. Benign managers would welcome the flexibility inherent in a fairness standard; the less benign would welcome the greater scope to enter into self-serving, self-dealing arrangements. According to Harold Marsh’s account of the evolution of self-dealing law, the US originally adopted a strict approach which rejected fairness but moved over time to a fairness-based approach. According to March, this transition was unexplained by the courts in legal or policy terms.

Juxtaposing the contemporary fairness standard next to the historical strict standard Marsh allows us to draw a conclusion and begs a key question. The conclusion is that contemporary US corporate law is management friendly and more managerial friendly than it used to be. The question is why it has become so receptive to managerial interests. There are two components of the answer that a contemporary corporate lawyer is likely to give to this question. First, a strict rule was not suitable for carrying out business activity through the corporate form, and therefore it needed to be changed to a more suitable standard. The second component of the answer today would be to explain that managerial pressure is likely to be more acute in this context than in any other, because, for the self-serving director, self-dealing matters – it is a significantly redistributive area of the law. Furthermore, state law-makers, including judges, are likely to be receptive to such pressures as managers make the reincorporation decision. The conclusion, the question, and its answer are reinforced when one looks at self-dealing law in comparative perspective. The United Kingdom commenced with a strict standard, maintained its strict standard, and has not been exposed to the distortive incentive effects of charter competition.

But if, as is argued in this article, self-dealing law in the US and the UK resulted from the adaption of existing fiduciary law to the conception of the corporation in the mid to late-19th century then: there is no unexplained shift from strict rule to management friendly standard to explain; no need to rely upon non-legal pressures and incentives to explain legal change that the courts failed to account for; and the UK’s maintenance of the strict standard has nothing to do with allegedly weaker receptivity to management’s interests. That is of course not to say that the external context of business activity was not important to the translation of existing fiduciary law to the business context. Clearly in both the United States and United Kingdom courts were cognisant of the different role of self-dealing transaction in the corporate form as compared to the trust context. But law is responsive to these pressures in internally consistent ways – generating responsive solutions that are legally coherent and consistent. The common law

does not, as Marsh's narrative implies, sacrifice its internal rules and policy commitments to satisfy external business demands.

If there was no shift from strict to flexible standards, then in the context of self-dealing law charter competition has limited explanatory power. Although it is theoretically compelling that in significantly redistributive areas of corporate law state lawmakers are likely to be very receptive to considerable managerial pressure, if, as we saw in New Jersey and New York, fairness coexisted at all times with the strict standard, then there is no shift to a more managerial friendly position for this theory of legal change to explain. Of course, such pressures may manifest themselves at the margin, for example in the application of the standard or in the form taken by the procedural rules which determine the application of the fairness standard, such as evidentiary standards and burdens of proof. But the fairness standard itself, as standard bearer of the management friendly bias of US corporate law, is not explained by these pressures. Rather it is explained by the core components of the conception of the US corporation: its emphasis on the public creation of the corporation; its concomitant restraint on contractibility; and the state's direct empowerment of the board of directors.

Legal realism taught us that hiding in the mouth of the legal dragon²⁵⁵ are economic and social policy choices. What it did not teach us is that law is a space where only policy debate takes place and where common law legal outcomes are only policy choices dressed up to create the effect of legal necessity or inevitability. Delaware's corporate legal style, born of its remarkable success in the race for corporate charters, even in the absence of an independent corporate legal engine that one would have assumed originally propelled such success, plays to this misreading of legal realism. It creates the impression that Delaware's legal rules have only a perfunctory connection to legal tradition, whereas in fact, at least in the self-dealing context, they are rooted in, a largely unattributed, legal tradition. The dominant narrative of self-dealing law also plays to this misreading of legal realism. Law apparently ignored legal constraint to make a different, although unspoken, policy election. In demonstrating that this dominant account of the evolution of self-dealing law is wrong, we see that we need to open the mouth of our contemporary corporate dragon and search for systemic legal constraint, and we see that for contemporary corporate law a significant dose of inevitability was administered at the inception of general incorporation.

²⁵⁵ Holmes, n 3 above, noting, 'When you get the dragon out of his cave on to the plain and in the daylight, you can count his teeth and claws, and see just what is his strength.'