THE PATH OF CORPORATE FIDUCIARY LAW

DAVID KERSHAW*

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 view dominates the 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: it 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. In formulating this argument, the article considers the internal constraint of the legal conception of the corporation in 19th-century U.S. and U.K. corporate law on the evolution of self-dealing law in these two jurisdictions. It shows how two jurisdictions that began with 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. This article takes the position that, contrary to the dominant account of the evolution of self-dealing law in the United States, the contemporary self-dealing rule is not the unexplained product of external market pressures but is the logical 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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I. 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 adaption 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 lawmaking, then the vantage point of both scholar and lawmaker will be critical of law's failure to fulfill its function

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and will be 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 marketplace 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 behavior."[1]

This article argues that this dominant theory of legal change is partial and therefore inaccurate. The dominant theory treats subsidiary drivers as primary drivers and pays scant regard to the actual 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] corporate scholars have increasingly ignored the fact that a legal system may have certain internal biases that have a substantial impact on the path of legal change. 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 mistake the interests of individuals, such as

1. Karl Marx & Friedrich Engels, *The German Ideology*, *in* KARL MARX: SELECTED WRITINGS 102, 111 (Lawrence H. Simon ed., 1994) ("Conceiving, thinking, and the intellectual relationships of men appear here as the direct result of their material behavior. The same applies to intellectual production as manifested in a people's language of politics, law, morality, religion, metaphysics, etc.").

2. O. W. HOLMES, JR., THE COMMON LAW 1 (1881).

3. O. W. Holmes, Jr., *The Path of Law*, 10 HARV. L. REV. 457, 469 (1897).

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managers, for the interests of commerce.[4] A second and dominant economic account of corporate legal change for the past forty years focuses on the horizontal competition between states for corporate charters,[5] and the vertical pressures placed on state corporate lawmaking as a result of the threat of federal pre-emption of corporate law.[6] Through these lenses, law is seen as 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 management-friendly nature of Delaware law as the product of the state's responsiveness to the interests of managers who control the re-incorporation decision. "Race-to-the-top" theorists, on the other hand, view corporate law as responsive to the economic imperative of maximizing the value of the corporation's shares. Scholars that adopt 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 maximize value where they are not.[7] Other accounts of legal change and variation fall outside of

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4. *See generally* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 (1977); MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960 (1992).

5. *See, e.g.*, Lucian Ayre Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775 (2002); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125 (2009).

6. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005).

7. *See* Bebchuk, *supra* note 5. *See also* William W. Bratton, *Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-Five Years*, 34 GA. L. REV. 447, 450-452 (2000) ("[S]tates pursued suboptimal policies of management accommodation respecting fiduciary rules and antitakeover legislation. . . . I take the middle-ground view of charter competition . . . .").

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the charter competition debate but share the same underlying conception 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 United States and the United Kingdom is the result of variation in the structure of corporate ownership in these countries, particularly the stronger presence of institutional investors in the United Kingdom in the late 1960s, who lobbied 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 that pressures 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 is essentially 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 standard-bearers of legal change as the outcome of economic pressures and incentives. The most important example is the general decline of the dis-

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8. *See, e.g.*, Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV 127, 157 (1999) ("Interest 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. . . . [T]he 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.").

9. John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727 (2007).

10. *Id. But see* Harald Halbhuber & David Kershaw, The Power of Ideas in Corporate Law: Evidence from Takeovers (Nov. 2, 2010) (unpublished manuscript) (on file with the authors) (taking issue with this interpretation of U.S. and U.K. takeover law).

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ciplinary power of fiduciary duties[11] and, more specifically, the evolution of the self-dealing standard from a strict standard under which all self-dealing transactions were voidable regardless of fairness, to a standard that requires only fairness. Other important narratives relate to the evolution of takeover defenses, 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 the dominant economic understanding of legal change by challenging the widely accepted narrative about the evolution of U.S. self-dealing law and the related claim about the decline of U.S. 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. Self-dealing law in both the United Kingdom and the United States began by adopting the same fiduciary principles from English trust law to fill the gaps in their silent corporate codes, and for a brief period they both looked to the same U.K. case as the leading case. However, their laws rapidly diverged to provide starkly different fiduciary standards for directors. The mid-19th-century U.K. common law held that a self-dealing transaction was voidable by the company in the absence of *ex-ante* authorization or *ex-post* ratification.[13] The leading case, *Aberdeen Railway Co. v. Blaikie*,[14] observed that "[s]o strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness . . . of the transaction." Key U.S. states such as New Jersey and New York adopted an apparently identical rule in the mid-to-late 19th century. Indeed, the leading U.S. cases of this period invariably relied upon, and often extensively quoted from, *Aberdeen*

11. *E.g.*, Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 414 n.1 (2004) (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 & Kershaw, supra note 10.

13. *See* James Edelman, The Fiduciary Self-Dealing Rule, in Fault Lines in Equity 107 (Jamie Glister & Pauline Ridge eds., 2012) (arguing that that self-dealing transactions are void). But see Matthew Conaglen, Fiduciary Loyalty Protecting the Due Performance of Non-Fiduciary Duties 77-79 (2010) (taking issue with the position articulated by Edelman).

14. Aberdeen Ry. Co. v. Blaikie, (1854) 1 Macq 461, 461.

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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 U.S. corporate scholars.[16] In his 1966 article, *Are Directors Trustees?*, Marsh describes the evolution of U.S. self-dealing law in three stages. First, in 1880, the rule was as stated above; then, 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, in the third stage, 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 United Kingdom was unaltered from the strict voidability rule articulated in *Aberdeen Railway* in 1854.

How do we explain the apparent evolutionary dynamism of U.S. corporate laws and the evolutionary stasis of U.K. corporate law? Naturally, when legal starting points – the absence of regulation in either U.K. or U.S. corporate codes, the shared sources of English fiduciary law upon which both U.S. and U.K. corporate law were based, and the apparently identical initial interpretation of such underlying legal principles – are the same, we look outside of the law and not within it to explain the divergent paths taken by each country. The widely held understanding of U.S. self-dealing law, even without this comparative viewpoint, has been to understand its evolution as

15. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966).

16. ROBERT CHARLES CLARK, CORPORATE LAW 160 (1986) (referring to the evolution of self-dealing law as a historical puzzle).

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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 the instrumental economic needs of the marketplace: 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 U.S. 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 U.K. self-dealing law next to U.S. 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 U.S. 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 U.K. corporate case next to its Delaware counterpart, the absence of consequentialist reasoning and policy discussion as an acknowledged driver of legal outcomes in the U.K. judgments would be immediately striking. By contrast, the Delaware courts pride themselves on their receptiveness to the needs and vocabulary of the marketplace and the understanding of the policy rationales that underpin the legal rules.[19] One might therefore conclude that the different paths of U.K. and U.S. self-dealing law can be explained by a much greater receptivity on the part of U.S.

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17. *See id.* at 160-66. *See also* James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1079 (2003) ("Because 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.").

18. *See, e.g.*, MICHAEL J. WHINCOP, AN ECONOMIC AND JURISPRUDENTIAL GENEALOGY OF CORPORATE LAW 2 (2001) ("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 recognise the importance of their decisions for corporate governance. By contrast, English . . . courts retreated from a cautious pragmatism to a sometimes arid formalism.").

19. *Compare Re* D'Jan of London Ltd [1993] B.C.C. 646, *with In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

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courts, as compared to their U.K. counterparts, to the instrumental economic needs of the marketplace. Furthermore, the United Kingdom is not, and has never been, a jurisdiction that is subject to charter competition in any meaningful respect.[20] Accordingly, the different U.K. and U.S. trajectories of self-dealing law fit well with a narrative that explains U.S. legal evolution through the lens of the pro-managerial pressures on lawmaking 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. 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 and the path that law crafts through interaction with these pressures. Legal changes and adjustments, even when pursued by the most instrumental of lawmakers, must benefit from a façade of legitimacy and must be proffered in ways that are consistent with 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 to whom the changes are attributed did not view the change as profound at all, in which case it is necessary to dig deeper to understand how apparent legal change can be explained through the lens of continuity.

To explain the divergence of U.K. and U.S. self-dealing laws, it is necessary to understand their points of departure. Both jurisdictions started with a blank slate – there were no rules on self-dealing in the corporate code and no prior common law rules dealing with generally incorporated companies,

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20. *See* Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England,* 1998 COLUM. BUS. L. REV. 51, 68-77 (arguing that corporate legal federalism and its absence in the United Kingdom is primary driver of legal difference in takeover law and derivative action regulation). See generally John Armour, *Who Should Make Corporate Law? EC Legislation* versus *Regulatory Competition,* 58 CURRENT LEGAL PROBS. 369 (2005); William W. Bratton et al., *How Does Corporate Mobility Affect Law Making? A Comparative Analysis,* 57 AM. J. COMP. L. 347 (2009), for information on the state of regulatory competition in Europe.

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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 core systemic characteristics of U.S. and U.K. corporate law, with which they translated these source materials into the corporate context, were profoundly different. Most important in this regard were each jurisdiction's divergent conceptions of the corporation.

In the United Kingdom, a generally incorporated company, known as a registered company, was viewed conceptually as the continuation of unincorporated companies, which were known as deed of settlement companies. These were effectively large-scale partnerships formed by using contract and trust law, which were widely used prior to the availability of general incorporation. The generally incorporated company was not viewed as a paradigm shift in the form of business organization, 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 U.K. incorporated company was viewed from inception as the endogenous product of private contract. 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 U.K. company was understood to be delegated directly from shareholders to directors, who *then* formed the board. This contractual conception of the governance of a U.K. company operated as the safety valve for instrumental economic pressures in multiple contexts, including self-dealing, and allowed directors and shareholders to mold 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 contrast, 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

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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, including those applicable to self-dealing transactions, without permission from the state to do so. Accordingly, responses to external pressure to allow self-dealing transactions had to come from within the law itself. However, U.S. state courts did not respond by tearing up and re-writing the rules. Rather, they responded in different, internally consistent and jurisdiction-specific ways. The juxtaposition of U.K. and U.S. self-dealing laws sheds light on the evolution of U.S. self-dealing law. It allows us to see that the path of U.S. 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 consistent with the early 19th-century fiduciary law and the options made available by the U.S conception of the corporation.

This article does not directly address claims about the influence of charter competition on U.S. corporate law, but it should generate, as a by-product, a dose of skepticism 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 because the nature of such effects renders it impracticable to identify a single case or event to demonstrate increased managerial bias or lawmakers' resistance to managerial bias to ensure that the governance rules maximize value in the eyes of smart arbitrageurs. But it does mean that rules over time must gravitate to particular positions that support the claim. The relevant time period starts from the advent of the competition. The timeline established by this article does not support the existence of any significant charter competition effect in the self-dealing context because fairness review was established before the charter competition process was kick-started by New Jersey in 1889.[21]

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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 1896 when New Jersey adopted what is often viewed as the first modern corporation code. *But see* Charles M. Yablon, *The Historical Race Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910*, 32 J. CORP. L. 323, 333 (2007) ("In the decade from 1880 to 1889, there was not yet any public recognition that New Jersey, or any other

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Part I of this article 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 contractible. 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 U.S. jurisdictions: New Jersey, New York and Delaware. Part III concludes.

II. THE CONCEPTION OF THE CORPORATION

A. *The United Kingdom: A Contractual Conception of the Company*

Prior to the introduction of general incorporation in the United Kingdom, large-scale business activity was carried out through unincorporated associations or companies that, 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."

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state, had become a particularly popular state in which to incorporate, although there is evidence of a different perception among knowledgeable business professionals."). Arguably West Virginia tried the "charter mongering" strategy first in 1888 but to little avail. *See* CHRISTOPHER GRANDY, NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW 43 (1993) ("Before 1890, . . . New Jersey corporate statutes focused on firms operating within the state."); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006).

22. Leonard S. Sealy, *The Director as Trustee*, 1967 CAMBRIDGE L.J. 83, 84.

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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 name[23] and the problem of unlimited member liability which, although partially managed through contract, could never be fully excluded.[24] The U.K. Parliament was clearly cognizant of these practical problems in the early 19th century. Indeed, the introduction of general incorporation – known as "incorporation by registration" – in the United Kingdom 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 organizational 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 offi-

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23. *See* Michael Lobban, *Corporate Identity and Limited Liability in France and England 1825-67*, 25 ANGLO-AM. L. REV. 397, 403-04 (1996).

24. For a discussion on the pre-general incorporation construction of an 'entity' through trust and contract, see Joshua Getzler & Michael Macnair, *The Firm as an Entity Before the Companies Acts*, *in* ADVENTURES OF THE LAW: PROCEEDINGS OF THE SIXTEENTH BRITISH LEGAL HISTORY CONFERENCE, DUBLIN, 2003 267 (Paul Brand et al. eds., 2005).

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

26. Lord Cranworth, in *Oakes v. Turquand*, explained 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." [1867] L.R. 2 (H.L.) 325. Gladstone, upon requesting leave from the House of Commons to move a bill on the Joint Stock Companies, observed that the bill "did 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." 73 PARL. DEB., H.C. (3d ser.) (1844) 1754-58.

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cial"[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, Considered as a Branch of the Law of Partnership*, Lindley refers to companies incorporated by registration as "[p]artnerships incorporated by registration."[30] Francis Palmer, a leading 19th-century commentator on company law, observed that the unincorporated company was 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]

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27. 4 & 5 W. & M. 4, c. 94; 1 NATHANIEL LINDLEY, A TREATISE ON THE LAW OF PARTNERSHIP, INCLUDING ITS APPLICATION TO COMPANIES 9 (4th ed. 1878).

28. This began in 1826 with The Banking Act, 1826, 7 Geo. 4, c. 46, § 4, which enabled joint stock unincorporated banking companies to appoint a public officer in whose name the bank could sue and be sued.

29. SIR NATHANIEL LINDLEY, A TREATISE ON THE LAW OF COMPANIES, CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP 2 (5th ed. 1902).

30. *Id.* at 8. Note that this book involves the breaking out of the section on companies found originally in Lord Nathaniel Lindley's A TREATISE ON THE LAW OF PARTNERSHIP, INCLUDING ITS APPLICATION TO COMPANIES (4th ed. 1878). 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." 73 PARL. DEB., H.C. (3d ser.) (1844) 1754-58.

31. FRANCIS BEAUFORT PALMER, COMPANY LAW: A PRACTICAL HANDBOOK FOR LAWYERS AND BUSINESS MEN 5 (5th ed. 1905).

32. LINDLEY, *supra* note 29, at 8 ("Corporations in the proper sense of the term . . . must be created either by royal charter or by Act of Parliament . . . , and to them the law of ordinary partnerships has little, if any, application.").

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This view of incorporated companies reflected the position encoded within the general incorporation legislation. The 1844 Joint Stock Companies Act defines the "joint stock company," which is required to be registered and incorporated, to include "[e]very 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 copartners [and e]very partnership which at its formation, or by subsequent admission . . . shall consist of more than twenty-five members."[33] As a precondition to registration, the Act required 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 that consolidated the Acts regulating companies enacted between 1844 and 1856 and is viewed as the United Kingdom's first major piece of companies legislation[36] – similarly provided that the memorandum of association[37] is a contract binding on the members and members *inter se*.[38]

See also NATHANIEL LINDLEY, A TREATISE ON THE LAW OF COMPANIES, CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP 8, 57, 102 (5th ed. 1889).

33. Joint Stock Companies Act, 1844, 7 & 8 Vict., c. 110, § 2.

34. *Id.* § 3.

35. *Id.* § 7 ("And that such deed must contain a covenant on the part of every shareholder, with a trustee on the part of the company . . . to perform the several engagements in the deed contained on the part of the shareholders . . . .").

36. PALMER, *supra* note 31, at 1 (referring to the 1862 Act as company law's Magna Carta).

37. Companies Act, 1862, 25 & 26 Vict., c. 89. The 1862 Act replaced the deed of settlement with the memorandum of association and the articles of association. The memorandum of association was, prior to 2006, 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* Companies Act, 2006, c. 46, §§ 8, 18.

38. Companies Act, 1862, 25 & 26 Vict., c. 89, § 11 ("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.").

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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 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 "[f]or the Registration of Joint Stock Companies, and for 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, U.K. legislators and commentators in the 19th century did not envisage the corporate form as a concession[43] of the state, empowered by the state. In the United Kingdom 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 cor-

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. *See, e.g.*, Wood v. Odessa Waterworks Co., [1889] 42 Ch.D. 636.

40. A similar provision is found today in § 33(1) of the Companies Act 2006, but it 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. 73 PARL. DEB., H.C. (3d ser.) (1844) 1754-58.

43. References to concession can at times be found particularly when the interests of creditors are concerned. *See* Ashbury Ry. Carriage & Iron Co. v. Riche, [1875] L.R. 7 (H.L.) 653.

44. *See, e.g.*, 1 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS 55-77 (1895).

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poration and the state or whether the corporate charter amounted to a legislative act. References to the relationship between the state and the corporation in leading 19th-century U.K. 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 1890 unless specifically permitted by the statute,[47] contained information about, among other things, 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 restric-

45. LINDLEY, *supra* note 29; PALMER, *supra* note 31. The only context in which the idea of legislative authorization 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 Ashbury*, L.R. 7 (H.L.) at 653.

46. On the adoption of limited liability in the United Kingdom, see Marie-Laure Djelic, *When Limited Liability Was (Still) An Issue – Conflicting Mobilizations in Nineteenth Century England* (European Grp. for Org. Studies, Working Paper No. 006, 2011).

47. The Companies Act 1890 enabled the amendment of the memorandum with court approval for one of seven specified reasons. Companies Act, 1890, 53 & 54 Vict., c. 62, § 27. Prior to 1890 the memorandum could only be altered to increase capital, to decrease capital in accordance with the Companies Act 1867, to subdivide its shares, or to 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*. *See Ashbury*, L.R. 7 (H.L.) at 653. The Companies Act 1867 allowed for court controlled capital reductions. *See generally* David Kershaw, *The Decline of Legal Capital: An Exploration of the Consequences of Board Solvency Based Capital Reductions*, *in* CORPORATE FINANCE IN THE UK AND US 27 (Dan Prentice & Arad Reisberg eds., 2011).

49. *Ashbury*, L.R. 7 (H.L.) at 668.

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tions on contractibility[50] 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 supermajority 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.

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

50. *See* MICHAEL J. WHINCOP, AN ECONOMIC AND JURISPRUDENTIAL GENEOLOGY OF CORPORATE LAW (2001) (first using the term "contractibility" to characterize the United Kingdom's approach to corporate law).

51. *Ashbury*, L.R. 7 (H.L.) at 668 ("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, 7 & 8 Vict. c. 110, § 27.

53. *Id.* 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 contrary intent (in relation to particular articles) on the formation of the company, such model articles would be adopted by the company.

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company, the directors were empowered by the shareholders through the company's constitution, a document which could only be altered by the members and, as contrasted with most U.S. jurisdictions, over which the board had no amendment veto.[55] Accordingly, for a U.K. 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 U.K. incorporated company may have been created by a process of registration, but its ability to function through representative directors was dependent upon the powers the shareholders were willing to confer through contract. Contract was, and is, at the heart of the conception of the corporation in the United Kingdom and at the heart of board power. In *Ernest v. Nicholls*,[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 "[d]irectors 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 of 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

55. *See, e.g.*, General Corporation Act of New Jersey § 27 (1896) (providing for board and shareholder approval).

56. PALMER, *supra* note 31, at 146.

57. (1857) 10 Eng. Rep. 1351, 1354.

58. *Id.* at 1358.

59. Companies Act, 1947, 10 & 11 Geo. 6, c. 47, § 29.

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simply the corporate contract. "[Y]ou must look," held Lord Justice Bowen in *Imperial Hydropathic Hotel Co. 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. This article considers the role of contractibility in the context of self-dealing in detail below. Even the duty of care was viewed as being legitimately contractible. It was common practice in U.K. companies until 1929[61] to include duty of care liability waivers in the articles of association, similar to those that are now permitted in Delaware pursuant to Section 102(b)(7) of the Delaware General Corporation Law. 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 Acts to render such waivers void.[63] Statutory action was required to constrain the underpinning contractibility of U.K. company law.

B. *The United States: A Public Conception of the Corporation*

1. *Incorporation as State and Private Action*

As discussed above, 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 viewpoint contrasted with the perception of the chartered or statutory company, which was a corporation "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

60. [1882] 23 Ch.D. 1.

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

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

63. Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 129.

64. NATHANIEL LINDLEY, A TREATISE ON THE LAW OF COMPANIES, CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP 8 (5th ed. 1889).

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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 United Kingdom,[67] it was a process widely considered to be 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 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 "[t]he defendant corporation was organized under the general corporation law of the state, but its legal status would be [sic] the same if it had been created by a special act of the Legislature."[72]

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65. *See* JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE (9th ed. 1871) (treating statutory companies and generally incorporated companies as different exercises of state power).

66. *Id.* at 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. *Id.* at 42 ("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. JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970, at 9 (1970); Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 181 (1985).

69. *See* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 549 (1933) (Brandeis, J., dissenting in part) (listing general incorporation statutes). On the types of statutes for the different industries, see THOMPSON, *supra* note 44, at 99-126.

70. 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 17 (2d ed. 1886).

71. *See* ANGELL & AMES, *supra* note 65, at 2 (explaining that 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 of the exclusive exercise of some right . . . .").

72. 143 A. 257, 259 (Del. 1926).

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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 *Trustees of Dartmouth College v. Woodward*,[73] a case involving a specifically chartered company. He held that "[a] corporation" 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 U.S. literature on whether the conception of the corporation described by Justice Marshall evolved and changed during the course of the 19th century,[74] it is clear that the presence of the state as the creator of the corporation hardly receded during this period. Writing in 1861, Angell and Ames distinguished a partnership from a corporation by noting that the latter involves confirmation of the coming together of property and labor by a "special legislative authority;"[75] a corporation is "a body, created by law, composed of individuals."[76] Writing in 1895, Seymour Thompson commenced his analysis of "Creation by Special Charters" by observing that "[n]othing less than sovereign power can create a corporation."[77] He commenced the subsequent section on general incorporation by observing that "a corporation can only be created by or under authority of the sovereign power, which power is in this country expressed in acts of the legislature."[78] For Cook, writing in 1898, "[t]he state creates the corporation upon the application of individuals, who are called incorporators. The incorporators then organize the corporation."[79] Even Victor Morowetz, who is viewed by some commentators as being at the vanguard of late-19th-century attempts to portray the corporation as an aggre-

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73. 17 U.S. 518 (1819).

74. *See* Horwitz, *supra* note 68. *See generally* John C. Coates IV, *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. Rev. 806 (1989).

75. Angell & Ames, *supra* note 65, at 31.

76. *Id.* at 1.

77. Thompson, *supra* note 44, at 31.

78. *Id.* at 127.

79. 1 William W. Cook, A Treatise on the Law of Corporations Having a Capital Stock 12 (8th ed. 1923).

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gation of private actors with much in common with a partnership,[80] could not avoid foregrounding the legislative act central to corporate creation. For Morawetz, a corporation is formed only when authorized by an act of the legislature. He supports this position with a quotation from Justice Cowen in *Thomas v. Dakin* on the distinction between partnerships and corporations:

> The difference consists in this: the former are authorized 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, and conferring extraordinary privileges.[81]

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 incorporators - and as a compact or contract between the state and the corporation. Angell and Ames observed in this regard that "[p]rivate 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

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80. *See* Horwitz, *supra* note 68, at 182 ("Up until the 1880s, there was a strong tendency to analyze corporation law not very differently from the law of partnership."). Note that, as addressed in the next section, if at the heart of partnership is contract, the U.S. 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 "[w]e should have been glad to see some modification of his fundamental conception of the nature of the corporation." James Barr Ames, Book Review, 1 HARV. L. REV. 109, 110 (1887).

81. MORAWETZ, *supra* note 70, at 8 n.3 (quoting Thomas v. Dakin, 22 Wend. 109 (N.Y. Sup. Ct. 1839)).

82. ANGELL & AMES, *supra* note 65, at 22 (emphasis in original).

83. 13 Mo. App. 197, 200 (Mo. Ct. App. 1883).

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in *Ellerman v. Chicago Junction Railways & Union Stockyards 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.*

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 company. 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 *People v. The Assessors of the Village of Watertown,* the report refers to the corporation as "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."[85] Section 1 of the New York Act of 1848 authorizing the formation of corporations for manufacturing, mining, mechanical or chemical purposes (as amended in 1851) provides that "any three or more persons may *organize and form themselves into* a corporation in the manner specified and required in and by the act."[86] But for commentators of this period, aggregate is always enveloped in state action. Consider Seymour Thompson's *Commentaries on the Law of Private Corporations* in this regard:

84. 23 A. 287, 295 (N.J. Ch. 1891) (emphasis added).

85. 1 Hill 616 (N.Y. Sup. Ct. 1841).

86. Act of Feb. 17th, 1848, ch. 40, § 1, 1848 N.Y. Laws 54, 54-55, *amended by* Act of Feb. 7th, 1851, ch. 14, § 1, 1851 N.Y. Laws 16 (emphasis added). The provision bears a close resemblance to the U.K. Companies Act's association clause. *See, e.g.,* Companies Act, 1862, 25 & 26 Vict., c. 89, § 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.") (footnotes omitted).

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> 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, *authorized by the legislature*, under a scheme of organisation and by methods thereby *prescribed or permitted* . . . .[87]

The fact that the corporation is in some notable respect the product of state action is trivial if not banal within U.S. corporate legal discourse. However, when juxtaposed with the legal conception of the U.K. company, this focus on the role of the state is shown to be a distinctive aspect of the conception of the U.S. corporation. In the United States, the corporation is a different creature than it is in the United Kingdom: in the United States, it is a private entity that is firmly contained within the orbit of public creation; in the United Kingdom, it is 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 United Kingdom, neither in the U.S. general incorporation statutes nor in any 19th-century U.S. commentaries is there any sense of organizational 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 in the United States.

2. *Non-Contractibility*

Some commentators have argued that early corporate law in the United States was heavily influenced by partnership law.[88] This is incorrect. At its heart, partnership law is rooted in contract: the provision of default rules that may be contractually varied by the members.[89] Yet the contractibility of U.S.

87. THOMPSON, *supra* note 44, at 3 (emphasis added).

88. *See* Horwitz, *supra* note 68, at 73.

89. 1 CLEMENT BATES, THE LAW OF PARTNERSHIP 2-3 (1888) ("Partnership is a contract relation . . . . [A]n agreement of partnership, like any other contract, must be founded on a consideration either of mutual promises or contributions."); LINDLEY, *supra* note 27, at 18 ("Partnership is the result of an agreement to share profits and losses.").

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corporate law in the 19th century was significantly attenuated. Of course, the bylaws of the corporation, which provided for "the government of [the corporation and its] members and officers in the management of its affairs,"[90] delegated significant rulemaking authority to shareholders, and, in some instances, directors. However, the bylaws were a subordinate constitutional document responsible primarily for regulating the procedural aspects of corporate activity.[91] Corporation statutes made it clear that, to the extent the constitution was capable of addressing the core issues of the power and authority of the board and the obligations of the directors, these issues must be addressed through the certificate and only to the extent permitted by the statute. Governance was not, as it was in the United Kingdom, left to contract.

Arguably, this stance follows logically, in both the United States and the United Kingdom, from the allocation of corporate power to the board. In the United Kingdom, corporate power is located with the shareholders, and its distribution is 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.[92] The statute created and empowered the corporation and the board, and it necessarily follows that only the statute could permit variation of the power distribution and the rules associated with the exercise of power.

90. THOMPSON, *supra* note 44, at 762.

91. Act of Apr. 21st, 1896, ch. 185, § 1(VI), 1896 N.J. Laws 277, 278-79 (concerning corporations).

92. *E.g.*, *id.* § 12, 1896 N.J. Laws 277, 2781 (concerning corporations) ("The business of every corporation shall be managed by its directors . . . ."); Act of June 21st, 1875, ch. 611, § 10, 1875 N.Y. Laws 755, 757 (concerning the organization and regulation of corporations) ("The business of every corporation . . . shall be managed by a board of directors . . . ."); Act of Feb. 17th, 1848, ch. 40, § 3, 1848 N.Y. Laws 54, 55 (concerning the formation of corporations for manufacturing, mining, mechanical, or chemical purposes) ("The stock, property and concerns of such company shall be managed by not less than three nor more than nine, trustees . . . ."); Plaquemines Tropical Fruit Co. v. Buck, 27 A. 1094, 1101 (N.J. Ch. 1893) ("[T]he board of directors is the legal executive, recognized as such, not only in practice and on principle, but by the statute."); WILLIAM H. CORBIN, THE ACT CONCERNING CORPORATIONS IN THE STATE OF NEW JERSEY, APPROVED APRIL 7, 1875, WITH ALL THE AMENDMENTS TO JANUARY 1, 1892, TOGETHER WITH NOTES AND FORMS 9-10, (7th ed. 1892) ("The business of every such company, shall be managed and conducted by the directors . . . .").

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Typically, statutes provided for variation. However, as outlined below, the courts policed the power of variation very restrictively, in many instances striking down attempted contractual variations 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 U.K. counterparts[93] 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 New Jersey case of *Audenried v. East Coast Milling Co.*, 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.[94] 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 enacted in 1896 and amended in 1898, contained a provision, which 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."[95]

93. 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.

94. 59 A. 577, 584 (N.J. Ch. 1904) (citing First Nat'l Bank v. Drake, 11 P. 445, 448 (Kan. 1886); WM. L. Clark & WM. L. Marshall, 3 A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 677, at 2074 (1901)).

95. Del. Code Ann. tit. 8, § 102(b) (2011), *available at* http://delcode.delaware.gov/title8/c001/sc01/index.shtml; Act of Apr. 21st, 1896, ch. 172, § 8, 1896 N.J. Laws 277, 2781, *amended by* Act of Apr. 19th, 1898, ch. 172, sec. 2, § 8(VII), 1898 N.J. Laws 407, 408. A similar provision was introduced into the New York Business Corporations Law and enabled amendment to the certificate, which limited the powers of directors, provided that such amendment "does not exempt [the directors] from any obligation or from the per-

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The words "creating" and "defining" were added in 1898, prior to which, by implication, an amendment that did anything but limit or regulate powers of the corporation and the directors was not authorized by the statute.[96] 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 *Audenried* 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."[97] Any ability to contract out of such important principles must, according to the court, be expressly authorized by the legislature and was "not to be inferred from ambiguous expressions."[98] For the New Jersey Chancery Court, these rules belonged to a structure of governance provided by the legislature and designed to enable the corporation to function and to protect the public interest implicated by incorporation. The fundamental building blocks of this structure are accordingly only alterable by the shareholders with the legislature's explicit authorization 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

formance of any duty imposed by law." Act of May 18th, 1892, ch. 691, §2(9), 1892 N.Y. Laws 2042, 2043 (concerning amendment of corporations law).

96. *See* JAMES. D. DILL, THE STATUTORY AND CASE LAW APPLICABLE TO PRIVATE COMPANIES UNDER THE GENERAL CORPORATION ACT OF NEW JERSEY 21-22 (2d ed. 1899) (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. Chi. Junc. Rys. & Union Stock-Yards Co., 23 A. 287, 295], that the certificate of incorporation is equivalent to a special act of the legislature" and amounts to a "delegation to [incorporators] of the lawmaking 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.

97. *Audenried*, 57 A. at 584.

98. *Id.*

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> *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.[99]

Audenried shows that the state's interests are necessary considerations when assessing the extent to which incorporators and shareholders can mold the governance structure of the corporation as set forth in the charter, the statute and the

99. *Id.* (emphasis added).

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existing body of common law and equitable rules – the "settled legal principles"[100] – applicable to the company. While no attempt is made to define or enumerate the invariable rules falling under the umbrella of "settled legal principles," 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. For example, in his annotated text on the New Jersey Act Concerning Corporations, Corbin observed that "[d]uties required of an incorporated company are in the nature of conditions annexed to the grant of the franchise."[101] Writers and judges in this period would have willingly extended this observation to the duties of directors as well as of corporations.[102]

To be clear, such core rules are not strictly invariable but rather variable *only* pursuant to an enabling permission set forth in the corporation law and *only* where, in the absence of the explicit authorization 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 ex rel. Cochran v. Penn-Beaver Oil Co.*,[103] where a stockholder was denied access to inspect the corporation's books and records based upon a provision in the charter that 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's starting point in *Audenried*, was that such a provision would only be legitimate if authorized by the state through the Delaware General Corporation Law. If valid, "it would be as effective as though the Legislature had granted it by direct and special act."[104] The portal for answering this question was whether such a provision fell within the same enabling provision considered in *Audienried*, namely the power to create, define and limit the powers of the corporation and the directors, provided that such provisions were not contrary to

100. *Id.*

101. William H. Corbin, The Act Concerning Corporations in the State of New Jersey 8 n.(t) (7th ed. 1892).

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

103. 143 A. 257 (Del. 1926).

104. *Id.* at 259.

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the law of the state.[105] The court held that, had a power of variation been applicable to this common law rule, the court would have expected the legislature to have granted this power explicitly. The legislature, however, had not done so, and indeed "[i]t would probably have been difficult, if not impossible, to induce the Legislature to grant such power."[106] Accordingly, the charter provision was invalid.

Subsequent Delaware decisions have arguably struck a more lenient tone. For example, in *Sterling v. Mayflower Hotel Corp.*,[107] 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,[108] that the fundamental regulatory protections that Delaware law applies to self-dealing 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 Co. v. McCollom*,[109]

105. DEL. CODE ANN. tit. 8, § 5, par. 8 (Rev. Code 1915, § 1919) (current version at DEL. CODE ANN. tit. 8, § 102(b) (2011), *available at* http://delcode.delaware.gov/title8/c001/sc01/index.shtml).

106. *Cochran*, 143 A. at 260.

107. 93 A.2d 107, 118 (Del. 1952).

108. *Id. See also* Helfman v. American Light & Traction Co. 187 A. 540 (N.J. Ch. 1936).

109. 16 N.Y.S.2d 844, 847 (N.Y. Sup. Ct. 1939) (emphasis added).

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where the Official Referee, in holding that a director was not entitled to indemnification for his litigation expenses, observed 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*." Drawing on an earlier New York case involving a municipal corporation, the court concluded that 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."[110] Accordingly, indemnification could only be granted by "judicial sanction" (state action) "based upon equitable considerations" and, by implication, without regard to any indemnification provision in the charter.[111] It follows from this analysis that any attempt to provide for indemnification for breach, or waiver of liability for breach, requires an enabling provision in the Statute. That is, indemnification or variation must be permitted by the state. Indeed, as is well known, such legislative provisions have represented some of the most important amendments to corporate codes over the past century.[112]

The absence of serious discussion about the permissible scope for the shareholders to vary the governance structure and the obligations of directors through contract in the 19th-century U.S. corporate law texts is striking to a U.K. corporate lawyer. Discussions about charter amendment are typically taken up with discussions about the scope for the state to amend the charter and the conditions that determine the validity of such amendments.[113] For U.S. corporate legal dis-

110. *Id.* at 849 ("When a citizen accepts a public office, he assumes the risk of defending himself against unfounded accusations at his own expense.") (quoting Chapman v. City of New York, 61 N.E. 108, 110 (N.Y. 1901)).

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

112. For amendments to the Delaware General Corporation Law allowing corporations to provide for director indemnification, see generally S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 77-80 (1967). *See also* Act of June 18th, 1986, ch. 289, sec. 2, § 102(b)(7), 65 DEL. LAWS 1986, *available at* http://delcode.delaware.gov/sessionlaws/ga133/chp289.shtml (providing for duty of care liability waivers) (codified as amended at DEL. CODE ANN. tit. 8, § 102(b)(7) (2011), *available at* http://delcode.delaware.gov/title8/c001/sc01/index.shtml).

113. *See, e.g.*, HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 449-64, 557 (4th ed. 1898).

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course 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. Part II of this article below illustrates that in both the case law and the commentary, there is significant legal borrowing and transplantation from U.K. case law addressing issues arising from what were in many respects for both jurisdictions *sui generis* legal institutions. However, when adopting the English case law, U.S. law filtered out the contractarian mileu of U.K. company law: the substantive legal rules travelled, but their contractibility did not.

U.S. 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 was replaced by an organic "real entity" theory of the corporation.[114] Although such conceptual evolution may have been – and the article takes no position on this – operable in the public, political and constitutional debates about the corporation in the 19th century and early 20th century, it is not a stage theory of the conception of the corporation that makes sense of the law's self-conception of the corporation, which maintains a consistent commitment to the state empowerment conception of the corporation. One need only juxtapose the U.S. corporate texts that are said by some commentators[115] to represent the high-water mark of the 19th century's partnership conception of the corporation next to Lindley's *Treatise on Company Law as a branch of the Law of Partnerships* to realize that the central contractual component of partnership was missing from the U.S. conception.

III.
THE FORMATION OF CORPORATE SELF-DEALING LAW

In the 19th century, both in the United States and in the United Kingdom, directors of corporations were readily

114. Coates, *supra* note 74, at 816-17, 823-25; Horwitz, *supra* note 68, at 181-83.

115. *Compare* Horwitz, *supra* note 68, *and* Coates, *supra* note 74, *with* LINDLEY, *supra* note 27.

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viewed as, or at least labeled, trustees of the corporation. Like trustees, directors performed a representative function. Indeed, in many early U.S. general incorporation statutes, directors were referred to as "trustees."[116] 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 "transplanter" 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. The concern here is with the 19th-century corporate lawyers' conception of the corporation and of corporate power. The article asks how the distinctive conceptual backgrounds of U.K. and U.S. lawyers informed the process of transplanting fiduciary law rules to address corporate self-dealing and how this background informed 19th-century lawyers' attempts to, 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*

Nineteenth-century English company law naturally looked to trust law to regulate the behavior of directors of both unincorporated and incorporated companies. Directors were viewed as "in some sense trustees."[117] As Professor Sealy has

116. Act of Feb. 17th, 1848, ch. 40, § 3, 1848 N.Y. Laws 54, 55 (concerning the formation of corporations for manufacturing, mining, mechanical, or chemical purposes).

117. PALMER, *supra* note 31, at 180-81 ("[I]t is impossible now to dispute the proposition that [directors] are in some sense trustees, that proposition having been established by a long series of cases.") (citing Charitable Corp. v. Sutton, (1742) 26 Eng. Rep. 642; 2 Atk. 400). The labeling 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 trustee-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 Co. v. Hampson, [1882] 23 Ch.D. 1 ("[W]hen persons who are directors of a company are from time to time spoken of by Judges as agents, trustees, or managing partners of the

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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 trust law and contract. However, Sealy has shown that this assumption 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 trust 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 or *entrusted* with the management of the company's assets.[118]

For the first companies incorporated by registration under the Joint Stock Company Act of 1844, it was unnecessary to borrow from trust law to address self-dealing contracts as the Act addressed these transactions directly. Section 29 of the 1844 Act prevented a conflicted director from acting in relation to such transactions and, reflecting the trust law position to be discussed below, rendered such transactions unenforceable without shareholder approval. This provision, however, was no longer present in the Joint Stock Companies Act of 1856, leaving the regulation of self-dealing transactions to rely on the court's adaptation of fiduciary law to the company.

English company law struggled in the 19th century to determine for whom the directors of an incorporated company were trustees or had trustee-like responsibilities, and to whom they owed their obligations of trust. Today, U.K. company lawyers acknowledge that directors are appointed by the company

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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 . . . . [I]t 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.").

118. York & Midland Ry. Co. v. Hudson, [1853] 16 Beav. 485 ("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.").

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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 individual who empowers the trustee to act and to any other person who the person who empowers the trustee to act directs the trustee to act on behalf of. In *Charitable Corp. v. Sutton*,[119] a case involving a chartered corporation, Lord Hardwicke, the Lord Chancellor, described directors as "most properly agents to 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."[120] Applying this logic, it follows that in a U.K. company that is incorporated by registration, where 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 obligation of the directors to observe good faith *towards the great body of shareholders*, to attend diligently to their interests and to act within the limits of *the authority conferred by them*. Directors are not only agents, but to a certain extent trustees. 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. . . . [A]lthough 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 trust, and is to

119. (1742) 26 Eng. Rep. 642, 644.
120. *Id.*

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> be exercised *bona fide for the purposes for which it was given*, and in the manner *contemplated by those who gave it* . . . .[121]

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 onto the director and the shareholder.

An early and important example of borrowing from trust law was the self-dealing case of *Aberdeen Railway*, which is also a case of considerable importance in 19th-century U.S. corporate law. In *Aberdeen Railway*, the Aberdeen Railway Company, a chartered, not a registered company,[122] 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:

> [I]t 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

121. 1 NATHANIEL LINDLEY, A TREATISE ON THE LAW OF PARTNERSHIP, INCLUDING ITS APPLICATION TO COMPANIES 596-97 (3d ed. 1873) (emphasis added).

122. In this context, although commentators noted the important conceptual differences between chartered and registered companies, see *supra* text accompanying notes 30-32, 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 introduced in 1862.

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> 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.
>
> The English authorities on this subject are numerous and uniform. . . . The inability to contract depends not on the subject-matter of the agreement, but on the fiduciary character of the contracting party . . . .[123]

There are two distinct legal considerations invoked by self-dealing transactions in *Aberdeen Railway.* The first is the duty of loyalty – the duty 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 that is 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, the rest of whom were not conflicted, and, therefore, the contract should be enforceable. Lord Cranworth rejected this claim through the lens of duty, holding that "[i]t was Mr[.] Blaikie's duty to give to his co-Directors, and through them to the Company, the full benefit

123. Aberdeen Ry. Co. v. Blaikie, (1854) 1 MACQ 461, 461 (citing Keech v. Sandford, [1726] Sel. Cas. Ch. 61 and Whelpdale v. Cookson, [1741] 1 Ves. Sen. 9 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* (1803) 8 Ves. Jr 337.").

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of all the knowledge and skill which he could bring to bear on the subject."[124] He could have alternatively held that the directors were not authorized to enter into such a transaction given the "fiduciary character" of the contracting party.[125]

The judgment reads as an absolute prohibition on self-dealing. However, it was clear from the trust authorities relied upon by the court that the informed consent of the *cestui que trust*, and by analogy the shareholders, could authorize a self-dealing transaction or validate a voidable agreement.[126] 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.[127] That is, the general grant of authority to exercise trust powers is qualified and does not extend to self-dealing transactions.

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 by contractually amending their application. Typically, compa-

124. *Id.* 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.

125. *Id.* More recently, Lord Millett LJ 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." Ingram v. IRC, [1997] 4 All. E.R. 395, 426.

126. *See Ex parte* James, [1803] 8 Ves. 337; *Ex parte* Lacey, [1802] 6 Ves. 625.

127. *See Ex parte* James, [1802] 8 Ves. Jun. 338, 351-52 ("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."); Downes v. Grazebrook, [1817] 3 Mer. 200, 208 ("[H]e continues to be a trustee, he cannot, without *the express authority of his cestu[i] 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 shew [sic] that he had *such an authority to enable him to become a purchaser at that sale*.") (emphasis added).

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nies 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.[128] The contractual variant provided that the office would only be vacated if the director failed to disclose the contract and the contract was not approved by the disinterested directors. By implication, such disclosed contracts approved by the disinterested directors 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 and, 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*,[129] a director of the plaintiff company purchased debentures at a 5% discount and sold them to the company at a 1.5% 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. The company, however, 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 cognizant 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 degree impeach it . . . .
>
> [H]owever, 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

128. Companies Clauses Consolidation Act, 1845, 8 & 9 Vict., c. 16, § 86.
129. [1871] L.R. 6 Ch. App. 558.

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> 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.[130]

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 and the disinterested directors had approved of the transaction,[131] he was entitled to keep the profit.[132] His deference to a contractual conception of the corporation is explicit and forthright. Following on from the above quotation he observed:

> 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

130. *Id.* at 565, 567. Counsel for the defendant director submitted that "[t]his company, like other similar companies, chose directors who could bring them business, and the companies were willing, for the sake of getting that business, to waive the ordinary rules as to directors." *Id.* at 564.

131. The courts held that, where the articles contained a disinterested director voting provision in a separate article from the disclosure article, compliance with both provisions was necessary to avoid the requirement to obtain shareholder approval. *See* Costa Rica Ry. Co. v. Forwood, [1901] 1 Ch. 746. Although most companies' articles contained a disinterested director voting provision, the articles could provide for disclosure-only to avoid the shareholder approval requirement. *See* Boulting v. Ass'n of Cinematograph, Television & Allied Technicians, [1963] 2 Q.B. 606, 636.

132. *Imperial Mercantile*, L.R. 6 Ch. App. at 567. Note that the House of Lords 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. Imperial Mercantile Credit Ass'n v. Coleman, [1873] 6 H.L. 189. It did not challenge Lord Hatherley's conclusion that contractual variation was permissible. *See id.*

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> aware of what the consequences would be of intrusting their property to the management of others where nothing is expressed as to the implied arrangement.[133]

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 have, quite legitimately, simply said that the board had authority to enter into such contracts and such contracts would then have been enforceable without disclosure.[134] This combination of trust law's fiduciary standards and contractual variation left the courts on the sidelines with no role to play apart from determining whether the parties had complied 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, U.K. company law's self-dealing landscape could be accurately and comprehensively summarized 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 suboptimal regulation of self-dealing transactions in the United Kingdom. The recurring regulatory diagnosis in the United Kingdom in relation to directors' duties, typically brought into

133. *Imperial Mercantile*, L.R. 6 Ch. App. at 568.

134. PALMER, *supra* note 31, at 166 ("These are the rules *prima facie* applicable to such transactions, but a company is at liberty to waive the benefit of such rules, and to allow a director to make a contract, or to be interested in a contract, with the company, and the regulations[, i.e., the articles,] very commonly make provision accordingly."). *See also Boulting*, 2 Q.B. at 606.

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focus by a corporate crisis or scandal, has been that (i) 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 ability to 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 United Kingdom's repeat regulatory move in response to crisis has been to remove contractibility.[135] 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 that the United States provides for the United Kingdom, as explained below.

Today, U.K. company law's self-dealing regulation requires shareholder approval where the transaction value exceeds the lower of £100,000 or 10% of the company's value.[136] Such transactions are known as "substantial property transactions." These rules, introduced in 1980 following a corporate scandal,[137] 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% of the company's capitalization), the company is subject to the additional regulation set forth in the United Kingdom Listing Authority's Listing Rules,[138] which require a disinterested shareholder vote.[139]

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135. Consider, for example, the duty of care and liability waivers. See *supra* text accompanying notes 61-63.

136. Companies Act, 2006, c. 46, §§ 190-191.

137. *See* Margaret Walters, *Substantial Fraud Alleged at L&C*, THE TIMES, Jan. 30, 1976, at 23.

138. Financial Services Authority Listing Rules, 2010, Listing Rule 10. Until October 2009, these rules were mandatory for U.K. companies. Since 2009, U.K. companies may elect for a "standard listing" in contrast to a "premium listing" to which such rules do not apply. Most U.K. listing companies have a premium listing.

139. 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

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This article's central submission is that, in order to understand the path of self-dealing law in the United Kingdom and the United States, closer attention needs to be paid 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 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 United Kingdom's decision to keep the standard while removing its twin of contractibility is cause for concern. The United States' experience, particularly with respect to the trajectory of New Jersey law addressed below, suggests that the U.K. self-dealing standard would have been different but for such contractibility.

B. *The Evolution of Self-Dealing Law in the United States*

Harold Marsh, in his seminal 1960 article *Are Directors Trustees?*,[140] 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 observed, would have been able to state that this was the general rule with confidence. By 1910, however, the rule was modified such that self-dealing transactions were enforceable if fair and approved by disinterested directors. By 1960, according to Marsh, the disinterested director approval requirement had disappeared and it could be said, as it can be said today, that

> with some assurance 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 re-

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without obtaining shareholder approval, but in keeping the U.K. company law's underlying bias in favor of contractibility, it leaves it open to companies to craft other regulatory solutions. Companies Act, 2006, c. 46, §177.

140. Marsh, *supra* note 15.

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> view 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.[141]

Marsh argued that the transition from voidability to disinterested director approval plus fairness and then to fairness alone is unexplained in policy terms by the cases. The first transition, he submitted, took 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."[142] Marsh argued that "[o]ne searches in vain in the decided cases for a reasoned defense of this change in legal philosophy, or for the slightest attempt to refute the powerful arguments which had been made in support of the previous rule."[143]

Although Marsh's view of the evolution of self-dealing regulation is widely accepted in the U.S. corporate legal debate,[144] it is not correct. This article is not the first to suggest so. Professor Beveridge argued in the 1990s[145] that Marsh's account was incorrect and that fairness considerations were central to U.S. self-dealing law much earlier than Marsh had identified. However, Beveridge's views failed to generate significant traction in the academy and were either rejected,[146] relegated

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141. *Id.* at 43.

142. Wardell v. R.R. Co., 103 U.S. 651, 658 (1880) (quoting Marsh v. Whitmore, 88 U.S. 178, 183-84 (1974)).

143. Marsh, *supra* note 15, at 40.

144. CLARK, *supra* note 16, at 160-66. See sources cited *infra* notes 146, 148, which adopt Marsh's view. These articles represent only a fraction of the articles that adopt Marsh's view.

145. Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655 (1992) [hereinafter Beveridge, *Duty of Loyalty*]; Norwood P. Beveridge, *Interested Director Contracts at Common Law: Validation Under the Doctrine of Constructive Fraud*, 33 LOY. L.A. L. REV. 97 (1999) [hereinafter Beveridge, *Interested Director Contracts*].

146. There is minimal direct assessment of Professor Beveridge's claim. Those that consider it in more depth have rejected it. For example, in WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 650-51 (7th ed. 1995), the claim is considered and rejected. In the 8th edition there is no consideration of Beveridge's position. *See also* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 613 n.43 (1997) (adopting Marsh's view but citing Beveridge and noting that

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to a qualifying footnote to Marsh's established position,[147] or forgotten.[148] The case made by Beveridge is in essence correct but not sufficiently compelling to dislodge the considerable disciplinary investment in 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,[149] and the dominant and compelling narrative that charter competition drives management-friendly solutions in areas of corporate law that have the potential to be significantly redistributive to managers.

"[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"); Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163 (1997).

147. Solomon v. Armstrong, 747 A.2d 1098, 1115 n.48 (Del. Ch. 1999) ("Marsh's characterization is most likely still viable."); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. Corp. L. 625, 648 n.149 (2004); John H. Langbein, *Questioning The Trust Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 959 n.146 (2005); Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 OR. L. REV. 993, 1009 n.81 (2006) (viewing Marsh's position as "widely accepted" although, citing Beveridge, "not free from doubt"); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. REV. 821, 837 n.56 (2004).

148. *Solomon*, 747 A.2d 1098; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 334 (2004); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001); James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1079 (2003); Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 414 n.1 (2004) (citing Marsh for the observation that the fiduciary "sealant decayed during the twentieth century"); David W. Deal, *Director's Vulnerability to Breach of Fiduciary Duty Claims for Compensation Decisions: Where Have We Been, Where Are We Now?*, 30 OKLA. CITY U. L. REV. 311, 321-22 (2005); Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. KAN. L. REV 975 (2006); Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT'L L.J. 367 (2005); Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV 929 (2008); Edward Rock & Michael Wachter, *Dangerous Liasons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 668 (2002); David A. Skeel, Jr., *Icarus and American Corporate Regulation*, 61 BUS. LAW. 155 (2005); Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010).

149. *See* Cunningham, *supra* note 11.

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The starting point for the key 19th-century U.S. 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.[150] Early 19th-century cases in the Supreme Court and in state courts readily relied upon this analogy, in some instances relying on the English chartered corporation case of *Charitable Corp. v. Sutton.*[151] This analogy naturally led to the application and translation of fiduciary law principles addressing relationships between trustee, trust and beneficiary. Indeed, many of the early corporate self-dealing cases apply the same English trust cases, as well as U.S. state trust cases that were directly based upon such cases, which formed the bedrock of the United Kingdom's self-dealing law analyzed above. These cases also often directly relied on some of the key U.K. cases that translated English trust law principles into the company context, in particular *Aberdeen Railway.*[152] This initial step in U.S. 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 1860s and 1870s and affirmed in multiple cases thereafter – in some jurisdictions until as late as the 1940s – articulating a position that was, or at least can be read as being, effectively identical to the position taken in *Aberdeen Railway.*

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 U.S. fiduciary law authorities that were available for borrowing to regulate director conduct. In fact, U.S. corporate law sampled more broadly from the English fiduciary law pool than did U.K. corporate jurisprudence and, in doing so, created multi-

150. *See* Act of Feb. 17th, 1848, ch. 40, § 3, 1848 N.Y. Laws 54, 55.

151. (1742) 26 Eng. Rep. 642.

152. (1854) 1 MACQ 461. *See also* Benson v. Heathorn, (1842) 62 Eng. Rep. 909; 1 Y. & C.C.C. 326 (cited in Wardell v. R.R. Co., 103 U.S. 651,658 (1880); Cumberland Coal & Iron Co. v. Parish, 42 Md. 597, 605 (1875); Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., 16 Md. 456, 492 (1860); Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. 1918); and Hoyle v. Plattsburgh & Montreal R.R. Co., 9 Sickels 314, 329 (1873)).

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ple 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 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 discussed above and to be further explained below, in the U.K. context, corporate law borrowed from trust law's approach to self-dealing, which provides for the voidability of interested transactions regardless of their fairness. Through this lens, the board of directors is the trustee and entering into 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 rather than on behalf of the shareholders. A transaction between the director and the corporation could also, therefore, be analogized to a transaction between a trustee (in his personal capacity) and the beneficiary, a transaction between an agent and his principal or a transaction between an attorney and his client, with the corporation as the 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 U.S. courts in the 18th and 19th centuries. However, they were not subject to the strict voidability

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rule that was applicable to a self-dealing transaction between trust and trustee, but rather to fairness-like regulation with respect to both process and price. 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 U.S. self-dealing regulation is not about one being replaced by the other in the 19th century, i.e., the chronological acceptance of fairness coupled with the silent rejection of the policy positions underpinning the strict rule. Rather, the story of fairness and strictness in 19th-century U.S. corporate law, in the 1880s and before, is one of their mutual presence. The interesting question, therefore, is not, as is suggested by Marsh, where fairness review came from and how it came to replace the strict voidability rule. It was there and available at the inception of U.S. corporate law's regulation of self-dealing when it elected to borrow from other fiduciary contexts. The interesting question, rather, is what it was about U.S. corporate law that enabled its development in a very short time frame, as is illustrated below, whereas in the United Kingdom, *where in theory it was equally available*, it was not developed at all.

This section argues that the conception of the U.S. corporation and its understanding of corporate power opened the door more widely to fiduciary law's fair-dealing approach than the U.K. conception of the company allowed for. Where the path of fiduciary law's fairness standard was not taken by state courts, the limitations on contractibility for the U.S. 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 first examine the development of the law in the 19th century's most important U.S. corporate law jurisdictions – New Jersey and New York – and then it will turn to Delaware. Nineteenth- and early 20th-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.[153] This is also characteristic of re-

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153. *See* THOMPSON, *supra* note 44.

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sponses to Beveridge's critique of Marsh.[154] However, 19th-century U.S. corporate law is characterized by a strong sense of jurisdictional specificity. This jurisdictional specificity generated different paths of legal evolution and, in the self-dealing context, different paths towards fairness review. In this context, taking a "U.S. 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, 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 partiality in the contract as amounts to fraud."[155] Two of the three regulatory strategies deployed in self-dealing law in the United States can be identified in this statement. 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." Second, the contract must be fair to the corporation to be enforceable (articulated through the more demanding language of "gross partiality" and "fraud"). Angell and Ames cited three Vermont cases in support of this proposition, two of which dealt with religious corporations incorporated to build meeting houses, and the third of which dealt with a school district.[156] The early New Jersey Chancery case of *Stratton v. Allen* relied directly on this passage in Angell and Ames' book in holding that:

154. *See* CARY & EISENBERG, *supra* note 146, at 651 (referring to cases from Alabama, California, Connecticut, New Jersey, New York and Maryland in response to Beveridge).
155. ANGELL & AMES, *supra* note 65, at 200.
156. *Id.* at 200 n.4.

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> 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.[157]

Stratton 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' position and the cases to which they refer.[158] 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 Co. v. Martin*[159] by the New Jersey Court of Errors and Appeals and, in 1879, was relied upon at first instance in the important case of *Gardner v. Butler*,[160] its influence assessed in terms of citations disappeared thereafter.

The real story of New Jersey self-dealing regulation does not start with Angell and Ames or *Stratton* but with the case of *Stewart v. Lehigh Valley R.R. Co.*,[161] an important case relied on by Harold Marsh to demonstrate the state of the law in the 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 trust law principles governing self-dealing transactions. In a familiar passage the court held as follows:

> [S]o 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 [self-dealing] contracts should not be enforced or regarded. . . . A director of a corpora-

157. Stratton v. Allen, 16 N.J. Eq. 229, 232 (N.J. Ch. 1863).

158. *See* Beveridge, *Duty of Loyalty*, *supra* note 145; Beveridge, *Interested Director Contracts*, *supra* note 145.

159. 40 N.J.L. 568 (1878).

160. 30 N.J. Eq. 702 (1879).

161. 38 N.J.L. 505 (1875).

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> tion 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.[162]

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 . . . .[163]

The court cited the leading English self-dealing case of *Aberdeen Railway* and the New York corporate law cases of *Butts v. Wood*[164] and *Gardner v. Ogden*,[165] which both relied upon *Aberdeen Railway* and the trust authorities upon which *Aberdeen Railway* rested.[166] The court also cited the influential 1816

162. *Id.* at 522-23.
163. *Id.* at 523.
164. 37 N.Y. 317 (1867).
165. 22 N.Y. 327 (1860).
166. The English trust cases relied upon in *Aberdeen Railway* and directly in *Butts* and *Gardner v. Ogden* include *Keech v. Sanford*, [1726] Sel. Cas. Ch. 61 and Whelpdale v. Cookson, [1747] 1 Ves. Sen. 9.

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New York trust case *Davoue v. Fanning*, which imported the same line of English trust cases into New York trust law.[167] Indeed, the structure of the judgment is almost identical to *Aberdeen Railway*: a focus on conflicts, a rejection of fairness, and a rejection of board composition as a means of mitigating the conflict because a director is required to serve and not abstain.

Stewart served as a leading reference point for New Jersey self-dealing law for another 60 years. For example, in 1920 in *Busch v. Riddle*, the Court of Errors and Appeals referred to the doctrine set forth in *Stewart* as "uniformly recognized and repeatedly enforced in this state."[168] In 1939, citing *Stewart*, 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."[169]

However, the strict rule articulated in *Stewart* 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

167. Davoue v. Fanning, 2 Johns. Ch. 252 (N.Y. Ch. 1816). The New York Chancery Court in *Davoue* 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. *Davoue*, 2 Johns. Ch. at 268. *York Buildings* was also cited in *Stewart*, 38 N.J.L. at 523. The court's summary in *Davoue* of the judgment in *York Buildings* bears a close resemblance to the language deployed in *Stewart*. *Compare Davoue*, 2 Johns. Ch. at 270 ("[T]hat 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 . . . .") *with Stewart*, 38 N.J.L. at 522-23.

168. 114 A. 348, 352 (N.J. 1920). *See also* Voorhees v. Nixon, 66 A. 192, 193 (N.J. 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."); Gen. Inv. Co. v. Am. Hide & Leather Co., 127 A. 529, 535 (N.J. Ch. 1925) ("It 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." (quoting *Stewart*, 38 N.J.L. at 523)).

169. Wiencke v. Branch-Bridge Realty Corp., 4 A.2d 415, 418 (N.J. 1939).

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more or less identical starting points. The second strand of jurisprudence commenced in 1879 with *Gardner v. Butler*, a judgment given four years after *Stewart*. It is in this strand of cases that the seeds of the contemporary fairness solution were 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 6% 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.[170] The validity of the arrangement at first instance was based on three intersecting rationales. First, following *Stratton*, a director stands in relation to the company as a stranger when he transacts with the company. Second, if the rule in *Stewart* applies, the director is still entitled to reasonable compensation – a rationale developed in greater depth by the Court of Errors and Appeals. Third, as an outcrop of the first and second rationales and the instrumental benefits of self-dealing contracts, whilst *Stewart* 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

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170. Gardner v. Butler, 30 N.J. Eq. 702, 710 (1879). Judicial awareness of market practice and needs that we see in this case is found more explicitly in subsequent cases. *E.g.*, Stephany v. Marsden, 71 A. 598, 598 (N.J. Ch. 1908) ("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 corporation, but that the burden should be imposed upon these seeking to enforce or support such a contract to clearly establish its fairness."); Robotham v. Prudential Ins. Co. of Am., 53 A. 842, 856 (N.J. Ch. 1903) ("[T]heoretical rules have to give way to the practical necessities of business. . . . Common directors abound, and common directors are better than dummies.").

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> 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?[171]

Justice Van Syckle, giving judgment for the Court of Errors and Appeals, affirmed the Chancellor's holding at first instance and did so in a way that laid a clear track from the strict rule in *Stewart* to fairness review. The Court strongly affirmed the strict approach in *Stewart* as "well settled" law.[172] It then proceeded, following the lead of the Chancellor's second rationale, to explore the remedial implications of the rule – what would happen if a director entered into a contract to provide services or to sell assets to the company and the services had been provided or the assets consumed? In such circumstances what, if anything, would the company be entitled to, and what did it mean to require the director to account for any profits he has made from the executed voidable transaction? In exploring this issue, the Court relied hypothetically on the facts of *Aberdeen Railway*. The Court asked what would have happened in *Aberdeen Railway* if the railway 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 executory, and to allow simply a just remuneration, without reference to the contract price, where it is executed. The trustee thus derives no advantage

171. *Gardner*, 30 N.J. Eq. at 712.
172. *Id.* at 721.

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> from his breach of duty, and the company can suffer no detriment from his service in their behalf.[173]

Applying this logic, the court concluded:

> 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.[174]

In reaching this conclusion, the court directly applied the holding in *Stewart* that such contracts are voidable without regard to fairness and cannot be enforced by the breaching director. However, when the court got to the question of remedies, fairness – understood as it is today as arms-length contracting – entered through the back door. The effect of the *Gardner v. Butler* approach is that, for any executed self-dealing transactions, the *Stewart* 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 v. Butler* were fair, the self-dealing directors were not liable to account for any profit. Importantly, as the Court of Errors and Appeals observed, this approach applies beyond the compensation/operational services context of this case and applies "whether it is property conveyed or services rendered."[175] Note also that the court in *Gardner v. Butler* makes a distinction between executory and executed 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.[176] Many executed self-dealing transactions could in theory be voided and unwound. By relying on the executory/executed distinction, more space was created

173. *Id.* at 722, 724 (emphasis added).

174. *Id.* at 725.

175. *Id.* at 724.

176. *Id.* at 724. 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.

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for a remedial fairness approach as it included executed but rescindable transactions.[177]

In support of this position, the Court of Errors and Appeals in *Gardner v. Butler* relied on another English case, *Great Luxembourg Railway Co. v. Magnay*,[178] where the court held that "when it is said that he cannot make any profit by the transaction, it is not meant that he is not to have the proper value of the property which is actually taken by the company."[179] It is of interest in this regard that this case has not to date been cited for this holding in the United Kingdom. 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 discussed above, 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 considered further below, was unavailable in New Jersey.

It is important to stress that while *Gardner v. Butler* laid the first stones on New Jersey's path to fairness review, it did so in a way that is wholly consistent with *Stewart*. Indeed, in some cases, *Gardner v. Butler* is correctly cited alongside *Stewart* in support of the strict approach.[180] 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

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177. *See, e.g.*, Oliver v. Rahway Ice Co., 54 A. 460, 461 (N.J. Ch. 1903) (refusing to unwind a share buyback from the directors, comparing the shares to the railway chairs in *Aberdeen Railway* had they been used).

178. [1858] 25 BEAV. 586. For more recent engagement with this question, see Warman Int'l Ltd. v Dwyer (1995) 182 CLR 544 (Austl.).

179. *Gardner*, 30 N.J. Eq. at 723-24.

180. *See, e.g.*, Baumohl v. Goldstein, 124 A. 118, 121 (N.J. 1924); Hodge v. U.S. Steel Corp., 54 A. 1, 3 (N.J. 1903).

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strict rule coupled with a remedial fairness standard and a substantive fairness standard.

Many of the subsequent cases that 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*[181] in 1892, the Court of Chancery observed that "[t]he [directors] are entitled to what their services are reasonably worth, and no more." In *Davis v. Thomas A. Davis Co.*[182] in 1902, the burden, the Court of Chancery held, is on the directors to show that "what they have done . . . merits 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 extended the application of the *Gardner v. Butler* approach beyond services to property[183] with direct reference to Justice Van 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."[184] In *Marr v. Marr*,[185] the Court of Chancery explicitly extended the *Gardner v. Butler* approach to loans to the company. Consistent with *Gardner v. Butler*, they observed 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* 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."[186] In *Stephany v. Marsden* in 1908, although the Court does not cite *Gardner v. Butler*, it applies the identical

181. 24 A. 499, 502 (N.J. Ch. 1892).
182. 52 A. 717, 718 (N.J. Ch. 1902).
183. Oliver v. Rahway Ice Co., 54 A. 460, 461 (N.J. Ch. 1903). *See also* Burger v. U.S. Steel Corp., 53 A. 68 (N.J. 1902).
184. *Oliver v. Rahway*, 54 A. at 461.
185. Marr v. Marr, 66 A. 182, 183 (N.J. Ch. 1907).
186. Stewart v. Lehigh Valley R.R. Co., 38 N.J.L. 505, 522 (1875).

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structure of analysis: the affirmation of *Stewart* coupled with a remedial fairness standard:

> [W]here 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 . . . .[187]

In *Tooker v. National Sugar Refining Co. of New Jersey*,[188] a case involving a contract to sell to the corporation stock purchased by a director, the court affirmed *Stewart*'s holding that a conflicted director's recusal from the meeting that resolved to enter into the self-dealing contract would not validate the contract (indeed it amounted to a "breach of trust").[189] The court also 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."[190] *Tooker* is particularly interesting as an example of how remedial fairness overreaches to become the substantive standard. Pursuant to the *Stewart* and *Gardner v. Butler* approach, the transaction is voidable, however, if it has been executed, 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*'s understanding of *Gardner v. Butler*, voidability becomes a function of the fairness of the transaction.

Aside from *Gardner v. Butler*, there are other separate, apparently stand-alone, early strands of fairness review. *Stratton* has already been mentioned. Another short strand of case law

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187. Stephany v. Marsden, 71 A. 598, 599 (N.J. Ch. 1908). The Court in *Stephany* observes that "the general rule . . . as established by [the] 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 . . . and it has since been by that court so repeatedly approved and recognized that [it] must [be] regard[ed] as a fixed part of the jurisprudence of [New Jersey]." *Id.* at 598.

188. Tooker v. Nat'l Sugar Ref. Co. of N.J., 84 A. 10, 15 (N.J. Ch. 1912).

189. *Id.*

190. *Id.*

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commenced in 1886 with *Wilkinson v. Bauerle,*[191] 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 the director failed to do so, the creditors could "compel them to account for the full value of the property."[192] 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,[193] 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 competition[194] – and the coexistence of *Stewart* and *Gardner v. Butler* represent a direct and powerful challenge to Marsh's consensus position. The later cases are arguably more consistent with Marsh's position as he argued 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 or non-participating director condition is a regulatory bystander in New Jersey case law. In *Gardner v. Butler,* a majority of interested directors participated in the board decision and a majority of disinterested directors was identified as a relevant factor in only a few subsequent cases, either before 1910 or after. Furthermore, in several of such cases the key issue is less the legitimacy of the transaction and more the directors' ability to vote and be counted in the quorum.[195] From 1878 to 1960, New

191. Wilkinson v. Bauerle, 7 A. 514 (N.J. 1886).

192. *Id.* at 519.

193. *See, e.g.,* Mitchell v. United Box Bd. & Paper Co., 66 A. 938 (N.J. Ch. 1907); Barry v. Moeller, 59 A. 97 (N.J. Ch. 1904).

194. *See supra* note 21.

195. Metro. Tel. & Tel. Co. v. Domestic Tel. & Tel. Co., 14 A. 908 (N.J. 1888) (referring to *U.S. Rolling Stock Co. v. Atlantic & Great Western R.R. Co.,* 34 Ohio St. 450 (1878), suggesting that two companies with overlapping in-

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Jersey law is best characterized 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 *Stewart* 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. As illustrated below, by way of contrast, 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 a function of the interested director's non-participation.

New Jersey's contemporary common law fairness position is the product of the courts' recognition that a strict standard plus a remedial fairness approach is 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.*[196] 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.*[197] and *Hill Dredging Corp. v. Risley.*[198] 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

terested directors could enter into a contract where those directors are in the minority, and holding that an interested director is incapable of acting and counting for the board quorum). Subsequent New Jersey authority has cited *Metropolitan Telephone* for the holding. *See, e.g.*, Hill Dredging Corp. v. Risley, 114 A.2d 697 (N.J. 1955); Robotham v. Prudential Ins. Co. of America, 53 A. 842 (N.J. Ch. 1903) (suggesting less onerous rules where the interlocking directors in two companies are in the minority, but also suggesting that where a director participates on both sides of the transaction, fairness review is applicable and the role of the director in making the decision may affect who bears the burden of proving fairness).

196. Abeles v. Adams Eng'g Co., 173 A.2d 246, 255 (N.J. 1961).

197. Eliasberg v. Standard Oil Co., 92 A.2d 862 (N.J. Super. Ct. Ch. Div. 1952).

198. Hill Dredging Corp. v. Risley, 114 A.2d 697 (N.J. 1955).

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perfunctory prohibition, which, if not observed, results in fairness review.[199] Interestingly, *Eliasberg* relied upon the then recent Delaware jurisprudence providing for a substantive fairness standard.[200]

One might ask why it took 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 what was then the 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 was 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 United States and the United Kingdom were both clearly aware of the instrumental economic pressures to facilitate some self-dealing contracts. However, from an identical starting point – the application of the English corporate and trust authorities on self-dealing – the United Kingdom and New Jersey took very different paths to facilitating and regulating self-dealing contracts. The United Kingdom'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

199. Both *Eliasberg*, 92 A.2d at 867 and *Hill Dredging Corp.*, 114 A.2d at 712 rely on *U.S. Steel Corp. v. Hodge*, 53 A. 601 (N.J. Ch. 1902), which clearly affirms *Stewart*. Having stated the voidability rule, the court in *Eliasberg* observes that "[w]here 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." Eliasberg, 92 A.2d at 867. The court in *Hill Dredging Corp.* cites this statement with approval. Hill Dredging Corp., 114 A.2d at 713. The court stated the strict rule that the transaction could not be entered into without shareholder approval, but if it was entered into without approval, then, quoting *Eliasberg* favorably and citing *Stephany*, "the burden is upon the director to completely justify the transaction." *Id. See also* Daloisio v. Peninsula Land Co., 127 A.2d 885 (N.J. Super. Ct. App. Div. 1956).

200. *See* Gottlieb v. Heyden Chem. Corp., 83 A.2d 595 (Del. Ch. 1951); *see also* Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652 (Del. 1952).

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Jersey generated an internal response because the United Kingdom's external contractual one was not available. It is noteworthy that although *Aberdeen Railway* played such a central role in the development of New Jersey self-dealing law, there is no reference in New Jersey case law to the leading U.K. contractibility case of *Imperial Mercantile*.[201]

Although it appears that New Jersey corporations and shareholders may have adopted contractual opt-outs from the strict rule in their constitutional documents,[202] it is unclear at what point in time this practice commenced.[203] It is also important to distinguish their adoption from their effectiveness.[204] As discussed in Part I of this article, U.S. courts – in particular New Jersey courts – imposed significant constraints on contractibility. Prior to 1889, contractual amendment of directors' 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,

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201. In no state has *Imperial Mercantile* been cited to support contractibility. There are a limited number of non-New Jersey references to the House of Lords judgment, *Imperial Mercantile Credit Ass'n v. Coleman*, (1873) 6 H.L. 189 (Eng.), which addresses the question of what constitutes adequate disclosure. There are also a couple of non-New Jersey cases that 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, 422 (1874), and one New York case, *Metro. Elevated Ry. Co. v. Manhattan Ry. Co.*, 14 Abb. N. Cas. 103, 289-90 (N.Y. Sup. Ct. 1884), that refer to Lord Hatherley's judgment in *Imperial Mercantile* in relation to self-dealing, but only as support for the strict voidability rule and not in relation to contractibility.

202. Marsh, *supra* note 15, at 45-46, gives a personal account of the drafting of these provisions from when he was a law firm associate. An example of contracting out language is provided in WILLIAM MEADE FLETCHER, CORPORATION FORMS AND PRECEDENTS §§ 1031-32 (2d ed. 1928).

203. There are only very few cases, dating from the 1930s, that consider contractually opting out of the strict rule. This suggests that such provisions were very rare until later in the 20th century. See the discussion and invalidation of such an opt-out in the New York case, *Whalen v. Hudson Hotel Co.*, 170 N.Y.S. 855, 858 (App. Div. 1918), which refers to an opt-out as "this most unusual provision" and quotes HERBERT BROOM, A SELECTION OF LEGAL MAXIMS 289 (8th Am. ed. 1882) ("unusual clauses always excite suspicion.") in the concurrence. *Whalen*, 170 N.Y.S. at 865 (Woodward, J., concurring).

204. *See* William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH L. REV 898, 927 (1993) (relying on Marsh and assuming that adoption equals effectiveness).

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the state created the corporation, the charter could be viewed as a legislative act, and contractibility was a function of the state explicitly permitting contractibility where the governance rule in question was viewed as important (as a "settled legal principle"). Although increasing flexibility in relation to contractibility was apparent during the course of the 20th century, as discussed in Part I, 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"[205] well into the 20th century.[206]

Juxtaposing the evolution of U.K. self-dealing regulation with that of New Jersey, which in historical perspective is the United States' most important corporate law jurisdiction, it is clear that the path of self-dealing law is, in significant respect, a function of the conception of the corporation.

2. *New York*

a. Channels of Fiduciary Law

Along with *Stewart*, the New York case *Munson v. Syracuse, Geneva & Corning Railway Co.*,[207] 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.[208] *Munson v. Syracuse* 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

205. On the inability to contract out of "settled legal principles" without explicit legislative authority to do so, see *Audenried v. East Coast Milling Co.*, 59 A. 577, 584 (N.J. Ch. 1904).

206. Some limited contractibility in relation to the voidability rule is suggested by *Hodge v. U.S. Steel Corp.*, 54 A. 1 (N.J. 1903), which approved of a bylaw 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, but simply the procedural mode of approval. *See Whalen*, 170 N.Y.S. at 858 for an explicit invalidation of contracting out under New York law.

207. Munson v. Syracuse, Geneva & Corning Ry. Co., 8 N.E. 355 (N.Y. 1886).

208. *See* Marsh, *supra* note 15, at 37.

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party he represents."[209] The judgment cited and followed the holding in *Aberdeen Railway*. 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."[210] Earlier, if less-celebrated, examples of New York courts expressing similar sentiments include the Court of Appeals judgments in *Barnes v. Brown*[211] and *Butts* and the New York Supreme Court's decision in *Cumberland Coal & Iron Co. v. Sherman*,[212] applying Maryland law, all of which relied upon *Aberdeen Railway*.

One way of telling the story of self-dealing law in New York, and of problematizing Marsh's stage theory, is to juxtapose the strict approach taken in *Munson v. Syracuse* next to alternative and apparently contradictory approaches found in the case law during this period. Indeed, there are several early New York cases that suggested, or explicitly adopted, a fairness approach to self-dealing. For example, in *Gamble v. Queens County Water Co.*[213] 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 was concerned with the assessment of the "fair value to the company of the property purchased." In *Sage v. Culver*,[214] decided in 1895, the New York Court of Appeals held that "[w]hen 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."[215] To "explain" it, the court provided that the director must "show that [the transaction] was fair, and that no undue advantage has been taken by him of his position, for his own advantage, or the advantage of some other corporation in which he has an inter-

209. *Munson*, 8 N.E. at 358.
210. *Id.* at 358.
211. Barnes v. Brown, 80 N.Y. 527 (1880).
212. Cumberland Coal & Iron Co. v. Sherman, 30 Barb. 553 (N.Y. Sup. Ct. 1859).
213. Gamble v. Queens County Water Co., 25 N.E. 201, 203 (N.Y. 1890).
214. Sage v. Culver, 41 N.E. 513, 514 (N.Y. 1895).
215. *Id.*

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est."[216] *Sage* 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. The same is true of 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 and its board of directors and stockholders. From this vantage point, *Munson v. Syracuse* 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.[217] In relation to the exercise of delegated power, it provided that a fiduciary could not 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.[218] 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

216. *Id.*

217. J. C. SHEPHERD, THE LAW OF FIDUCIARIES 156 (1981) ("The basic theoretical distinction between dealings with the *corpus* and dealings with the beneficiaries is that, in the former, the fiduciary's power is one of control, while in the latter his power is one of influence.") (emphasis in original).

218. *See, e.g., Ex parte* James, (1803) 32 Eng. Rep. 385; 8 Ves. Jun. 337; *Ex parte* Lacey, (1802) 31 Eng. Rep. 1228; 6 Ves. Jun. 625.

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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 1803 by Lord Eldon in *Ex Parte Lacey*, where he said that the rule is "not[ ] that a trustee cannot buy from his *Cestu[i] que trust*, but[ ] that he shall not buy from himself."[219]

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."[220] Although such arrangements were subject to the "most guarded jealousy,"[221] 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, whereas 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*,[222] an 1802 case brought against a financial advisor by the estate of the advisee, counsel for the defendant argued "that a trustee . . . may, if the agreement is fair, buy of his *cestui que trust*."[223] Lord Eldon observed:

> A trustee may deal with his *Cestu[i] que trust* but the relation must be in some way dissolved: or, if not, the parties must be put as much at arm's length, that they agree to take the character of purchaser and vendor; and you must ascertain whether all the duties of those characters have been performed . . . . [H]e who

219. 31 Eng. Rep. 1228, 1228; 6 Ves. Jun. 625, 626.
220. *Id.* at 1228; 6 Ves. Jun. at 626.
221. *Id.* at 1228; 6 Ves. Jun. at 626.
222. Gibson v. Jeyes, (1801) 6 Ves. Jun. 266. *See also* Coles v. Trecothick, (1804) 9 Ves. 234.
223. *Gibson*, 6 Ves. Jun. at 270.

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> bargains in a matter of advantage with a person placing confidence in him, is bound to shew [sic] that a reasonable use has been made of that confidence.[224]

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

> There are certain relations known to the 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.[225]

As is evident from these extracts, the courts typically focused on fair process rather than fair price when setting forth and applying the influence standard. However, in several authoritative early cases the courts expressed the view that the influence standard required both fair price and fair process.[226] 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 *Lacey* and *Gibson* applicable standards.[227] In the New York Court of Appeals case of *Cowee v. Cornell*,[228] decided in 1878, the court, in considering the validity of an

224. *Id.* at 277-78.

225. Hunter v. Atkins, (1834) 47 Eng. Rep. 166, 167; Coop. T. Brough 464, 466-67.

226. *See* Thomson v. Eastwood, (1877) 2 App. Cas. 215, 236 (Eng.) ("[T]here is no rule of law which says that a trustee shall not buy trust property from a *cestui que trust*, but it is a well known doctrine of Equity that if a transaction of that kind is challenged in proper time, a Court of Equity will examine into it, will ascertain the value that was paid by the trustee, and will throw upon the trustee the *onus* of proving that he gave full value, and that all information was laid before the *cestui que trust* when it was sold.") (Lord Cairns, L.C.) (emphasis in original). *See also* Dougan v Macpherson, [1902] A.C. 197 (affirming the above dicta on value).

227. Note also that the New York courts understood the influence standard through the lens of fair price as well as fair process. *See, e.g.*, Whitehead v. Kennedy, 69 N.Y. 462, 466 (1877) (citing *Gibson*, 6 Ves. Jun. 266). The parties and the courts focused on the issue of fair price.

228. 75 N.Y. 91, 99-100 (1878) (internal citations omitted).

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agreement between a deceased grandfather and his grandson, observed, citing *Hunter*, 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. This doctrine is well settled.[229]
>
> The principle referred to it must be remembered is distinct from one that would absolutely forbid a trustee or agent from purchasing the subject of a trust for his own benefit and charging it when so purchased with the trust. That amounts to incapacity in the fiduciary to purchase of himself. He cannot act for himself at all, however fairly or innocently, in any dealing to which he has duties as trustee or agent. The reason of this rule is subjective. It removes from

229. Note that the court refers to this doctrine as the doctrine of constructive fraud. The Court cites here *Nesbit v. Lockman*, 34 N.Y. 167 (1866), 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, AS ADMINISTERED IN ENGLAND AND AMERICA § 311 (10th ed. 1870), *Sears v. Shafer*, 6 N.Y. 268 (1852), *Huguenin v. Baseley*, (1806) 33 Eng. Rep. 234; 13 Ves. Jun. 105, (1807) 33 Eng. Rep. 526; 14 Ves. Jun. 273, (1808) 33 Eng. Rep. 722; 15 Ves. Jun. 180, *Wright v. Proud*, (1806) 33 Eng. Rep. 246; 13 Ves. Jun. 136, *Harris v. Tremenheere*, (1808) 33 Eng. Rep. 668; 15 Ves. Jun. 34, *Edwards v. Myrick*, (1842) 67 Eng. Rep. 25; 2 Hare 60, and *Hunter v. Atkins*, 47 Eng. Rep. 166. For other cases articulating the influence of the fairness standard, see Judge Andrews' opinion (the same judge who decided *Munson v. Syracuse*) in *Whitehead v. Kennedy*, 69 N.Y. 462, 466 (1877) (citing *Gibson v. Jeyes*, (1801) 31 Eng. Rep. 1044; 6 Ves. Jun. 266) and the Court of Appeals' judgment in *Fisher v. Bishop*, 108 N.Y. 25, 28-29 (1888) ("When this [fiduciary] 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*, 6 Ves. Jun. 266).

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> 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; instead, it presumes it unfair and fraudulent unless the contrary is affirmatively shown.

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 one of fairness. The fiduciary influence standard is referred to in some of the cases, primarily the non-corporate cases, as a doctrine of "constructive fraud."[230]

There are two difficulties involved in translating these standards from trust 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—the board and the shareholder meeting. This transplantation of the fiduciary standards from a bilateral to a 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 vested in the corporation itself. Furthermore, although directors may be fiduciaries of the corporation, it is the directors acting collectively as a board,

230. *See, e.g.*, Butler v. Prentiss, 158 N.Y. 49 (1899); Cowee v. Cornell, 75 N.Y. 91; Ten Eyck v. Craig, 62 N.Y. 406 (1875); Rosevear v. Sullivan, 62 N.Y.S. 447 (App. Div. 1900); Metro. Elevated Ry. Co. v. Manhattan Ry. Co., 14 Abb. N. Cas. 103 (N.Y. Sup. Ct. 1884).

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not the individual directors, that possess and wield corporate power[231] 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 may be, and the corporation looks more like the beneficiary than the trust.

Early U.K. authority dealing with unincorporated companies suggested that the "paralyzing" of the director's role to enable self-dealing arrangements was not possible.[232] The issue was placed partially in play in *Aberdeen Railway*, where the court considered whether the fact that Blaikie "was one of a body of directors" made any difference to the applicable standard.[233] 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* 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,"[234] just as a trustee could not divulge himself of power without revoking his trusteeship. This rendered a self-dealing transaction as one that always involved the exercise of director power, regardless of formal voting participation. The fiduciary influence standard was thereby sidestepped.

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

232. Benson v. Heathorn, (1842) 62 Eng. Rep. 909; 1 Y. & C.C.C. 326.

233. Aberdeen Ry. Co. v. Blaikie, (1854) 1 MACQ 461, 473.

234. *Ex parte* Lacey, (1802) 31 Eng. Rep. 1228, 1228; 6 Ves. Jun. 625, 626.

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This U.K. approach is consistent with the 19th-century U.K. 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 U.K. 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 [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 is *entrusted to them.* So the powers which the directors have, *e.g.*, of calling meetings, electing members of their own board, allotting, transferring and forfeiting shares, making calls, &c., &c., *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 regarded as a breach of trust, and is treated accordingly.[235]

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, 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 individually. This required that the deed of settlement provide that, when some directors were not present, 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.*"[236] That is, the court of directors brought together the power vested in each of the individual directors in order for

235. LINDLEY, *supra* note 29, at 510 (emphasis added) (footnote omitted).
236. Benson v. Heathorn, (1842) 62 Eng. Rep. 909; 910 (emphasis added).

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that power to be exercised collectively. Consistent with this approach, the delegation of power to directors in an incorporated U.K. company has never typically been to a board of directors, but rather to "the directors."[237] This is also why English courts sometimes refer to corporate powers as "fiduciary powers": powers entrusted to fiduciaries, to be exercised in accordance with their fiduciary duties.[238] 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"[239] is that participation is irrelevant because, when the board makes a decision, the powers held by all the directors are 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 corporation statute for manufacturing companies provided that the "stock, property and concerns of such company shall be managed by not less than three, nor more than thirteen trustees."[240] Furthermore, as early as 1829, the corporation laws of New York provided for quorum requirements in relation to the exercise

237. For example, the default constitution (the Table A articles) issued pursuant to the Companies Act of 1862 provides that "[t]he 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." Companies Act, 1862, 25 & 26 Vict., c. 89, § 55 (Eng.). 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 they have to follow to exercise power. For example, "[t]he directors may delegate any of *their* powers to committees consisting of such member or members of their body as they think fit." *Id.* § 68 (emphasis added). The Aberdeen Railway Company was a chartered company and its constitution was provided by the Companies Clauses Consolidation Act of 1845, which also empowers the directors, rather than the board of directors. *See* Companies Clauses Consolidation Act, 1845, 8 & 9 Vict., c. 16, § 90 (Eng.).

238. *See, e.g.*, *In re* Nat'l Provincial Marine Ins. Co., (1870) 5 Ch. App. 559 (Eng.); *In re* Coalport China Co., (1895) 2 Ch. 404 (Eng.); *In re* Cawley & Co., (1889) 42 Ch. D. 209 (Eng.).

239. Aberdeen Ry. Co. v. Blaikie, (1854) 1 MACQ 461, 473.

240. §12 New York Manufacturing Corporation Act of 1848.

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of power by the trustees and that "every decision of a majority of the persons duly assembled as a board, shall be valid as a corporate act."[241] Writing in 1886, Victor Morawetz observed that "[t]he active management and direction of the affairs of a business corporation are ordinarily vested in a board of directors or trustees."[242] By 1892, the New York General Corporation Law provided that "[t]he affairs of every corporation shall be managed by its board of directors [and that] the act of a majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors."[243] 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 explained in 1887, a director "may be deemed to be relieved of any trust relation to the stockholders, except so far [sic] as his own individual action may affect the complete exercise of the power lodged in the whole board."[244] Logically, therefore, the fiduciary standard applicable to such a non-participating director in a self-dealing transaction would be the *Gibson* influence standard, i.e., a fairness standard, and the stricter *Lacey* power standard would apply to a participating director. Because of the understanding of director empowerment in a U.K. company, this distinction was not available to U.K. company law, whereas it was logical and arguably correct in the New York context. This understanding of board power opened a channel through which the established fiduciary influence standard could flow into corporate law.[245]

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241. OF THE GENERAL POWERS, PRIVILEGES AND LIABILITIES OF CORPORATIONS, REVISED STATUTES OF NEW YORK, tit. III, § 6 (1829).

242. MORAWETZ, *supra* note 70, at 477.

243. N.Y. GEN. CORP. LAW § 29 (1892).

244. Paul K. Ames, *May a Director Deal with His Corporation?*, 1 COLUM. L. TIMES 193, 193 (1887-88).

245. Beveridge argued that this standard was, by the mid-1870s, the general U.S. self-dealing fiduciary standard. Beveridge, *Interested Director Contracts*, *supra* note 145, at 103 (citing a casebook on trusts, JAIRUS WARE PERRY, A TREATISE ON THE LAW OF TRUSTS AND TRUSTEES 248-49 (2nd ed. 1874)). 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.

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To be clear, this article does not suggest that New York corporate law's understanding of board power is determinative of the 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 U.K. law – which provided one means of being responsive to the instrumental economic pressures to enable self-dealing. Small disconnects in an argumentative structure may drive different legal paths, though they will not necessarily do so. Indeed, the New Jersey courts, dealing with corporations with effectively identical understandings of board power to their New York counterparts,[246] did not take this opening and adopted the United Kingdom's approach to director participation in 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 U.K. corporate law. For example, in 1863, the Maryland Court of Appeals in *Cumberland Coal & Iron Co. v. Sherman,*[247] following the U.K. cases of *Aberdeen Railway* and *Benson,* considered and rejected the influence standard. However, in 1875 in *Cumberland Coal & Iron Co. v. Parish,*[248] the Maryland Court of Appeals reiterated the same position and then incongruously held that the question of voidability hinged on an influence standard, i.e., 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 U.K. 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 *Sherman,* adopted a position that did not de-

246. Arguably, it is noteworthy that early New Jersey Corporation statutes did not refer to a board, but rather to empowered directors directly. *See* JOHN J. TREACY & JOHN MILTON, THE GENERAL CORPORATION ACT OF NEW JERSEY (1896). However, the New Jersey courts were clearly of the view that the board and not individual directors were empowered. *See, e.g.,* Titus v. Cairo & Fulton R.R. Co., 37 N.J.L. 98, 102 (N.J. Sup. Ct. 1874) ("The affairs of corporate bodies are within the exclusive control of their boards of directors, from whom authority to dispose of their assets must be derived.").

247. Cumberland Coal & Iron Co. v. Sherman, 20 Md. 117 (1863).

248. Cumberland Coal & Iron Co. v. Parish, 42 Md. 598, 606 (1875).

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pend upon director participation.[249] Rather, the claim made here, and argued 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 adopted Marsh's position were aware of this influence strand of fiduciary law and the analogy of the corporation to the beneficiary. However, it was viewed as both a marginal and unpersuasive *ex-post* technical justification and a cover for the unspoken drivers of legal change.[250] Compounding the sense that this justification was outside of the mainstream legal position, Marsh cited only one 1902 Texas case in support and suggested that it was the only case that made this connection.[251] However, in New York the influence strand of fiduciary law is neither marginal nor an *ex-post* explanation of legal change. It arose, 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 U.S. corporation. The

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249. *See* Hoyle v. Plattsburgh & Montreal R.R. Co., 54 N.Y. 314, 328 (1873) ("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, e.g.,* Globe Woolen Co. v. Utica Gas & Elec. Co., 136 N.Y.S. 16, 21 (N.Y. Sup. Ct.), *rev'd* 136 N.Y.S. 24 (N.Y. App. Div. 1912) (citing *Hoyle* for the proposition that "[i]f the director enters into a contract between himself and his corporation, *and assumes to act for both,* his contract is voidable") (emphasis added); Metro. Elevated Ry. Co. v. Manhattan Ry. Co., 14 Abb. N. Cas. 103 (N.Y. Sup. Ct. 1884) ("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 Bd. & Paper, 128 N.Y.S. 959 (N.Y. App. Div. 1911).

250. *See* Marsh, *supra* note 15, at 40 ("The only explanation which seems to have been given for this change in position was the technical one . . . ."). *See also* CLARK, *supra* note 16, at 161 ("At most, they made technical, analogical arguments.").

251. *See* Marsh *supra* note 15, at 40 (referring to "[t]he only explanation that seems to have been given" and then quoting from the Supreme Court of Texas' opinion in *Tenison v. Patton,* 67 S.W. 92, 95 (Tex. 1902)).

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courts did not, unsurprisingly, consider it 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 Fiduciary 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 *Lacey* standard set forth in *Aberdeen Railway* was applicable. But in New York, one cannot extrapolate from these cases a generally applicable voidability standard. On the contrary, the early cases that were held up as the standard-bearers of the strict standard took pains to stress the participation of the director in the board decision. Underpinning the court's focus on participation was, it is submitted, an awareness that the applicable standard depended upon whether power was exercised or merely influence exerted. In *Butts*, for example, the Court stressed the participation of the defendant in the approved transaction.[252] In *Munson v. Syracuse*, there is a pervasive focus on the participation of the director in approving the transaction. The Court observed that "[t]he 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 favor of the contract."[253] The court observed further that "[t]he law cannot accurately measure the influence of a trustee with his associates . . . in an action by the trustee in his 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 characters of principal and representative*."[254] 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

252. *See also* Barnes v. Brown, 80 N.Y. 527, 535 (1880) ("He could not act as trustee and for himself at the same time . . . .").

253. Munson v. Syracuse, Geneva & Corning Ry. Co., 8 N.E. 355, 358 (N.Y. 1886) (emphasis added).

254. *Id.* at 358.

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Munson v. Magee stressed that Munson's role in acting for the corporation was central to the voidability decision.[255]

The post-*Munson v. Syracuse* and *Butts* cases that adopted a strict voidability approach to the facts of the case are relatively few in number, and those that did adopt a strict standard involved a director who participated in the decision. In these cases, the courts identified such participation. For example, in *Koster v. Pain*, the Court of Appeals observed that "[a]s 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."[256]

Although the power/influence dichotomy silently structured the most important and influential early cases, in the

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255. Munson v. Magee, 55 N.E. 916, 918 (N.Y. 1899) ("[T]he 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.").

256. Koster v. Pain, 58 N.Y.S. 865, 866 (N.Y. App. Div. 1899) (emphasis added). *See also* Jacobson v. Brooklyn Lumber Co., 76 N.E. 1075, 1078-79 (N.Y. 1906) (citing both *Butts* and *Munson v. Syracuse* for the proposition that "[t]he courts in this state have frequently asserted the voidability of acts and votes of corporate officers, when they are affected by private interests"); Merrill v. United Box Bd. & Paper, 128 N.Y.S. 959, 962 (N.Y. App. Div. 1911) (relying on *Munson v. Syracuse* and observing that "the plaintiff voted to approve his own contract"); Miller v. Crown Perfumery Co., 109 N.Y.S. 760, 765 (N.Y. App. Div. 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*, 37 N.Y. 317 and *Barnes v. Brown*, 80 N.Y. 527). *But see* Barr v. New York, L.E. & W.R. Co., 26 N.E. 145, 149 (N.Y. 1891) (distinguishing *Munson v. Syracuse* on the basis that in *Munson v. Syracuse* "a director of the defendant corporation was a party to [the agreement], and participated in the action of the corporation in assuming the obligation."); Strobel v. Brownell, 40 N.Y.S. 702 (N.Y. App. Div. 1895) (distinguishing *Munson v. Syracuse* 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); Beers v. N.Y. Life Ins. Co., 20 N.Y.S. 788, 795 (N.Y. Gen. Term 1892) ("[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.").

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1880s, only one New York case explicitly toyed with the fiduciary influence fairness standard. This is the case of *Rudd v. Robinson*, an 1889 Supreme Court decision where the court juxtaposed a strict voidability rule with the influence standard, voiding certain transactions and subjecting others – involving loans – to the influence standard.[257] Absence of explicit consideration of this standard in the 1880s could be read as the absence of the standard. This is not correct – it is clear that the early strict decisions themselves operated within the context of this fiduciary power/influence 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,[258] Cary and Eisenberg argued that although this may be correct, "the opinions did not limit the rule to such cases."[259] Indeed, in the absence of the above fiduciary context, a literal reading of the cases would identify no explicit limit. However, with this context, we 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 offers an explanation for 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 U.S. self-dealing law, cites Victor Morawetz, a New York attorney,[260] who in 1880 opined that "there is no impropriety in

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257. Rudd v. Robinson, 7 N.Y.S. 535, 538 (N.Y. Gen. Term 1889) (following Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875)). *Cf.* Hoyle v. Plattsburgh & Montreal R.R. Co., 54 N.Y. 314, 319 (1873) (following Benson v. Heathorn, (1842) 62 Eng. Rep. 909; 1 Y. & C.C.C. 326 and suggesting that such disability was not possible, although the director in this case participated in the decision to auction corporate assets).

258. Beveridge, *Duty of Loyalty*, *supra* note 145, at 662 ("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.").

259. CARY & EISENBERG, *supra* note 146, at 651.

260. Morawetz joined the well-known New York corporate law firm, Cravath, in 1887.

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a contract between a director and the corporation, if the latter is represented by other agents." In the 1886 edition of his book, Morawetz observed that a quorate board is empowered to act on behalf of the company and, provided that the agent (i.e., the director) does not participate, the transaction is sound. However, "even if the [corporation] was represented by a majority of the board, [the transaction] will always be scrutinized 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."[261] In rejecting Beveridge's arguments, Cary and Eisenberg argued that the commentators in this period went further than the majority of the cases.[262] But they did not. Although one does not find a New York case in the 1880s that explicitly stated the law in the terms outlined by Morawetz, he understood *Butts* and *Munson v. Syracuse* to be articulations of the existing power/influence fiduciary position, which was consistent with his statement. As Morawetz observed, "[t]he principle acted upon in these cases is a general principle of the law of agency."[263] 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 represented to 19th-century New York lawyers an available stream of fiduciary doctrine that sat alongside the voidability rule and whose applicability was dependent on the role of the director in relation to the transaction in question.

261. MORAWETZ, *supra* note 70, at 495. Morawetz's second edition was reviewed by Professor Ames in the Harvard Law Review. J. B. Ames, Book Review, 1 HARV. L. REV. 109, 110 (1887) (referring to Morawetz's treatise as "the best treatise on the subject of Corporations").

262. CARY & EISENBERG, *supra* note 146, at 651.

263. MORAWETZ, *supra* note 70, at 484-85. *See also* HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS (2d ed. 1888). This text has strong New York influences, as Taylor was a member of the New York Bar. Although Taylor does not state the rule as clearly as Morawetz does, his analysis is structured by participation: "A director or other corporate officer can *on behalf of his 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." *Id.* at 580-81 (emphasis added) (citations omitted).

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c. Entrenching Fairness Review

It was in the 1890s that the influence doctrine came to the fore in New York. The Court of Appeals decision in *Sage*, as noted above, adopted an explicit fairness-based approach rooted in the fiduciary influence standard.[264] The court in *Sage* cited, but did not discuss, *Gibson* and *Cowee* as authority for the fairness standard. For *Sage*, fairness review was a product of the courts viewing self-dealing through equity's lens of influence and not of power. However, it is true that the rigor of equity's distinction between power and influence was not always maintained in this and subsequent cases that adopted the influence standard. The court in *Sage* did 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 moved from voidability to fairness, but one that arguably commenced the disconnection of the influence standard from the absence of the exercise of directorial power.

The source of fairness review in *Sage* is readily traceable to the fiduciary influence doctrine. However, multiple other New York cases in the 1880s and 1890s that also adopted 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 Cott* 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 [ ] there is no proof of any fraud . . . ."[265] In *Gamble*, referenced above, the Court of Appeals applied a non-participating director/fairness standard.

264. *Sage v. Culver*, 41 N.E. 513 (N.Y. 1896) is a central but largely forgotten case for U.S. commentators. The case attracts only seven citations from a Westlaw Journals and Reviews search, and only one of those considers *Sage* in the text of the article. *See* Claire M. Dickerson, *Interested Directors of New York Corporations and the Burden of Proof*, 1988 COLUM. BUS. L. REV. 91, 95-97. *See also* Beveridge, *Interested Director Contracts*, *supra* note 145, at 121 (citing but not considering the case in detail); Lauren B. Homer, Note, *The Status of the Fairness Test Under Section 713 of the New York Business Corporation Law*, 76 COLUM. L. REV. 1156, 1161 (1976).

265. Van Cott v. Van Brunt, 82 N.Y. 535, 539, 541 (1880).

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In 1895 in *Strobel v. Brownell*, distinguishing *Munson v. Syracuse* because of the absence of the exercise of power and following *Gamble*, the New York Supreme Court held:

> 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.[266]

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 *Butts* to *Sage* represent not change but continuity underpinned by longstanding fiduciary doctrine. This period of continuity continued well into the 20th century. For example, the judgment of *Davids v. Davids* 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, suggested 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.[267] In *Globe Woolen Co. v. Utica Gas & Electricity Co.*, the trial court upheld an executory contract between corporations with common directors.[268] The court distinguished the automatic voidability rules applicable where the director acts, citing *Butts* and *Munson v. Syracuse*, from the situation, citing *Strobel* and *Gamble*, where the director does not participate. The Court held that, provided "there being no fraud, conspiracy, bad faith or concealment, a valid contract

266. Strobel v. Brownell, 40 N.Y.S. 702, 705 (N.Y. App. Div. 1895).

267. See *Carr v. Kimball*, 139 N.Y.S. 253, 262 (N.Y. App. Div. 1912) (citing Davids v. Davids, 120 N.Y.S. 350 (N.Y. App. Div. 1909), and *Sage*, 41 N.E. 513), for a similar degree of schizophrenia about the relationship between power and the applicable standard.

268. Globe Woolen Co. v. Utica Gas & Elec. Co., 136 N.Y.S. 16 (N.Y. Sup. Ct. 1912).

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may be made between a corporation and one of its directors."[269] 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 v. Syracuse* 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."[270] Accordingly, the Court held:

> There was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other. [Citing *Sage* and *Davids.*] 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.[271]

The Court of Appeals invalidated the contracts as the "unfairness is startling."[272] Although *Globe Woolen* represents a clear reassertion of the power/influence framework, it represents a high watermark in this regard. Post-1920, although there were cases that firmly assert the power/influence framework, rendering transactions voidable simply because of the exercise of power,[273] the *Sage* fairness standard, together with a disregard for the distinction between power and influence, came to dominate.[274] In some instances, reference to *Sage* was 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*[275] and the per curiam affirmation by the Court of Appeals,[276] a decision that Marsh

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269. *Id.* at 21.

270. Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 379-80 (N.Y. 1918).

271. *Id.* at 380.

272. *Id.*

273. One of the few of these cases is *Hauben v. Morris*, 291 N.Y.S. 96 (N.Y. Sup. Ct. 1936).

274. *See* Schall v. Althaus, 203 N.Y.S. 36 (N.Y. App. Div. 1924); Blaustein v. Pan Am. Petroleum & Transp. Co., 21 N.Y.S.2d 651 (N.Y. Sup. Ct. 1940); Cleary v. Higley, 277 N.Y.S. 63 (N.Y. Sup. Ct. 1934). Each of these cases quotes extensively from *Sage v. Culver*, 41 N.E. 513.

275. La Vin v. La Vin, 128 N.Y.S.2d 518 (N.Y. App. Div. 1954).

276. La Vin v. La Vin, 121 N.E.2d 620 (N.Y. 1954) (per curiam).

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described as "shamefaced" for failing to address what he viewed as a departure from the strict rule.[277] However, *Sage* is commonly cited as authority for a fairness-based standard that applies regardless of director participation in the board decision.[278] *Munson v. Syracuse* was not forgotten during this transition to fairness review[279] regardless of participation, but at worst it was cited in support of the general fairness standard[280] and at best as support for the position that the distribution of the burden of proof is dependent upon whether the director participated.[281]

This is the unexplained shift in New York case law, which Marsh rightly identified: 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*, 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*.[282] But this shift is unexplained, indeed inexplicable, in policy terms, for it was clearly not necessary to adjust to the instrumental economic

277. Marsh, *supra* note 15, at 41.

278. *See, e.g.*, Everett v. Phillips, 43 N.E.2d 18, 22 (N.Y. 1942) (holding that the dual position of directors did not render the transaction void but subjected it to fairness review); Kaminsky v. Kahn, 259 N.Y.S.2d 716, 725 (N.Y. App. Div. 1965); Foley v. D'Agostino, 248 N.Y.S.2d 121 (N.Y. App. Div. 1964); Wohl v. Miller, 169 N.Y.S.2d 233, 241 (N.Y. App. Div. 1958) (connecting explicitly actual participation to fairness review); *Schall*, 203 N.Y.S. at 39; Strax v. Murray Hill Mews Owners Corp., 809 N.Y.S.2d 759, 763 (N.Y. App. Term 2005) (Suarez, P.J., dissenting); *In re* Meyer's Estate, 119 N.Y.S.2d 737, 756 (N.Y. Sup. Ct. 1953) (holding fairness review applicable when a director is "serving two masters"); Stearns v. Dudley, 76 N.Y.S.2d 106, 125 (N.Y. Sup. Ct. 1947); Bayer v. Beran, 49 N.Y.S.2d 2, 6-7 (N.Y. Sup. Ct. 1944).

279. *Munson v. Syracuse* is regularly cited in the non-corporate context of trusts and wills. *See, e.g.*, *In re* Estate of Grace, 247 N.Y.S.2d 695, 698 (N.Y. Surr. Ct. 1964); *In re* Estate of Dickson, 237 N.Y.S.2d 572, 577 (N.Y. Surr. Ct. 1963). There are very few post-*Globe-Woolen Munson v. Syracuse* citations in the corporate cases.

280. *Strax*, 809 N.Y.S.2d at 763 (citing *Sage* and *Munson v. Syracuase* as authorities for fairness review).

281. Hazzard v. Chase Nat'l Bank of New York, 287 N.Y.S. 541, 570 (N.Y. Sup. Ct. 1936).

282. Blaustein v. Pan Am. Petroleum & Transp. Co., 21 N.Y.S.2d 651, 713 (N.Y. Sup. Ct. 1940); Cleary v. Higley, 277 N.Y.S. 63, 75 (N.Y. Sup. Ct. 1934).

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need for self-dealing. As discussed in Part I, in the United Kingdom, 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 did the same defendant or the same judge appear twice. Nor are self-dealing defendants archetypal repeat players.[283] Company resources could not be deployed to defend these actions. Indemnification to the extent provided for was, at this time, of doubtful legality,[284] and the plaintiffs appeared to be well resourced, as they were typically either significant shareholders suing derivatively or liquidators. Regulatory competition as an explanatory factor is dinted by the fact that *Sage*, as early as 1895, appeared to ignore the power/influence distinction. Furthermore, in several of the 20th-century cases, where the fairness standard was adopted and the distinction ignored, the decision itself did not favor management, suggesting that those judges were not receptive to the claims that New York law needed to adjust in favor of managers in order to attract re-incorporations.[285] A persuasive explanation is not available. But one cannot disregard an explanation that discounts politics, pressure groups and rational responses of lawmakers to those pressures and views legal change as the result of a fair pinch of incompetence in reading the cases and applying the common law method.

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283. For a discussion on repeat players, see Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974).

284. See *supra* text accompanying notes 109-112.

285. *See, e,g.*, Schall v. Althaus, 203 N.Y.S. 36 (N.Y. App. Div. 1924); Stearns v. Dudley, 76 N.Y.S.2d 106 (N.Y. Sup. Ct. 1947). Other cases, of course, would fit in the race-to-the-bottom paradigm. *See, e.g.*, Everett v. Phillips, 43 N.E.2d 18 (N.Y. 1942); Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. Sup. Ct. 1944).

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3. *Delaware's Borrowed Goods*

The dearth of Delaware self-dealing case law is striking. Delaware has no place in the first two stages of Marsh's evolution of self-dealing cases because there are no cases. Marsh referred to no Delaware cases before 1948.[286] 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 largely borrowed directly from New Jersey and there were hardly any important Delaware cases. The lack of authority clearly creates open space for judges to tailor solutions to their primary constituencies. However, in the context of the above analysis of New Jersey and New York self-dealing law, Delaware self-dealing law appears clearly rooted in the approaches formed in other states. It borrowed from and brought together those approaches. In doing so, it asserts its independence through only limited citation of its neighbors' cases upon which Delaware law rests.

Delaware law on self-dealing commenced in the 1920s with the important case of *Cahall v. Lofland*.[287] 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 relied on *Du Pont v. Du Pont*, a Delaware District Court case applying New Jersey law, which observed, without citing authority, that "[i]f [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."[288] The language of constructive fraud echoes the

286. Marsh cited *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 581 (Del. 1948) in relation to the discussion of whether an interested director could be counted for the purpose of determining whether the board is quorate. Marsh, *supra* note 15, at 42 n.27. He also cited the earlier Federal case of *Hand v. Missouri-Kansas Pipe Line Co.*, 54 F. Supp. 649 (D. Del. 1944) in relation to board expenses in a proxy fight. Marsh, *supra* note 15, at 60 n.88.

287. Cahall v. Lofland, 114 A. 224 (Del. Ch. 1921).

288. Du Pont v. Du Pont, 242 F. 98, 136 (D. Del. 1917).

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power/influence fiduciary dichotomy that was so influential in New York, although, whereas the term is usually used to refer to the regulation of influence,[289] here it was connected to the exercise of power.[290] Following this statement, the Chancery Court then proceeded to rely on the New Jersey case of *Gardner v. Butler* to understand the application of this rule. It extracts two principles from *Gardner v. Butler*: a disinterested director principle and a fairness principle. In *Gardner v. Butler*, the board resolution was passed by a majority of interested directors. As observed above, *Gardner v. Butler* followed *Stewart*, which viewed interested director non-participation as irrelevant. Nevertheless, for the Chancery Court in *Cahall v. Lofland*, the facts of *Gardner v. Butler* served as the basis for its holding that majority interested director participation renders the transaction constructively fraudulent and therefore voidable. The judgment did 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 observed that *Gardner v. Butler* provided 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 [therefor]."[291]

The Delaware Supreme Court's judgment in *Lofland v. Cahall*[292] focused on the effects of director participation in approving the self-dealing contract and affirmed the invalidity of

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289. For example, in defining constructive fraud, the court in *Cowee v. Cornell*, 75 N.Y. 91, 99-100 (1878) (citing, among other cases, the U.K. case of *Hunter v. Atkins*, (1834) 47 Eng. Rep. 166; 3 Myl. & K. 113) observed that "[w]henever, 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."

290. *See supra* note 231.

291. *Cahall*, 114 A. at 232 (quoting Gardner v. Butler, 30 N.J. Eq. 702, 724-25 (1879)).

292. Lofland v. Cahall, 118 A. 1 (Del. 1922).

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the self-dealing transactions as constructive fraud. The court did 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 imprecise, of constructive fraud suggest that the influence fiduciary fairness standard would be applicable to such transactions. Unlike the Chancery Court, the Supreme Court did not explore *Gardner v. Butler* remedial fairness, nor did the court refer to authority on self-dealing law apart from *Du Pont*, although it did affirm that the authorities considered by the Chancery Court were the leading authorities.

Lofland v. Cahall brought together remedial fairness and the fiduciary influence standard. It arguably applied a fairness standard whether or not the directors participated in approving the transaction: if the director did not participate, then it suggested that the fiduciary influence fairness standard applies. But where the director did participate, remedial fairness applies. Thirty years later in *Gottlieb v. Heyden Chemical Corp.*,[293] the court, citing only the Supreme Court's judgment in *Lofland v. Cahall*,[294] set 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 made 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. The analysis of the limited Delaware self-dealing case law illustrates 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

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293. Gottlieb v. Heyden Chem. Corp., 90 A.2d 660 (Del. 1952).

294. While *Lofland v. Cahall* was the only case cited, the court also cited 2 WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 921 (1917). *Gottlieb*, 90 A.2d at 663.

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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 maneuver within "fairness," and there is much room to attract managers with a signaled favorable approach to application and procedure.

IV. CONCLUSION

If one posits 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 asks 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, while 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 United States originally adopted a strict approach that rejected fairness but moved over time to a fairness-based approach. According to Marsh, this transition was unexplained by the courts in legal or policy terms.

Juxtaposing the contemporary fairness standard with the historical strict standard, Marsh allowed for the conclusion that contemporary U.S. corporate law is management-friendly and more so than it used to be. However, the question remains as to 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 lawmakers, 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 a comparative perspective. The

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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 United States and the United Kingdom resulted from the adaption of existing fiduciary law to the conception of the corporation in the mid-to-late 19th century, then it follows that: (i) there is no unexplained shift from a strict rule to a management-friendly standard to explain; (ii) there is no need to rely upon non-legal pressures and incentives to explain legal change that the courts failed to account for; and (iii) the United Kingdom'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 into the business context. Clearly, in both the United States and the United Kingdom, courts were cognizant of the different role of self-dealing transactions 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 observed in New Jersey and New York, fairness coexisted at all times with the strict standard, then there is no shift to a more management-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, as standard-bearer of the management-friendly bias of U.S. corporate law, is not explained by these pressures. Rather, it is explained by the core components of the conception of the U.S. corporation: its emphasis on the public creation of the corporation, its concomi-

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tant restraint on contractibility, and the state's direct empowerment of the board of directors.

Legal realism teaches that hiding in the mouth of the legal dragon[295] are economic and social policy choices. What it does not teach 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 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, it becomes apparent 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.

295. Holmes, *supra* note 3, at 469 ("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 [sic].").

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