NOTES

ECONOMIC INSTITUTIONS AND VALUES: FIDUCIARY RESPONSIBILITY OF CORPORATE OFFICERS AND DIRECTORS

This year’s LAWYER Economic Institutions and Values Survey is approached from three viewpoints. Part I will cover common law remedies for shareholders damaged by breaches of fiduciary responsibility committed by officers and directors of corporations. Part II will survey state statutory attempts to regulate this problem; and Part III will cover federal securities regulation, particularly as it pertains to the prevention and regulation of so-called “conflicts of interest.”

Part I. The Common Law

A. The fiduciary relation

The status of a director or an officer of a corporation is one which characteristically involves the ability—in fact, the duty—of one person or group of persons to use the property of others. This situation has invited innumerable attempts to classify the relationship in terms of common law offices of varying degrees of similarity.

At the outset, the case of one merely an officer of the corporation should be recognized as that of agent (or sub-agent), because he owes his appointment, his delegated power, and the continuance of his authority to the assent of the directors, whose voice in the conduct of business is that of the corporation. The description of directors involves a greater difficulty. They have been variously characterized as analogous to trustees, agents, fiduciaries, quasi-fiduciaries, and mandatories. The more common descriptions seem to be those of trustee or agent.

A trust is a fiduciary relationship with respect to property, subjecting the person who holds title to the property to equitable duties to deal with the property for the benefit of another person, which relationship arises as a result of manifestation of intention to create it. The situation of the corporate director is readily distinguishable from that of the trustee because the corporation, not the director, holds the legal title to the corporate property. It is a legal creature, the holder of title over which the directors have control, but whose property is held in its own name. The director, therefore, cannot properly be said to be a trustee in the common law (i.e., equitable) sense.

Similarly, “agent” fails to describe adequately the factual situation. Agency is the fiduciary relation which results from the manifestation of consent given one person by another that the other shall act on his behalf and subject to his control, and consent by the other so to act. The one who is to act is the agent. If the director is termed an agent and the corporation is thought of as principal, the normal power situation is reversed, since the corporation is under control of the directors. And, on the other hand, if the body of stockholders is thought of as principal, the aspect of control fails, too, since the directors are not subject to the direct will of the majority stockholders. The shareholders’ remedy is through periodic elections. Further, the quantum of the directors’ authority is largely described by statute, in contrast to the principal’s normal capacity to define the delegated power.

4 Holcomb v. Forsyth, 216 Ala. 486, 113 So. 516, 519 (1927).
6 Uhlman, The Legal Status of Corporate Directors, 19 B.U.L. Rev. 12, 13-14 (1939);
7 1 Restatement (Second), Agency § 1 (1958).
8 See generally Johnson, Corporate Directors as Trustees in Illinois, 23 Ill. L. Rev. 653 (1929).
9 1 Restatement (Second), Trusts § 2 (1959).
10 See Part II, infra.
Even though these terms are not strictly accurate, they are commonly used, perhaps only to justify the imposition of a fiduciary duty on the corporate official.\textsuperscript{11} A better approach, it would seem, is to realize, as did a Minnesota court,\textsuperscript{12} that the position of director-of-a-corporation is \textit{sui generis}, or, short of that candor, to characterize him simply as a fiduciary.\textsuperscript{13}

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

And what are the consequences of his deviation from duty?\textsuperscript{14}

There would seem to be little doubt that the corporate director is a fiduciary to his corporation and that he must exercise good faith and refrain from placing himself in a position where his self-interest might work toward the detriment of the interests of the corporate entity.\textsuperscript{15}

Similarly, there would seem to be no dispute that a director occupies a fiduciary relation to the shareholders of the corporation as an aggregate and must exercise care to protect their interests, and to treat alike the interests of all the stockholders, whether members of the majority or the minority.\textsuperscript{16}

Beyond this point, diverse attitudes are encountered. Whether a corporate director occupies a fiduciary relationship to individual stockholders of his corporation has provoked considerable dispute. The question has often arisen when the director attempts to purchase stock from a corporate stockholder,\textsuperscript{17} but there is nothing in the rule which so strictly limits the area of its operation.\textsuperscript{18}

The majority rule in this area does not hold the director to the responsibilities and duties of a fiduciary in personal dealings with stockholders, since he is not exercising a corporate function, and is therefore free to deal with them at arm's length.\textsuperscript{19}

The minority view would hold the director a fiduciary and require a full disclosure of pertinent official information tending to increase the value of the stock.\textsuperscript{20}

A middle ground was established in \textit{Strong v. Repide}.\textsuperscript{21} The "special facts" or "special circumstances" doctrine therein enunciated requires disclosure of information such as an assured sale, known to the officers but not to the stockholder, and not ascertainable from the books.\textsuperscript{22} A great number of courts profess to follow the majority rule, indicated above, but append to its application the "special circumstances" exception.\textsuperscript{23}

The question to whom a corporate director is fiduciary will not be discussed further at this point, since the Survey is limited to his duties toward the stockholders and the corporation. The subsequent sections deal with the specific obligations arising out of varied factual situations, classified on the basis of the possible "conflicts of interest" described.

\begin{thebibliography}{22}
\bibitem{11} Johnson, \textit{op. cit. supra} note 8, suggests that historically the need for the imposition of a fiduciary duty was felt before any of the then-established "legal pigeonholes" was applied.
\bibitem{12} \textit{In re E. C. Warner Co.}, 232 Minn. 207, 45 N.W.2d 388 (1950).
\bibitem{13} Uhman, \textit{op. cit. supra} note 6, at 264.
\bibitem{17} Annot., \textit{Duty of Officer or Director of Corporation Toward One from Whom He Purchases Stock}, 84 A.L.R. 615 (1933).
\bibitem{18} \textit{Semble Kane v. Klos}, 50 Wash. 2d 778, 314 P.2d 672 (1957), noted 13 Wyo. L. J. 140 (1959), wherein decision was said to have been based on the fiduciary duty to the individual stockholder.
\bibitem{19} American Trust Co. v. California Western States Life Ins. Co., 15 Cal. 2d 42, 98 P.2d 497 (1940); 3 \textit{FLETCHER, CORPORATIONS} § 1168.1 (1947).
\bibitem{20} Mansfield Hardwood Lumber Co. v. Johnson, 265 F.2d 748 (5th Cir. 1959); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).
\bibitem{21} 213 U.S. 419 (1909).
\bibitem{22} Agatucci v. Corradi, 327 Ill. App. 153, 63 N.E.2d 630 (1945).
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B. What obligations does a director owe as a fiduciary?

1. Director dealing with his own corporation

The control over another's property imposes upon the director a fiduciary obligation but does not deprive him of any of the personal interest common to economic man. The area of overlap, where a conflict of loyalties is likely to occur, has been variously divided by the courts to give greater or lesser protection to the corporation, in a direct ratio to their view of the "size" of the fiduciary obligation. Accordingly, the burdens placed upon the director doing business with the corporation have been scaled to the courts' view of the dangers inherent in such a transaction. The recognition of the possible benefits accruing to the corporation from such transactions has been offset to varying degrees by consideration of corporate vulnerability.

Where a director deals immediately with his own company, the danger seems greatest and one might expect the most strained restrictions. In England, the difficulty has been resolved by a strict rule that contracts between directors and the corporation are voidable by the corporation. Directors are not allowed to assert validity on the basis of the fairness of the transaction or their good faith. Regal v. Gulliver\(^2\) indicates that, as in the case of the trustee, the director will be strictly liable for the profits of such a transaction, if, as in the case of an agent, a profit is made without the knowledge of the principal. This confusion of doctrines results in a readily understandable concept of broad fiduciary duty, whose incident is to prevent dealings between director and company where the director is bargaining on both sides. In the Regal case, neither the good faith of the director nor the impossibility of the company's investment in the transaction was a defense to the corporation's suit for recovery of the profits, which suit resulted from knowledge obtained through the fiduciary relationship. The House of Lords made it clear that "this doctrine as to purchases by trustees, assignees, and persons having a confidential character, stands much more upon general principles than upon the circumstances of any individual case."\(^25\) The plaintiff company has only to establish (1) that the transaction was done in the course of the director's management, and in utilization of their opportunities and special knowledge as directors; and (2) that it resulted in a profit to the directors.\(^26\) This absolute bar against such transactions may be avoided by obtaining the assent of the shareholders.\(^27\)

In a leading case, Aberdeen Ry. Co. v. Blaikie Bros.,\(^28\) which involved a contract between the railway and Blaikie Brothers, a member of which was a director of the railway company, the court said:

> 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 be 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.

This rule was applied in this country in some of the older cases\(^29\) and it appears to have been prevailing in New York,\(^30\) but it is no longer applied there.\(^31\)

This ability on the part of the corporation arbitrarily to avoid such a contract gives the corporation sufficient protection from undesirable results. In doing that, however, it discourages directors from entering into transactions which may be beneficial to the business organizations and which are completely fair and honest.

The disadvantages of the English position are largely eliminated by the

\(^{24}\) (1942). 1 All E. R. 378 (H.L.).
\(^{25}\) Id. at 386.
\(^{26}\) Id. at 392.
\(^{27}\) Id. at 394.
\(^{28}\) 1 Macqueen's App. Css. (H.F.) 461 (Scot. 1854).
\(^{29}\) See, e.g., Morgan v. King, 27 Colo. 539, 63 Pac. 416 (1900).
\(^{30}\) Welch v. Woodruff, 3 N.Y. Supp. 622, 625 (1889), 1 Morawetz, Private Corporations 495 (2d ed. 1886).
American rule\textsuperscript{32} which allows an interested director to contract with his corporation and gives the contract an opportunity to operate free of corporate caprice so long as the contract was considered by a disinterested quorum and approved by a voting majority, and the director shows the fairness of the agreement.\textsuperscript{33}

Where the above requirements are not met, the corporation may avoid the transaction and need not show any actual injury in doing so.\textsuperscript{34} Some courts have gone so far as to say that the corporation may avoid the transaction even though there is no proof of loss.\textsuperscript{35} Further, to the extent that it has been injured by the director's deviation from his fiduciary duty to the corporation, it may seek its remedy from the director involved.\textsuperscript{36}

Thus as the court in \textit{Mardel Securities Inc. v. Alexandria Gazette Corp.}\textsuperscript{37} said in quoting from \textit{Rowland v. Kable}:\textsuperscript{38}

\textit{The authorities are agreed that a director of a private corporation cannot directly or indirectly, in any transaction in which he is under a duty to guard the interests of the corporation, acquire any personal advantage, or make any profit for himself, and if he does so, he may be compelled to account therefor to the corporation. This does not mean that he may not deal with his corporation or sell his property to the corporation if the transactions are open, fair, and honest, and the corporation is represented by competent and authorized agents. The unbending rule is that the director must act in the utmost good faith, and this good faith forbids placing himself in a position where his individual interest clashes with his duty to his corporation. The purpose of the law is to secure fidelity in the director. If, in violation of the general rule, he places himself in a position in which he may be tempted, by his own private interest, to disregard that of the corporation, his transactions are voidable at the option of the corporation and may be set aside without showing actual injury.\textit{One who is entrusted with the business of another cannot be allowed to make that business an object of interest to himself.}}

This case involved a president-director, who was also a majority stockholder, and who had used his position to cause the corporation to publish a newspaper which the director owned and marketed in another city. As alleged by the plaintiff-minority stockholder, the corporation absorbed the losses, but the director retained the profits. The court, in finding for the plaintiff, pointed to the director's failure to sustain the burden of proving the fairness and bona fide nature of the transaction.\textsuperscript{39}

Where there are enough directors to constitute a quorum and to pass the measure with the requisite majority normally required, independent of the interested director, the American rule holds the contract valid so long as the interested director is successful in sustaining the burden of showing the fairness of the transaction. Where the interested director is essential to satisfy the quorum requirements or to carry the measure, it becomes voidable upon the election of the corporation.\textsuperscript{40} The validity of such a transaction has been upheld, however, merely on a finding of fairness; in such a case the corporation is bound.\textsuperscript{41} Thus the inherent fairness of the transaction is a crucial element and, although the same may usually be said for the other general requirement, it is not an indispensable element.

A third and so-called liberal rule places the burden of proof on the party

\textsuperscript{32} The primary value of the English rule is said to be its certainty. \textit{Lattin, Corporations} 258 (1959). See 1 Morawitz, \textit{op. cit. supra} note 30, at § 511. See 83 U. Pa. L. Rev. 56 (1934), 6 Ind. L. J. 413 (1931), and 29 Colum. L. Rev. 338 (1929), for differing approaches to these rules.

\textsuperscript{33} Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Cir. 1943); Winger v. Chicago City Bank and Trust Co., 394 Ill. 94, 67 N.E.2d 265 (1946).

\textsuperscript{34} Stoiber v. Miller Brewing Co., 257 Wis. 13, 42 N.W.2d 144 (1950).


\textsuperscript{36} See Part III, infra.


\textsuperscript{38} 174 Va. 343, 6 S.E.2d 633, 642 (1940).


\textsuperscript{40} \textit{Federal Mortgage Co. v. Simes}, 210 Wis. 139, 245 N.W. 169, 173 (1932).

\textsuperscript{41} \textit{Ballantine, Corporations} 173, § 69 (Rev. ed. 1946).
seeking to avoid the transaction, the contract being considered valid in the absence of fraud or unfairness. While this view may once have prevailed it can currently be dismissed on the basis of unnecessary devotion to the cause of the director.

One writer advocates a redefinition of the fairness test in terms of the director's conduct, namely: "Would reasonable and disinterested directors have conducted themselves as did the particular directors?" As advantages to this change, he points to the elimination of the hindsight of the court, informed by a knowledge of misadventure unforeseeable at the time of the agreement, and, "as in the fairness test, the answer would be determined by the court's discretionary weighing of the particular facts of each case."

It would seem that regardless of the character of the fairness test the rules regarding the quorum requirements and majority vote should be retained. Although it can be argued that the mere fact that the interested party knows the other directors may influence their vote, still the disinterested quorum requirements, and majority vote independent of the interested director, are obstacles, even though not complete ones, to free rein of the spoils system in corporate government. For the same reason the fairness test is a fortiori necessary. Its use, independent of the other mentioned rules, would seem to amount to elimination of existing safeguards which are not unduly burdensome.

2. Director dealing with other corporations

This subdivision is, in many ways, a mere extension of the preceding one. Here concentration will be given to the activities of a director of Corporation A as he deals with Corporation B, in cases where the director has some interest in Corporation B. This interest extends from bare ownership of stock to a conflicting directorship. Consideration will also be given to so-called "commercial bribery."

In regard to transactions between two corporations, there are three positions on the director with a conflict of interest. The older view applies the English rule which was seen in regard to contracts between an interested director and his corporation. Under this rule, the contract between corporations having interlocking directorates is voidable on the basis of the relationship between the corporations alone, and the fact that the transaction was honest or fair or made in good faith has no bearing on the outcome of the case.

Thus, in Metropolitan Elevated Ry. Co. v. Manhattan Elevated Ry. Co. the rule was applied to allow avoidance of a contract between the two corporations, because three of the directors of the plaintiff corporation were also directors of the defendant. There the court stated, in reply to counsel's contention that the disability of a director to contract with his own corporation did not extend to the case of a contract between two corporations, some of whose directors held that office in each corporation:

I can see no difference in principle between the case of a director contracting with his corporation and that of directors of one corporation contracting with themselves as directors of another corporation. The evils to be avoided are the same; the temptations to a breach of trust are the same; the want of independent action exists, and the divided allegiance is just as apparent.

This view as applied to the interlocking directorate situation is open to the same criticism as mentioned in relation to transactions between the corporation and one of its directors.

The majority view in the area of interlocking directorates is similar to that

42 Ransome Concrete Mach. Co. v. Moody, 282 Fed. 29 (2d Cir. 1922).
43 Ibid.
44 61 HARV. L. REV. 335 (1948).
46 11 Daly (N.Y.) 373, 11 Abb. N.C. 103 (Com. Pl. 1884).
47 Id. at 503.
48 See, eg., Geddes v. Anaconda Copper Co., 254 U.S. 590 (1921).
employed in the case of transactions between an interested director and his corporation in that it does not hold such contracts voidable at the election of the corporation, but rather it makes such contracts voidable unless the fairness of the transaction is shown. It differs in that it does not require a disinterested quorum or majority. Thus in *Shlensky v. South Parkway Building Corp.* the court held that the only basis for a corporation to avoid a contract between itself and another corporation having common directors was the unfairness of the transaction. This case involved a suit by a minority stockholder to recover, on behalf of the corporation, damages which it suffered as result of various dealings of the majority, and principally the president, with other corporations of which certain directors of the defendant corporation were directors. The court further pointed out, citing *Geddes v. Anaconda Copper Co.* and *Winger v. Chicago City Bank & Trust Co.*, that the burden of showing the fairness of the dealings rested upon the directors involved and, since they had failed to sustain it, they were properly held to account to the corporation for the profits received; the law presumed that their conduct amounted to a breach of the fiduciary duty involved. Thus, in regard to which party has the responsibility of showing the fairness of the transaction, this court followed the majority rule. In doing so it pointed out that the minority rule, which places the burden on the party seeking to upset the transaction, "places a premium on sharp practices by the directors by putting the onus on their victims and would tend to further separate management from ownership." On the other hand, the majority rule protects the stockholders, but is not unduly burdensome on the directors or the corporation.

In *Knox Glass Bottle Co. v. Underwood,* the directors of a corporation contracted with another corporation, in which they were interested by way of family ties, to haul the bottle company's products, when that corporation was financially able to purchase its own trucks. The court distinguished between a situation where a director deals both for himself on the one hand and for the corporation on the other, and that where a director represents himself and the corporation is represented by parties independent of the director. As to the latter the court said, "The burden of proof is upon the director or officer who seeks to uphold the transaction, not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation." In this case the court held the defendants to have represented both themselves and the corporation; where that occurs, it is well established that in the absence of ratification, or estoppel, and full disclosure the transaction is voidable at the option of the corporation, without proof of actual fraud or of actual injury to the corporation.

There is a third view in regard to interlocking directorates which requires a disinterested quorum or majority vote in order to uphold the contract.

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49 The general elements of the fairness test are said to be whether the corporation received in the transaction full value in all the commodities purchased; the corporation's need for the property; its ability to finance the purchase; whether the transaction was at the market price, or below it, or constituted a better bargain than the corporation could otherwise have obtained in dealing with others; whether there was a detriment to the corporation as a result of the transaction; whether there was a possibility of corporate gain siphoned off by the directors directly or through corporations they controlled; and whether there was full disclosure — although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one. *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960).

50 19 Ill. 2d 268, 166 N.E.2d 793 (1960).

51 254 U.S. 590 (1921).

52 324 Ill. 94, 87 N.E.2d 265 (1946).

53 *Knox Glass Bottle Co. v. Underwood*, 228 Miss. 99, 89 So.2d 799 (1956); see generally Annot., 33 A.L.R.2d 1060 (1954).


56 228 Miss. 99, 89 So.2d 799 (1956).

57 *Id.* at 814.

In the area of commercial bribery it is generally held that a director who receives any type of gift or bribe which may influence his official judgment in favor of another corporation or another person to the disadvantage of the corporation must account to the corporation for what he has received.\(^5\) This is just another phase of the general attitude of the common law that a director owes a fiduciary duty to the corporation and may not indulge in any practice which might result in placing the corporate interest in a subordinate or secondary position to the personal interests of the director. Thus, where the manager of a furniture company, who was building a private house for himself, received valuable mahogany and walnut lumber, veneer and varnish from suppliers of the corporation, the manager was held to account for the value of the property received. The court mentioned that by accepting the gifts from companies in the relation of suppliers to the plaintiff corporation the manager committed a breach of trust.\(^6\) The leading New York case in the area dealt with a corporate director who agreed to resign and turn over control of the company to other individuals who paid money to the director to reimburse him for money loaned to the corporation by way of notes which had become uncollectible. The director was held to account for the money he received in his official capacity.

In a later case in the same state, involving directors who sold stock, which they held in their own right, at double the market price, the court, in denying motion to dismiss the complaint, pointed out:

A director generally does not violate his duty in selling his own stock at a price above the prevailing market, instead of disclosing and affording to the corporation the opportunity of disposing of its unissued stock upon such advantageous terms. But where his acts are motivated by the aim of placing a competitive concern in a position to dominate the corporation, they clash with his duties as a fair and impartial director. And when the execution of such an aim is furthered by the motive of personal gain, the director who received such unlawful consideration must account to the corporation for the moneys so received.

\textit{Anderson v. O'Brian} dealt with a director who attempted to collect on a note given him by another director for his interest in the corporation upon sale of all corporate assets, when he no longer had an interest in the corporation. The court held that the plaintiff could not enforce the notes because they were without consideration and against public policy. The court commented further:

The principle requiring directors to account for secret profits also required them to account for and surrender to the corporation any gifts, gratuities, or bribes received by them for the purpose of influencing their official action. If directors of a corporation receive a sum of money as a bribe for the doing of a certain act which may or may not be prejudicial to their company, they are trustees in equity of the fund so corruptly received, and the corporation may also proceed against them for any damages it has thereby suffered.

Instances of sales of corporate control have been treated as if they amounted to commercial bribery.\(^65\) In these cases, the rule is generally that “the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it.”\(^66\) Furthermore, “absolute and most scrupulous good faith is the very essence of a director’s obligation to his corporation. The first principle duty arising from his official relation is to act in all things pertaining to his trust wholly for

\(^{60}\) Holland Furniture Co. v. Knoiihuizen, 197 Mich. 241, 163 N.W. 884 (1917).
\(^{61}\) McClure v. Law, 161 N.Y. 78, 55 N.E. 388 (1899).
\(^{63}\) 3 S.W.2d 842, 843 (Tex. Civ. App. 1928).
\(^{64}\) Quoting 2 THOMPSON, CORPORATIONS § 1342 (3d ed. 1927).
\(^{65}\) Perlman v. Feldman, 219 F.2d 175 (2d Cir. 1955).
\(^{66}\) Id. at 176.
the benefit of his corporation. As a practical matter, in situations where the interested director deals with his own corporation either directly or indirectly, the transaction normally involves some sort of contractual relationship between the parties, a relationship in which, it would seem, a stringent degree of devotion to the corporate interest is required.

3. A corporate director’s outside activities

Without denying a director’s responsibilities to those whom he represents, it is necessary to indicate some area within which he may act for his own benefit. It would seem that when he is dealing with “his” corporation he has a greater responsibility to it and its owners than when he deals with an outsider, one who might have dealt with the corporation had he not done business with the director. This would appear to be so whether the director deals directly with the corporation or indirectly, by way of an interlocking directorate. The problem may be reduced to a basic conflict between the director’s position of trust and confidence on the one hand, and his freedom of enterprise on the other. Inextricably related to the question is the fact that too great a restriction on directors may result in discouraging competent men from taking directorships.

An attempt toward protection of the corporation, and thus the stockholders, has been evidenced where corporate directors sought to enforce a contract against their corporation after the corporation had agreed to turn over a percentage of its gross receipts to a third party in return for the right to manufacture and sell patented articles. The directors involved had acquired the contract rights for themselves at a time when the corporation was able to purchase the contract, but the court refused to enforce the contract against the corporation, saying:

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

A contrary attitude appeared in an action by stockholders to impress a trust on certain oil leases which were held by the directors of an oil company, the leases being obtained by the directors as a result of knowledge acquired through the corporation. The court saw no reason why a director must be precluded from engaging in the same or similar business if he has acted in good faith toward the corporation and the stockholders. Conceding the rule that the director may not deal with any matter involving his rights and duties as a director, and that he may not profit at the expense of either corporation or stockholders, the court felt the director was free to engage in an independent competitive business so long as he violated no legal or moral duty which he owed the corporation. While this case may be explained by allusion to the Montana Supreme Court’s reluctance to overturn findings of fact by the trial court, it seems to indicate an unusual consideration for the interests of the director.

In Red Top Cab Co. v. Hanchett, a former president and general manager

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68 R. M. Ramsey, Director’s Power to Compete with His Corporation, 18 Ind. L.J. 293 (1943).
69 Ibid.
71 Greer v. Stannard, 85 Mont. 78, 277 Pac. 622 (1929).
72 Id. at 626.
73 2 THOMPSON, CORPORATIONS 853, § 1350 (3d ed. 1927).
74 48 F.2d 236 (S.D.N.D. Cal. 1931).
was the sole stockholder of record of what was in effect a subsidiary of Red Top; he had organized and operated a competing taxi company using the premises of the subsidiary. The court paid lip service to the general rule that corporate directors are not barred from entering into an independent and competing business merely because of their fiduciary status, but it upheld a decision imposing on the defendant a constructive trust on the profits earned by the competing taxi business. The opinion noted that the general rule was subject to the qualification that a director must act in good faith and may not injure the corporation by way of competition.

A Massachusetts court held that corporate directors, who purchased and operated a competing corporation after the complaining corporation declined to purchase it, did not violate their fiduciary duty to the plaintiff corporation; the court refused to impose a constructive trust on the acquired corporation. The basis for denying the trust was that the breach of fiduciary duty did not occur in the acquisition of the business, but in its operation. This case could have gone the other way, as one commentator points out, had it been established that the directors acted in bad faith in using corporate facilities and in personally acquiring an enterprise in the corporation's general line of business. The court's critic points out that, when a director innocently purchases property and only later decides to operate it competitively, compulsion to account for profits and an injunction restraining further competition would be enough; but where, as in this case, the purchase is accompanied by an intent to compete, the purchase itself is wrongful and a constructive trust should be imposed on the stock of the competing corporation.

In Witmer v. Arkansas Dailies, Inc. the corporation sought to restrain its former manager from contracting with customers of the corporation. The court declined to enjoin the defendant because the effect of such restraint would create too great an impediment to competition in business and would deny the director the right to engage in the advertising business. In a somewhat analogous situation the Supreme Court of Arkansas held the directors of an insurance agency liable for damages to the corporation for causing a diversion of business from the complaining corporation to another insurance agency owned by the defendants. The court distinguished the Witmer case, pointing out that, while a fiduciary of a corporation may engage in a competing business after leaving his corporation in the absence of contractual restriction, where the fiduciary relationship has not been terminated the corresponding duty to refrain from doing anything which might injure the corporation or "deprive it of the profit or advantage which his [the defendants'] skill, knowledge and ability might personally bring to it or enable it to realize the reasonable exercise of its power." New York appears to take a similar attitude toward this type of problem, as is indicated in Duane Jones Co. v. Burke, where the court held former directors of an advertising agency liable for damages resulting to that business from the solicitation of key employees of the agency for a similar business being organized by the former directors prior to their resignation. This case, according to one writer,
might also have gone the other way under an earlier New York decision. There an officer-director had essential influence with a necessary supplier because of his skill in converting the raw material into the finished product; he left his corporation and engaged in a similar business in order to protect his own interests, thereby forcing the corporation into liquidation. The court in the latter decision found no violation of the director's fiduciary duty. The commentator contends that it could have reached a similar result in Duane Jones, where there was evidence that the president of the corporation, at one time, acquiesced in a withdrawal of personnel, similar to the acquiescence of the plaintiff in the liquidation case.

The gray area surrounding a director who engages in a competing business was made somewhat less confusing in Urban J. Alexander Co. v. Trinkle, where a director of an investment and brokerage business acquired, as part of a private investment group, the stock of an ice and coal company which had been under option to the complaining corporation. The principal corporation did not have available the necessary resources to take advantage of the option and was legally incapable of increasing its equity capital. The court decided in favor of the defendant director, who had obtained an option from the owners of the ice business to sell their stock for them on commission or to buy it for himself. The court found that he was not precluded by his fiduciary position to the plaintiff from doing the latter or, presumably, from doing the former, where the plaintiff was incapable of so acting.

In contrast to the incapacity of the corporation to engage in the similar business, it has been held that bad faith on the part of the director engaging in the competing or similar business is not a crucial element to a recovery by the corporation. The crucial element seems to be that the fact that the similar business is itself of such a nature that under the particular circumstances of the case it should fairly belong to the corporation. This has been held to be sufficient to establish a duty upon the directors to acquire it for the corporation.

The rules governing competing or similar business are analogous, if not indistinguishable in some cases, from the doctrine of corporate opportunity. In practical effect the similar business problem is a member of the corporate opportunity genus. Thus, in this discussion, as well as in the discussion of competing or similar business, the same general principles are relevant and the same conflict is present. The cases uniformly point out that a director is in a fiduciary relationship to his corporation and may do nothing to injure it or deprive it from business which it would otherwise get. But the rule is, in application, far from absolute. As was seen in the earlier discussion within this subdivision, there are situations where the director may injure his corporation, even deprive it of business, with impunity, because there are present sufficient reasons why the directors should be allowed to act for themselves.

88 Ibid.
89 39 IOWA L. REV. 185 (1953).
90 Duane Jones Co. v. Burke, 306 N.Y. 172, 117 N.E.2d 237 (1954). Compare Renpak, Inc. v. Oppenheimer, 104 So.2d 642 (D. Ct. App. Fla. 1958), where the court upheld the device of injunctive relief to a corporation seeking to restrain defendant director from pursuing competing business after leaving the corporation, when he had solicited customers of the corporation prior to leaving it.
92 311 Ky. 635, 224 S.W.2d 923 (1949).
93 Ibid.
95 Ibid.
In regard to the corporate opportunity doctrine, it may fairly be said that the director may not acquire for himself any business opportunity in which the corporation has an interest, actual or reasonably expectable, in property. The rule is otherwise conditioned whether the purchase of property by the officer or director may hinder or defeat the plans and purposes of the corporation in carrying on the development of the legitimate business for which it was created. The cases commonly say that, when a business opportunity comes to the director personally, he may deal with it on a purely personal basis without violating any obligation to offer it to the corporation. The corollary is that, where the business opportunity comes to the director in his capacity as a director, he must treat it as belonging to the corporation and may not deal with it himself.

The earliest application of this rule seems to have been in real property cases, where the director appropriated for his own use a lease which the corporation was either seeking or could use to its advantage. In this area another common application is where the director purchases land for which the corporation was negotiating or, at least, would have been willing to negotiate. Thus the rule developed that the doctrine applied only to the acquisition of property by the director.

Current jurisprudence is far from being restricted by such narrow bounds; in recent years the rule has been applied to a situation where the director acquires, for his own use, a contract for manufacture and sale of goods which would otherwise belong to the corporation. As seen earlier the doctrine is applied in instances of competing or similar business by the director. It has been applied where the director not only takes corporate business for his own, but uses the corporate facilities to do so. In a rather unique case, the plaintiff attempted to invoke the rule to acquire an additional sum from a director, who was her former husband. She was suing for a property settlement, pursuant to an agreement which required him to pay her 25 per cent of all the money he received from the corporation. The plaintiff alleged misappropriation of a corporate opportunity; the result is authority for the proposition that the corporation, or at least one representing the corporation, is the only party capable of invoking the rule.

The cases are in general agreement on a test for finding a special duty on the part of the officer or director to act or contract as a representative of the corporation. The answer to this question naturally turns on the facts of each particular case, but certain general factual situations have been held to preclude a duty on the part of the director. One such defense was mentioned earlier, namely the legal inability of the corporation to avail itself of the opportunity. When this is present the director is free to put the opportunity to his own use. Where the corporation has been offered the opportunity, but has declined to use it, the courts have held the director under no obligation to the corporation to refrain from exploiting the opportunity to his own advantage. Although there is authority

103 Lagarde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900).
104 Ibid.
105 Central Ry. Signal Co. v. Longden, 194 F.2d 310 (7th Cir. 1952).
106 Raines v. Toney, 228 Ark. 1170, 213 S.W.2d 802 (1958).
109 Ibid.
110 Westerly Theatre Operating Co. v. Pouzzner, 162 F.2d 821 (1st Cir. 1947); Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (1939).
111 Urban J. Alexander Co. v. Trinkle, 311 Ky. 635, 224 S.W.2d 923 (1949).
to the effect that the corporation's financial inability to take advantage of the opportunity is a defense to a charge of appropriation of a corporate opportunity, one famous case held otherwise.

The decision in *Irving Trust Co. v. Deutsch* involved an action by a trustee in bankruptcy to compel the defendant-directors to account for profits made from a sale of stock which was purchased by them individually, according to an agreement, when the bankrupt corporation was unable to do so. The court, in refusing to recognize the financial inability of the corporation as a defense, commented favorably on the rule which does not permit the directors of a solvent corporation, such as the bankrupt was at the time, from dealing in the opportunity, where the corporation is financially unable to do so:

> If the directors are uncertain whether the corporation can make the necessary outlays, they need not embark upon the venture; if they do, they may not substitute themselves for the corporation any place along the line and divert possible benefits into their own pockets.

The court said, in regard to the contrary doctrine, that if directors are permitted to justify their conduct because of corporate inability, there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation; to the extent that the corporation fails to meet its opportunities, personal opportunities will be open to directors.

Undoubtedly the object of this prophylactic rule is the protection of the corporation, just as this is the object of the strict rule regarding a director's dealing with his corporation. It would seem unnecessary and overly restrictive. Further, a shift in the burden of proof to the director, once the plaintiff-corporation had established the corporation's interest "actual or in reasonable expectancy," to prove that he had acted in good faith and with due devotion to the interests of the corporation, would sufficiently safeguard the interests of the corporation and its stockholders. This would differ from the shift in the burden of proof as occurred in *Perlman v. Feldman*, where after the plaintiff established prima facie that the opportunity appropriated was one within the interest of the corporation, it was incumbent upon the defendant to refute this position and show that there was no possibility of corporate gain. In *Perlman*, the court refused to accept the absence of fraud, of misuse of confidential information, or of outright looting of a helpless corporation, as defenses to the charged misappropriation of corporate opportunity. Under the proposed rule, the court would be bound to accept a showing of good faith and due devotion to the interests of the corporation as a defense to the charged violation of fiduciary duty. While the objection may be made that good faith is irrelevant, still the law respects the good faith of the directors in other areas, under the business judgment rule. The change would bring a degree of flexibility into the law, but because of the difficulty in proof, a director would be more cautious in taking advantage of questionable opportunities. The objection of uncertainty might be raised, but the mere fact of such uncertainty would tend to make the directors more cautious in this regard. It would not discourage competent potential directors any more than does the rule of *Irving Trust Co.*

In regard to the burden of proof placed upon the complaining corporation to show its interest in the opportunity appropriated, it should not be difficult to

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114 73 F.2d 121 (2d Cir. 1934).
115 Wing v. Dillingham, 239 Fed. 54 (5th Cir. 1917).
116 Irving Trust Co. v. Deutsch, 73 F.2d 121, 124 (2d Cir. 1934).
117 Id. at 124.
120 Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955).
show the corporation's actual interest where such exists; rather the problem would seem to arise in showing a reasonable expectancy. As to this it has been held that the corporation must show "not only that the properties in question possessed value to it, but that it had a practical, not a mere theoretical, use therefor." It has been held that the rule which gives a court of equity the power to impress a constructive trust on property which is the product of the appropriation of a business opportunity by a corporate director is not satisfied by proof that after such appropriation the property would have been useful in the corporation's business.

Throughout this discussion mention has been made of the corporation's bringing action against directors for an accounting of profits, and impression of constructive trusts upon property, funds or stock. It is generally accepted that, pursuant to equitable principles, the corporation may bring an action in equity against the derelict director for an accounting for the profits made in the digression from his fiduciary responsibilities. Thus, the court pointed out in In re The Van Swerington Co., "where the directors of a corporation, contrary to their fiduciary duty, have made a personal profit in their dealings with the corporation, equity will compel them to account to the corporation for such profits made at its expense." The extent to which such a director may be held accountable for profits so acquired has been said to be limited to the direct product which he receives from the property. It has been further held that the director is accountable outside of proper consideration and expenses and for any advantage gained, either in performing his duties or in betraying his trust.

In Arneman v. Arneman, the plaintiff-stockholder, in a corporation in which the defendant, who was the plaintiff's brother, owned the balance of the stock, sought a decree ordering the imposition of a trust in his favor upon a one-half interest in the company. The court pointed out, in reversing a decree for the defendant, that

A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee.

Thus the court inferred that this remedy is available as against a delinquent director.

In addition to the equitable relief available as against unfaithful directors, there are two general legal remedies which may be invoked against the director, depending upon the factual situation involved.

The action at law for damages is available against the director who has breached his fiduciary obligation to the corporation through neglect or mismanagement. Similarly it is available for damages caused by unauthorized acts. Where the sum sought to be recovered from the director is known, there is no need for an accounting in equity, and the proper action for relief against the director is an action at law for money had and received.
Conclusion

In concluding this portion of the survey it may be pointed out that it would seem to make little difference whether a director is called a trustee, a quasi-trustee, or an agent, so long as it is recognized that he owes a fiduciary obligation to "his" corporation, to its shareholders as an aggregate, and, at least in certain instances, to the stockholders individually. The classification of a director's status as *sui generis* would seem the most accurate.

In regard to the questions, "What obligations does he owe as a fiduciary, and in what respect has he failed to discharge these obligations, and what are the consequences of his deviations from duty?" it can only be mentioned, recalling the preceding discussion, that these are largely questions of fact to be determined in each individual case.

William E. Kelly

II STATE STATUTORY REGULATION

The problem of a director's conflict of interest has received limited attention from state legislatures. Perhaps the comparative lack of statutory regulation in this area can best be explained by a brief look at the different philosophies behind corporation acts at the various stages in their historical development.

The ancestors of modern American corporations were British trading companies chartered by the Crown. The early American charter grants emulated the English, continuing the practice of allowing the corporate form only by special acts of the state legislature, a "close to the vest" policy possibly engendered by distrust of the corporate form's British origin and limited liability.

The gradual switch to general charters saw the same restrictiveness; it was not until the latter part of the 19th century that the first liberalizing wave was felt. The practice of "charter-mongering," whereby states made incorporation attractive in order to obtain additional tax dollars, came into favor; Delaware and New Jersey drafted the most liberal acts. Though these acts may have accomplished little else, they at least inspired modernization in other states.

Beginning in 1927, a new series of corporation laws was enacted. Such legislation as the Uniform Business Corporations Act, the Illinois Corporation Act, and the California Corporation Code provided models for those states which lagged behind in statutory revision. It can safely be said that the dominant theory of present corporation law, the "enabling act theory," is that most of the responsibility for corporate control should be placed on the corporation itself. There remain those, however, who regard the corporation as a quasi-public entity, possessing a social conscience and existing for the good of and subject to the community. These are the opposite poles.


the enabling act theory will be illustrated in a survey of the manner of state statutory regulation of the conflict of interest problem.

Thirty-one states have statutes providing for the creation of a board of directors in which corporate management powers are to reside. In the corporation acts of 32 states, no mention is made, either of the relation and duty or the liability of a director to his corporation, for actions taken in the ordinary course of business, in circumstances involving a conflict of interest. While provision is often made with respect to declaring dividends, issuing stock, and filing reports, director conduct in the day-to-day course of business is not covered.

Further evidence of this lack of restriction on directors is found in the similar treatment of this area by the Model Business Corporation Act. Work on this act was begun in 1940. A workable model was completed in 1946, and this draft was again revised in 1950. Although there has been some unfavorable comment, the act has been generally well received. It is a typical example of a statute which does not attempt to extensively regulate a corporation's business affairs. Iowa became the most recent adherent of the enabling theory in July of 1959, when it repealed its antiquated code.

Thus it would appear that the majority of state legislatures have not felt that the common law rules are insufficient shareholder protection against directors' abuses.

The common law definition of a fiduciary and his duties have been described. Legislatures in some states, however, did not feel that the common law rules provided adequate shareholder protection. The Uniform Business Corporations Act sets out the definition of the director as a fiduciary, in section 33. The reason for this section was given in the commissioners' note.

It is believed that the paragraph constituting the present section 33 has an appropriate place in a uniform corporation act in view of the unsettled state of the case upon the question of the standard of care and skill to which directors are held.

This section seems to embody the common law but certainly makes no great strides toward combatting the problem of conflicts of interest. The statute is neither remedial nor preventive; at best it seems to indicate an awareness of the problem. The nine states adopting this section of the Uniform Act, or one closely resembling it, have applied it to various situations, but the net effect of these decisions remains the same as it would have been at common law without any mention of the statute. New terminology does not alter the elements of duty.

New York has been more precise in codifying common law corporate regulation. Section 60 of the New York General Corporations Code enumerates causes

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4 Those states mentioned in the previous note and Hawaii.
5 E.g., ILL. REV. STAT. 32 § 157.42 (Smith-Hurd 1954).
6 Section 33.
9 Part I, supra.
10 Uniform Business Corporation Act § 33:
  Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.
12 IOWA CODE ANN. § 30-142 (1947); KY. REV. STAT. § 271.355 (1955); IA. REV. STAT. § 12.36 (1950); MICH. STAT. ANN. § 21.47 (Supp. 1959); MINN. STAT. ANN. § 301.31 (1947); N.C. GEN. STAT. § 55-35 (1960); OKLA. STAT. ANN. tit. 18, § 1.34 (1953); PA. STAT. ANN. tit. 15, § 2852-408 (1958); WASH. REV. CODE § 23.01.360 (1959).
14 Part I, supra.
15 N.Y. GEN. CORP. § 60 (1943).

An action may be brought against one or more of the directors or officers
of action against erring directors. But even New York has failed to place any affirmative duty on the corporate management; it has merely codified the actions a plaintiff would have had at common law.\textsuperscript{16} Georgia's statute closely resembles New York's in providing safeguards for the protection of minority stockholders. The statute\textsuperscript{17} is generally declaratory of common law, and as in New York, no affirmative obligations are placed on the director.

One of the most widely acclaimed state regulatory statutes is section 820\textsuperscript{18} of the California Corporation Code, adopted in 1931. It has since been adopted in toto by Nevada.\textsuperscript{19} The drafters of this section realized that a director's personal interest would not necessarily make a contract disadvantageous to the corporation. Usually, full disclosure and subsequent ratification by disinterested director or shareholder majorities are adequate to keep such contracts from being declared void. In addition, subsection (c) provides that showing the contract to be "just and reasonable to the corporation at the time it is authorized or approved" frees the

1. To compel the defendants to account for their official conduct, including any neglect of or failure to perform their duties, in the management and disposition of the funds and property, committed to their charge.
2. To compel them to pay to the corporation, or to its creditors, any money and the value of any property, which they have acquired to themselves, or transferred to others, or lost, or wasted, by or through any neglect of or failure to perform or other violation of their duties.
3. To suspend a defendant from exercising his office, for an abuse of his trust.
4. To remove a defendant from office and to direct the filling of the vacancy in accordance with the charter and by-laws of the corporation, or, if they contain no provision therefor, in such manner as the court shall direct.
5. To set aside a transfer of property, made by one or more directors or officers of a corporation, contrary to a provision of law, where the transferee knew the purpose of the transfer.
6. To enjoin such a transfer where there is good reason to apprehend that it will be made.

\textsuperscript{16} However, these sections (§§ 60-61) do not create any new causes of action, except as to the removal and suspension of directors, and the rights and remedies conferred are cumulative and not exclusive rights." \textsuperscript{3} \textsc{White, New York Corporations} § 60(D), p. 59 (12th ed. 1947).

\textsuperscript{17} Ga. Code Ann. § 22-711 (1935).

\textsuperscript{18} Duty to act in good faith; effect of personal financial interest or common directorship. Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation. No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm, or association in which one or more of its directors are directors or are financially interested, is either void or voidable because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes or approves the contract or transaction, or because his or their votes are counted for such purpose, if the circumstances specified in any of the following subdivisions exist:

\textsuperscript{a} The fact of the common directorship or financial interest is disclosed or known to the board of directors or committee and noted in the minutes, and the board or committee authorizes, approves, or ratifies the contract or transaction in good faith by a vote sufficient for the purpose without counting the vote or votes of such director or directors.

\textsuperscript{b} The fact of the common directorship or financial interest is disclosed or known to the shareholders, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of shareholders entitled to vote.

\textsuperscript{c} The contract or transaction is just and reasonable as to the corporation at the time it is authorized or approved.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves, or ratifies a contract or transaction.

contract from the ratification procedures.\textsuperscript{20} Through this provision a corporation may avail itself of advantageous dealings procured through its directors and still have some protection against behind-the-scenes transactions.\textsuperscript{21} Obviously, problems arise in a closely-held corporation where directors with similar interests might ratify measures for their own self-interest in opposition to the shareholder's interest. Protection against this possibility is set out in the introductory sentence of this section which restates the director's fiduciary duty.\textsuperscript{22}

The force of the duty-to-act-in-good-faith provision is illustrated in Remillard Brick Co. v. Remillard-Dandini Co.\textsuperscript{23} Defendants had formed a separate sales corporation to market the product of the plaintiff corporation, of which they were also directors. The contracts entered into were not fair and reasonable and thus their validity depended upon ratification by the shareholders under § 820 (b); the interested directors were incapable of ratification under § 820 (a). By these contracts the defendants had reaped large profits but had also literally complied with the disclosure and ratification provisions of section 820. Nevertheless, this disclosure was held to be insufficient to satisfy the first sentence of section 820, which requires that the directors act in good faith, with a view to the interests of the corporation.\textsuperscript{24} The court stated:

\begin{quote}
It would be a shocking concept of corporate morality to hold that because the majority directors or stockholders disclose their purpose and interest, they may strip a corporation of its assets to their own financial advantage, and that the minority is without legal redress.\textsuperscript{25}
\end{quote}

The court had already indicated the limitation placed on section 820 by the "good faith" provision: "That section does not operate to limit the fiduciary duties owed by directors to all the shareholders..."\textsuperscript{26}

The Remillard opinion was quoted extensively in Kennerson v. Burbank Amusement Co.\textsuperscript{27} Here one director sued for breach of an employment contract through which the board had effectively sacrificed control over the corporate assets. The court once again reasoned that ratification without good faith is not sufficient; the contract was unenforceable. Levin v. Levin\textsuperscript{28} illustrates the operation of the ratification section. Plaintiff claimed that the defendant director was charging an inadequate rental to a partnership in which the defendant director had an interest. In addition, the plaintiff also alleged that defendant was receiving excessive compensation. However, the court ruled that plaintiff's long acquiescence in, with full knowledge of defendant's conduct constituted a ratification.

The most recent case in this area, Tevis v. Beigel,\textsuperscript{29} underscores the utility of the ratification procedures of section 820. Here a decision allowing plaintiffs to recover secret profits realized by defendants through pipe sales at cut-rate prices was overturned because defendants had not been allowed to offer proof of ratification.

This statute and the line of expository opinions following it indicates an attempt by the state of California to draw the line in the conflict of interest field where the sin is actual, instead of insisting on a general delivery from all temptation. While the section is not a gross intrusion into the inner workings of California corporations, it shows an appreciation—perhaps too optimistic—of the important role of share-

\begin{footnotes}
\footnote{20} Note 18, supra.
\footnote{22} Note 18, supra.
\footnote{24} BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS § 84, p. 104 (1949):

The fiduciary duty is not relaxed by this section to the extent that a director may obtain any unfair advantage or profit for himself by misrepresentation, concealment, or undue influence.
\footnote{26} Id.
\footnote{27} 120 Cal. App. 2d 157, 260 P.2d 823 (1953).
\footnote{28} 123 Cal. App. 2d 158, 266 P.2d 552 (1954).
\end{footnotes}
holders and creditors in any prosperous business community. In effect, freedom to contract is preserved inviolate, but there is statutory insistence upon the reality of a two-party bargain. Section 820 of the California Code would seem to represent the best current legislation in this area. It has met with favorable comment and is an excellent model for imitation.\footnote{30 See generally, Jennings, The Role of the States in Corporate Regulation and Investor Protection, 23 LAW & CONTEMP. PROBS. 193 (1958).}

Connecticut has adopted a similar provision, effective January 1 of this year.\footnote{31 CONN. GEN. STAT. REV. § 33-323 (1961):}

One of the noteworthy differences in this statute and California's is the absence of a clause establishing the director's fiduciary status.\footnote{32 Note 18, supra.} Whether this lack would...
change the outcome of a Connecticut case similar to Remillard\textsuperscript{35} remains to be seen, but it appears doubtful that it would. Perhaps the common law restrictions on director conduct, if read into the Connecticut law, would be adequate to cope with the situation. However, subsection (a)(1) provides that, even though the contract in question has been approved by the directors, it must be shown that "the contract or transaction is not manifestly unfair as to the corporation." This clause would indicate that there, as in California, literal compliance with disclosure and satisfaction procedures does not automatically relieve the interested director from his obligation to be fair to the corporation. The Connecticut statute seems more lenient than its California counterpart, in that it requires disclosure only of substantial interests, as opposed to California's financial interest test.

The specificity of the Connecticut provisions should restrict its application. The basic requirements of full disclosure and ratification are quite similar, and there is no reason to suspect that cases will bring about different results.

The final subdivision describes what areas are not covered by the term "substantial interest."\textsuperscript{35} Subsection (d) excludes from the class of "substantial" interest-holders those stockholders who hold less than 10 per cent of the corporation's stock, directors not having some interest in addition to their positions as directors, and any director whose interest in another corporation arises from something other than the fact that his corporation has a debt or equity interest in such other corporation. By making the exceptions, the Connecticut legislature seems to be attempting to limit regulation to areas where abuse is not likely to occur. All things considered, this statute takes a reasonably lenient approach; it should prove effective.

The North Carolina Business Corporations Act is a progressive enactment combining the enabling act approach with adequate shareholder and creditor protection.\textsuperscript{36} This also seems true of North Carolina's coverage in the interest conflict field. The two sections regulating director conduct, would seem equivalent to section 820 of the California Code. The first section\textsuperscript{37} provides for the disclosure of an adverse interest followed by ratification in the usual manner by a disinterested director majority or by a majority of the stockholders. The final subdivision\textsuperscript{37} provides, as does California,\textsuperscript{38} that, in order for the contract not to be void or voidable, absent ratification by informed and disinterested directors or shareholders, it must be just and reasonable to the corporation at the time it is entered into or approved. The other section\textsuperscript{39} establishes the director as a fiduciary in a manner identical to those described earlier.\textsuperscript{40} It apparently is intended to perform the same task as the introductory clause of the California statute.\textsuperscript{41} The only difference between the two which could possibly be material is North Carolina's requirement that disclosure be made of an "adverse interest." "Adverse interest" is more inclusive than either California's "financial interest" or Connecticut's "substantial interest."\textsuperscript{42} This more stringent disclosure requirement should be favored, since it provides fuller protection and yet does not burden directors with excessive reporting.

Common directorships pose a serious problem in the conflict of interest field. There is an increased opportunity for a director's misconduct when he sits on the boards of both parties to a transaction.\textsuperscript{43} However, statutes have not changed the

\textsuperscript{33} Note 23, supra.
\textsuperscript{34} Note 31, supra.
\textsuperscript{38} Note 18, supra.
\textsuperscript{40} Note 18, supra.
\textsuperscript{41} Ibid.
\textsuperscript{42} Note 31, supra.
\textsuperscript{43} See generally, 23 Cornell L. Q. 445 (1938).
common law rule\(^{44}\) that such contracts are not voidable per se. The Rhode Island statute\(^{45}\) states that a contract between two corporations having common directors is voidable only if it would be voidable if made with a stranger. This statute is unique in that it represents the only attempt the states have made to test voidability by a criterion other than "fairness." There is no need for ratification until the voidability has been established. Ratification can be accomplished by affirmative vote of either non-common directors or a majority of stockholders. Actually this section provides little or no shareholder protection, due to the great opportunity for "rubber stamping" by a dominated directorate.

Besides providing for disclosure and ratification of contracts in which directors have a "substantial interest," the comprehensive Connecticut statute devotes a separate section to the voidability of contracts involving common directors.\(^{46}\) The transaction will not be voided as long as it is not manifestly unfair or if it is approved by a majority of the shareholders. Connecticut has established no criterion of voidability resembling the Rhode Island "stranger" test,\(^{47}\) apparently relying on the corporation's independent judgment as to when its interests are being served. Actually the Rhode Island voidability standard is no more objective than the Connecticut test; both involve subjective evaluations of fairness without hard and fast criteria.

When the validity of an agreement is questioned in Michigan, the burden of proving the fairness of such agreement is on the director asserting its validity.\(^{48}\) The Michigan legislature omitted any reference to ratification procedures, but Michigan courts have required that contracts involving interested directors must be ratified by a disinterested director quorum.\(^{49}\)

Vermont requires that a contract involving an interested director be approved by a quorum in the absence of the interested party. The statute states that the directors must have acted in good faith and, if such good faith is attacked, the burden is on the attackers to prove it.\(^{50}\)

West Virginia presents a somewhat watered-down version of the preceding statutes.\(^{51}\) The statute requires that an interested director may not vote or be present at a meeting while the object of his interest is being considered. This section would seem to presume some disclosure, but no sanctions are placed on the directors for failure to make such disclosure. The legislature has omitted any mention of a good-faith-in-dealing requirement, apparently relying on common law to fill this gap. However, if a legislature is going to allow contracts in which a director has an interest to stand, it might be wise to re-emphasize the good faith requirement.

None of the common directorship statutes relieve the director of his burden of proving good faith when it is questioned and both Michigan and Vermont explicitly place this burden on the director. This is the only way to insure shareholder protection in a situation which easily lends itself to abuse.

The greatest weakness of state legislation in the conflict of interest field lies in the lack of adequate sanctions and enforcement provisions. At common law the remedy for director misconduct consisted of a shareholder derivative suit.\(^{52}\) If the shareholder was victorious, the director was forced to disgorge his profits to the corporation. Thus, even a successful dissenting shareholder shares only ratably in the judgment, since in an action of this nature the corporation is a nominal plaintiff.

\(^{44}\) See Part I, supra.
\(^{45}\) R. I. Gen. Laws Ann. § 7-4-7 (1956).
\(^{46}\) Note 31, supra.
\(^{47}\) Note 45, supra.
\(^{52}\) Part I, supra.
Procedure of this sort cannot help but discourage shareholders from seeking to correct a legitimate corporate wrong.

Nor have state legislatures seen fit to alleviate this situation. Several states have enacted bonding statutes to combat vexatious suits by disgruntled shareholders. If the plaintiff loses, he forfeits his posted security. These requirements are normally placed on shareholders who have only a small minority interest. Yet cases are likely to arise when such statutes as these may deprive a shareholder of his most effective remedy, the derivative suit.

In addition, a director is often backed by an indemnification statute. If the plaintiff fails to prove the director's neglect of duty, the director is reimbursed for the costs of the litigation. In practice, statutes such as this would not seem to encourage misconduct; the director must win in order to be made whole. On the other hand, these provisions protect the director from heavy court costs when he was not at fault.

New York is the only state which has strengthened the derivative suit. Section 6 places the cause of action in the Attorney General, the corporation, corporate directors and officers, creditors, and receivers or trustees in bankruptcy. In conferring a cause of action on the attorney general, the legislature has taken a step forward in the protection of shareholder's rights. However, the attorney general's action has been limited to cases where the "public" interest is involved. This restriction accounts for the extremely limited use to which this provision has been put. The shareholder's interests would be well served if the attorney general could be called in to prosecute an action whenever it could be shown that a requisite jurisdictional amount was being called into question; and, secondly, whenever the corporation being sued was one whose activities had a substantial bearing on public affairs or welfare. To go further and force the attorney general to prosecute all derivative suits would both overburden the attorney general in performing his other duties, and would encourage strike suits.

If a plaintiff is successful in a derivative suit, the director is forced to reimburse the corporation in the amount of all secret profits he has made through his dealings. This weak remedy is no adequate deterrent to misconduct. However, the new Connecticut statute provides a more extensive remedy:

In any proceeding to void such contract or transaction, the court may, if it deems it equitable, rescind the contract or transaction in whole or in part, or award damages, or both, but the rights of third parties shall be protected.

If a suing shareholder were to receive damages independent of a pro rata share in the corporation's reimbursement, he would become an effective corporate watchdog. Directors would, in effect, be forced to pay punitive damages for their neglect. This Connecticut approach seems to be a fair one. The shareholder is rewarded personally for his diligence, the corporate wrong is remedied, and the director is punished. An effective civil remedy such as this would forestall any need for criminal sanctions; the state would not be obliged to prosecute wrongs which are to a

53 E.g., N.Y. GEN. CORP. § 61(a) (1943); CAL. CORP. CODE § 834 (1955); N.J. STAT. ANN. § 14-3-15 (1937).
54 E.g., Model Business Corporations Act § 4; CAL. CORP. CODE § 830 (1955); N.Y. GEN. CORP. §§ 63-68 (1943).
55 N.Y. GEN. CORP. § 61 (1943).

An action may be brought for the relief prescribed . . . by the attorney general in behalf of the people of the state, or, except for the relief prescribed in the third and fourth subdivisions, by the corporation or a creditor, receiver or trustee in bankruptcy thereof, or by a director or officer of the corporation.

Upon the application of either party the court shall make an order directing the trial by jury of the issue of negligence, and for that purpose the questions to be tried must be prepared and settled as prescribed in section four hundred and twenty-nine of the Civil Procedure Act.

56 People v. Lowe, 117 N.Y. 175, 22 N.E. 1016, 1021 (1889).
57 Note 31, supra.
large extent the private affair of the corporation. Traditionally, courts and legislatures have given business discretion wide freedom. To attach criminal penalties for what may be merely an abuse of discretion seems overly harsh.

Thus, at present, New York and Connecticut seem to have the necessary laws to bring about more effective enforcement and remedies. However, to bring about such results, New York must as mentioned above, broaden its use of the attorney general's suit.

The state statutory picture is varied and inconsistent, if not exactly chaotic. This variation suggests (1) a widespread acceptance of the enabling theory of corporate control by government, and (2) a certain legislative faith in the corporation as a vehicle of free enterprise. The continuing popularity of the enabling theory is underscored by a dearth of restrictive state regulations. The theory, and statutes enacted pursuant to it, have the advantage of being clear and workable; they are attractive to prospective investors and to legislators, to the latter by sheer dint of the fact that they encourage incorporation and thereby augment state revenue.

The American economy is based on the free enterprise concept, and the dominant spirit of a free-enterprise economy underlies the enabling-theory motive behind avoiding restrictive governmental regulation. By not imposing such harsh penalties as criminal prosecution, the states seem to have reaffirmed their faith in corporate self-regulation. Though a few mammoth corporations have taken on a public character, most lesser corporations remain vehicles of individual enterprise. Little or no attempt has been made to extend statute appropriate to public utilities or firms with a large public interest to the average small corporation, thereby making all corporations into quasi-public entities.

Nevertheless, abuses of corporate power exist, and shareholders should probably not have to bear the risk of director malfeasance. Thus, a combination of the increased use of disclosure, more effective means of enforcement, and stronger civil sanctions would provide strong shareholder safeguards and yet would not curtail economic freedom. Provisions of this sort must be supplemented by the corporation's greater awareness of its position in the public eye. Management must realize that besides injuring the individual shareholder, abuses of shareholders' trust cast an ugly and visible reflection on the corporation. The desire to foster good public relations and greater trust among investors should act as a spur to insure corporate self-regulation. If corporations wish to avoid additional governmental control, it is their duty to clean their own houses. Reliance on the purely selfish motive of self perpetuation should aid in accomplishing this end.

James K. Stucko

III FEDERAL SECURITIES REGULATION

History and purpose of federal securities regulation

Following World War I the people of the United States, perhaps conditioned by the wartime sale of Liberty Bonds, became increasingly security conscious. More Americans than ever were investing in commercial enterprises; prosperity was everywhere and it seemed as though it would continue. The aggregate value of stocks listed on the New York Stock Exchange, September 1, 1929, was $89 billion. Then came the great stock market crash; in 1932 the aggregate value was

58 See generally Oleck, Modern Corporation Law §§ 849-897 (1959) for a state-by-state recapitulation of directors' statutory powers and duties.
60 Notes 18 and 31, supra.
61 Note 56, supra.
62 Note 31, supra.
1 Loss, Securities Regulation 64 (1951).
down to $15 billion.\(^2\) One of the first official acts on the part of President Roosevelt, on March 29, 1933, was to send Congress a message urging it to enact a law on the issuance of securities.

In May, 1933, the Securities Act became law as the result of an investigation of the Senate Banking and Currency Committee begun in 1932.\(^3\) The Securities Act of 1933 is primarily concerned with the issue of new securities. In applying the act, the Securities Exchange Commission does not actually decide if a security is good or bad; it merely requires that sufficient facts concerning the issuer are disclosed so that the potential buyer will be enabled to make an intelligent choice as to whether he should buy the securities offered. "Congress did not take away from the citizen 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him."\(^4\)

On June 6, 1934, The Securities Exchange Act was enacted as a supplement to the Securities Act of 1933. Whereas the emphasis of the latter was upon the protection of purchasers of shares by requiring full disclosure of all relevant facts, the scope of the 1934 Act extended to actual regulation of securities exchanges, persons affiliated with the exchanges, and corporations whose shares were listed on the exchanges.\(^5\)

The Securities Exchange Act, which applied only to those corporations listed on the national securities exchanges, was designed to offer continuing protection to the purchasers of listed securities. This continuing protection is in the form of required annual and monthly reports and proxy statements which involve disclosure of facts about a corporation deemed necessary to enable a shareholder to evaluate his shareholdings.

The purpose of the Securities Exchange Act appears to extend beyond mere disclosure of facts. It aims toward a more active shareholder participation in corporate affairs. The provisions of the proxy statement required under this Act give a security holder information, but they also offer safeguards to make certain that his viewpoints are expressed as to how the corporation should be run. Rule X-14A-8, under the proxy rules, allows a shareholder to include in the management’s proxy a statement of 100 words or less about an issue which can properly be raised at the corporation's annual meeting. The proxy rules also require that the management either give shareholder lists or mail out proxies of insurgent shareholders.

This interest of the SEC towards encouraging an actual shareholder's control of the corporation, carried to its logical conclusion, would dictate a broader coverage to include those investors and those transactions presently exempted.

_The present SEC rules pertaining to conflicts of interest_

The evil of secret profits is not the existence of profit, but the ignorance of its existence by people who have a right to know about it. The SEC requires disclosure of certain relationships of corporate officials with regard to certain transactions having a definite bearing on the soundness of the corporation, while incidentally providing information which could be the basis of a derivative action for the recovery of such profits.

In the solicitation of proxies, Item 7(f) of Schedule 14A\(^6\) requires that the registrant:

> Describe briefly, and where practicable state the approximate amount of, any material interest, direct or indirect, of any of the following persons in any material transactions since the beginning of the issuer’s last fiscal year,\(^7\) or in any material proposed transactions, to which the issuer

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\(^2\) _Id._ at 75.

\(^3\) _Ibid._

\(^4\) _Id._ at 82.


\(^6\) 17 C.F.R. Schedule 14A (Supp. 1960). Similar provisions are contained in Form S-1, Item 20, and Form 10-K, Item 9. (Throughout this note, Form S-1 will be the form in effect as of Feb. 20, 1958, and Form 10-K, as revised Jan. 26, 1954.)

\(^7\) Form S-1 requires disclosure of material interests in material transactions for the past three years.
or any of its subsidiaries was or is to be a party:

1. Any director or officer of the issuer;
2. Any nominee for election as a director;
3. Any security holder named in answer to item 5(d)8; or
4. Any associate of any of the foregoing persons.

The instructions following are more illuminating as to the exact requirements, and some policy considerations. Instruction 2 provides:

As to any transaction involving the purchase or sale of assets by or to the issuer or any subsidiary, otherwise than in the ordinary course of business, state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction.

It should be noted that this does not except any material transactions from disclosure, but establishes a class of transactions where a fuller disclosure is required. Inherent in this classification is the questionable judgment that the purchase and sale of assets, other than in the ordinary course of business, is somehow more dangerous to the soundness of the company, or in the alternative that these are less likely to come to the attention of the shareholders. Perhaps history, if not reason, supports the former judgment; the latter seems baseless.

Instruction 5 dispenses with the necessity of disclosure of any transaction or interest therein in certain cases. Where the rates are fixed by law or determined by competitive bidding, no report is necessary. Assuming a bona fide competition in bids, this is a logical exception; there is no possibility of undue profits or of a fraud on the corporation.

Similarly, where the interest in question is solely that of a director9 of another corporation which is a party to the transaction, it need not be disclosed. Apparently, when the conflict is not financial in nature, the difficulties of a metaphysical bisec-tion of loyalty is not felt to be a concern of the investing community. There is no disclosure required when the interest of the specified person does not exceed $30,000. This is a crystallization of the de minimis rule, and, while the administrative necessity for such an exclusion might be admitted, the description of this “permissible fraud” area in dollars fails to distinguish between the large and the small company on a basis of relative importance. In addition, the possibility of a series of exempt transactions is not covered, nor is there a clause which would require disclosure where the combined interest of the directors, officers, or associates exceeds $30,000.

The latter difficulty may be merely loose wording. Item 9 under the annual report11 is substantially similar to this section of the proxy solicitation. There, however, the wording is changed to read, “the interest of the specified persons does not exceed $30,000,” which might be interpreted to require a disclosure where the aggregate interest exceeds that sum.

Instruction 5(v) provides that no information need be given as to any transaction or any interest therein where:

The transaction does not involve remuneration for services, directly or indirectly, and (A) the interest of the specified persons arises from the ownership individually and in the aggregate of less than 10% of any class of equity securities of another corporation which is a party to the transaction, (B) the transaction is in the ordinary course of business of the issuer or its subsidiaries, and (C) the amount of such transaction or series of transactions is less than 10% of the total sales or purchases, as the case may be, of the issuer and its subsidiaries.12

It should be noted that the qualifications for non-disclosure under this paragraph are conjunctive; therefore, the type of transaction which is permitted to go unreported under this exception may be rather narrowly described. It is a pur-

8 Any person who owns of record or beneficially more than 10 per cent of the outstanding securities of the issuer.
9 Rather than, for instance, being a shareholder and a director of the other corporation.
11 Form 10-K.
purchase or sale of goods in the ordinary course of business by a corporation whose directors, officers, and their associates own in the aggregate less than 10 per cent of the corporation which is the other party to the transaction, and this transaction represents less than 10 per cent of the total sales or purchases, as the case may be, of the first corporation and its subsidiaries. As to the justification for the area of exclusion, the first consideration aims at the nature of the exclusion; the second at its relative importance. There seems to be no reason for assuming more regularity in the purchase or sale of goods in the ordinary course of business than in other transactions. But, the interest in keeping the report a manageable size offsets any interest in absolute completeness. The "10 per cent of 10 per cent" is this section's version of *de minimis*. Rather than an expression of faith that men are not dishonest when dealing for small sums, it is justified to the extent that it minimizes the amount of conflicting loyalties.

However, if the problem of aggregate interests of specified persons is answered under this section, the possibility of a series of transactions exceeding the 10 per cent going unreported remains.

Instruction 7 merely states that an interest in any transaction is not required to be reported "unless such interest and transaction are material." The term "material" limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered. This qualification is no more vague than many other "reasonable men" in the law and may be said to read into the instruction a requirement of good faith.

The provisions in the original registration form and the annual report are similar. As might be expected, the current reports are less comprehensive and intended as a means to keep other filed material up to date. If the registrant or any of its majority-owned subsidiaries has acquired or disposed of a significant amount of assets, *otherwise than in the ordinary course of business*, the following information must be furnished:

a) The date and manner of acquisition or disposition and a brief description of the assets involved, the nature and amount of consideration given or received therefor, the principle followed in determining the amount of such consideration, the identity of the persons from whom the assets were acquired or to whom they were sold and the nature of any material relationship between such persons and the registrant or any of its affiliates, any director or officer of the registrant, or any associate of any such director or officer.

Instruction 2 gives a definition of acquisition and disposition excluding construction or development of property. Instruction 3 states that the acquisition of securities shall be deemed the indirect acquisition or disposition of the assets represented by such securities, if it results in the acquisition or disposition of control of such assets.

Instruction 4 describes the rule for determining if an acquisition or disposition involves a significant amount of assets:

(i) if the net book value of such assets or the amount paid or received therefor upon such acquisition or disposition exceeded 15 per cent of the total assets of the registrant and its consolidated subsidiaries, or (ii) if it involved the acquisition or disposition of a business whose gross revenues for its last fiscal year exceeded 15 per cent of the aggregate gross revenues of the registrant and its consolidated subsidiaries for the registrant's last fiscal year.

Possibly the reason for the distinction between the transactions "within the ordinary course of business" and those "not within the ordinary course of business" is that the SEC does not wish to overburden registered corporations by requiring a review of all their transactions every month. The information concerning the

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15 Form 8-K, Item 2. (Form 8-K as in effect Mar. 5, 1959.)
16 Form 8-K, Item 2(a).
interests of directors in transactions in the ordinary course of business appear to be important enough to the shareholders to require disclosure. A shareholder would want this information so he could take action immediately in order to stop an unfair pilfering by a director. To require a shareholder to wait until such information is disclosed in the annual report could result in unrecoverable loss. Instruction 4, calling only for the disclosure of an interest of a director in a transaction which involves more than 15 per cent of the assets or 15 per cent of the gross revenues, is subject to the objection that it, too, is an inelastic "de minimis" rule; i.e., it allows a perhaps major event to go unreported. It might be pointed out that a percentage exemption permits, in the case of a large company, a considerable financial interest to be affected. Further, the limitation is not drawn in terms of the individual's interest.

The information required in the general registration form, other than the part similar to that set out above, includes information concerning the interests of promoters in transactions involving assets purchased or about to be purchased by the stock issuer, and anything of value that the promoters are to receive from the registrant. This information is a secondary check on the activities of the directors, if they happen to be the original promoters of the business. Information concerning a director's occupations for the previous five years, required in the annual report and the proxy form, might also be an indication of possible conflicts of interest. Contracts with businesses in which he was employed might be viewed with suspicion.

There are also requirements for the disclosure of remuneration of directors and their stock purchase options which might be important for the stockholder to know, if he is to detect conflicts of interests among corporate directors.

Is the present SEC statute an effective deterrent to unfair transactions by interested directors?

Outside of the special instances covered by the regulatory acts enforced by the Commission, the SEC has no direct control over contracts made by corporate directors. It cannot require Commission approval, or bring action, even in cases of gross mismanagement. The power of the Commission to sue and regulate does not appear to be necessary in the case of an ordinary corporation. By a disclosure of all the pertinent information concerning the contracts of interested directors, the investors themselves should, theoretically, be able to decide if they approve of the transactions. This may be less effective than appears, however. Many stockholders or prospective stockholders never read the reports, and even if they did read them, most investors would not understand their impact. But it must be remembered that this information also goes to independent experts who can interpret the mass of required information and make the results known. "Probably the very best protection for investors will be the complete disclosure of all facts which may affect the soundness of their investments." Public officials cannot decide if a security is sound; they are not prophets. In the dissenting opinion in State ex rel Circuit Attorney v. Saline County Court, the

17 See The Wall Street Journal, Sept. 30, 1960, p. 1, col. 6. In the article cited, a two-month profit of $450,000 by a director resulting from questionable dealings with his corporation was disclosed. This serves to show the need for frequent current reports.
18 Form S-1, § 11.
19 Form 10-K, Item 6(b).
21 E.g., Form S-1, Item 17; Form 10-K, Item 7; Reg. X-14, Item 7.
22 E.g., Form S-1, Item 18(b); Form 10-K, Item 3; Reg. X-14, Item 7.
26 51 Mo. 350, 387 (1873).
NOTES

writer discusses the right of a prosecutor to sue for mismanagement; he notes that
when management is looking to a state's attorney for punishment, it is likely to
curry his favor rather than that of the owners. He feared the state would be in-
volved in expensive lawsuits, suits in which it would have no substantial interest.
Finally, he said, the institution of the suit could depend on nothing more than the
caprice of the attorney general. Such arguments would appear to be applicable to
suits brought by the SEC.

The question that arises is whether a sufficient amount of information is re-
quired to be disclosed. Is it possible for shareholders to decide if management is
properly doing its job? There is very little case law to show how the disclosure
provisions set out above are interpreted.27 Generally, interpretation of these provi-
sions comes about when counsel for a registrant requests an interpretation from the
Division of Corporate Finance at the SEC in Washington.28 These interpretations
are not made public, and they are strictly applicable only to the particular hypo-
thetical question submitted.29

The requirements of disclosure have been stated and briefly discussed above;
some areas of their inadequacy have been indicated. If the purpose of the SEC
is limited to the general soundness of the stock market, the limited coverage may
be justified. But if the legislation is seen as a remedy for shareholder ignorance as
a result of the separation of ownership and management, there are good grounds
for requiring fuller disclosure. The protection of the individual stockholder in this
case merits a disclosure of those matters dangerous to his investment. Considera-
tions of administrative practicability demand some limitation on the burdens of
disclosure imposed on the corporation, but the rules might be redrafted to achieve
greater individual protection.

Proposals to extend the jurisdiction of the SEC

The present SEC rules, under the 1933 and 1934 acts, however effective in
uncovering conflicts of interest among corporate directors they might be, extend
only to corporations which come under the statutes. The Securities Act of 1933
requires the registration of securities which are to be offered to the public through
the mails or the channels of interstate commerce.30 The Exchange Act of 1934
requires registration of an issuer who wants to trade on a national exchange.31
This in effect allows a company to choose for itself whether it wants to be governed
by the SEC rules.32 It may place its securities privately and avoid all the disclosure
regulations. Senators Frear and Fulbright have proposed bills which would place
companies having a stated amount of capital and a specified number of shareholders
under the rules of the SEC, without allusion to either commerce or stock exchange
requirements.33 It seems desirable that there be a single standard insuring all
security holders of information necessary to protect their interests. Such informa-
tion would possibly build confidence in business investments; it would also make
registered securities better collateral for loans.34

It has been argued that compulsory registration would unduly burden businesses
seeking neither capital nor stock market listing.35 However, a majority of the cor-
porations which would be included under the new provision would already have

27 This is discussed in Part III, supra.
28 See, e.g., Letter of Director of the Corporate Finance Division of the SEC (Securities
30 LOSS, SECURITIES REGULATION 83 (1951).
31 Id. at 84.
32 Id. at 615.
33 E.g., Hearings on S. 1178, 1179, 1180, 1181, 1182 Before a Subcommittee of the Com-
mittee on Banking and Currency, 86th Cong., 1st Sess. (1959), HEARINGS ON S. 2408 Before a
34 186 COMMERCIAL AND FINANCIAL CHRONICLE 182 (1956).
the records necessary for such registration. The extra cost to management would be infinitesimal compared to the entire operation of the company. Required registration would eliminate, at least in the affected companies, abuses such as proxies sent on the back of dividend checks (by endorsing the check a shareholder votes his proxy); and requests for ratification of all transactions made between annual meetings, with no disclosure as to what the transactions were. It would tend to cut down the private placing of securities; the best securities would be available to the public. No longer would a corporation be tempted to accept a single bid by a party rather than offer its securities on the public market in order to avoid registration. The adoption of the bill would make the decision whether or not to list on a national exchange one based on economic considerations, rather than on a desire to conceal operations. There is no apparent reason why SEC protection should be limited to the presently listed companies. The fraud upon stockholders which the SEC seeks to prevent is just as likely to exist among nonlisted companies. The shareholders of both need governmental protection—or neither needs it.

Whether or not all corporations should be regulated by the SEC, the Frear bill looks into the practicalities of the matter. The Securities and Exchange Commission would have to be greatly enlarged to investigate the reports of every corporation which sells securities in the United States. Since in a smaller corporation, with few shareholders, the shareholders are likely to be not far removed from the management, and there will not be a pressing need for formal reports, both the Frear and Fulbright bills, with good reason, make SEC jurisdiction depend upon the size of the corporation.

Uses of the information required

The information given in the registration forms, the annual forms, the monthly forms, and the proxy forms—information required by SEC rules—could conceivably be used as the basis for a stockholder’s derivative action or, possibly, even a suit by the corporation in its own name, the gravamen of which would be director or officer misconduct.

A corporate director, as a fiduciary of his corporation, has a duty apart from administrative reports to disclose his personal interest in a corporate transaction. Disclosure in this sense is essential to the fairness of the bargain; the SEC rules requiring disclosure should further encourage a director to fulfill this duty. Failure to disclose could subject an erring director both to the usual civil remedies for corporate mismanagement, and to criminal liability under SEC penalties for nondisclosure.

Once a director has disclosed his interest in the corporate transaction, there must be some way of determining if his power has been misused. If the board of directors believes the transaction is unfair, in light of the director’s disclosures, it may discharge the director and either rescind the contract, or sue for the benefit received by the interested director. In some jurisdictions this is possible even though the corporation has not been injured in the transaction. The initial factor is whether or not the director fully disclosed his interest in the transaction at the time it was made.

36 Bayne, Around and Beyond the SEC — the Disenfranchised Shareholder, 26 Ind. L.J. 207 (1951).
38 Loss, op. cit. supra note 30, at 619.
39 177 Commercial and Financial Chronicle 1849 (1953).
40 71 Harv. L. Rev. 1337 (1958).
41 Cf. Part I, supra.
43 Cf. Part I, supra.
44 Cf. Part I, supra.
45 Ibid.
If a stockholder institutes suit in the name of the corporation, he joins as defendants the interested director and the corporation itself. A stockholder's derivative suit is a rather weak avenue to redressing improper director interest, because the possible loss to the individual looms large as compared to any benefits returning to him.

The preliminary requirements to bringing the suit may include proof that the plaintiff was a shareholder at the time the action arose; a demand upon the directors and their refusal to bring the suit in the corporate name (or a showing that such a demand would be useless); and a posting of bond by the shareholder. The normal, practical difficulties of proof, growing out of the fact that needed evidence is in company files, may be complicated by the corporation's interposition of a defense. Dependent upon the outcome, the shareholder may shoulder the cost of the suit himself, and forfeit his bond; or he may recover the disputed profits for the corporation. In contrast, the defendant, if he successfully defends, retains the profits from the contract and is reimbursed for his legal expenses.

The difficulties inherent in derivative actions, and their absence of utility as a judicial device for protecting shareholder-investors, have not escaped the notice of commentators. Suggestions for substitutes have ranged from empowering the state to act as nominal plaintiff in mismanagement cases to the maintenance of a private organization whose sole function would be investigating corporate management. The utility of the latter suggestion would, of course, depend on the corporation's willingness to hire the management monitors. Some of the proponents of this solution have suggested that government underwrite the function. Whatever the merits of government investigation, it would not seem advisable to make of the state a plaintiff in what is essentially a derivative action for a private wrong, i.e., mismanagement. The state's interest in the internal affairs of the average business corporation would not seem to justify the public expense necessarily involved in bringing such suits.

Some sort of judicial action is necessary, however, if for no other reason than the coercive effect it has upon management. An unsuccessful suit—or the bare threat of suit—gives management a graphic reminder that its investors are dissatisfied; this reminder can conceivably encourage directors to prevent private profit from corporate transactions, or even to cancel a conflict-of-interest contract rather than suffer the expense and exposure of public trial.

As long as private actions have this coercive effect on management, the likelihood that government will take over the derivative suit is not great. But a growing public awareness of mismanagement could result in government assistance to shareholders whose private remedies are less than effective.

46 In some states, a shareholder must make the demand on the other shareholders of the corporation and obtain the consent of a majority of those who are disinterested. E.g., S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950); but see Mayer v. Adams, 141 A.2d 458 (Del. Sup. Ct. 1958).


49 BALLANTINE, CORPORATIONS § 157(a) (1946).

50 Berlack, Stockholder's Suits; a Possible Substitute, 35 Mich. L. Rev. 597 (1937); 61 Harv. L. Rev. 335, 341 (1948).


52 See Business Week, Oct. 6, 1960, p. 32.

53 See Circuit Attorney v. Saline County Court, 51 Mo. 350, 387 (1873) (dissenting opinion).

54 The publicity resulting from such a suit will often coerce directors into taking positive action to stop the taking of unfair profits. See Fortune, Nov., 1960, p. 132.

55 See Companies Act, 1954, 11 & 12, Geo. 6, c. 38 §§ 164-165; it has been suggested that the state has a sufficient interest in corporate management because a large segment of the population is composed of shareholders. 33 Mich. L. Rev. 597, 608 (1937).
Suggested changes in the SEC rules

Current rules pertaining to conflicts of interest among corporate directors place the burden of reporting conflicts on the registrant, the issuer, or the person soliciting the proxies. It may be useful to impose on this reporter the burden of revealing material interests in corporate transactions of all the directors, officers, nominees for directors, and owners of 10 per cent of the voting securities, but, for the most part, this knowledge must come from the individuals concerned. The information a corporation or the individual soliciting proxies is able to report necessarily depends on the cooperation of those whose transactions he is reporting.

It would seem a better solution to require the interested person himself to make the disclosure to the corporation, which in turn would put this information in the regular required reports. Such a requirement would underline the common law duty of a corporate director to disclose his interests in transactions with his own company; it would not increase his present legal duties, but it would be an additional assurance that they will be performed. The threat of criminal punishment under the Securities Exchange Act would perhaps be more incentive for prompt disclosure than private remedies to enforce the common law duty.

This suggested provision would make it obligatory for him to make reports concerning his interests in transactions which are material or part of a series of transactions which are material in the aggregate. This personal obligation placed upon a director, officer, or 10 per cent shareholder would resemble current requirements under section 16 of the Securities Exchange Act which require an insider to disclose his own stock purchases and sales.

The reports would supplement the common law rules concerning disclosure. Requiring them monthly would insure that transactions not continue without information available to the shareholders indicating director interest. It might be advisable to require copies to be sent to the corporation, the SEC, and the exchange upon which the stock is listed. No report would be required unless there was a reportable interest during the month.

A second suggestion is that shareholders be permitted to use the management proxy statement for the purpose of nominating directors in opposition to the management's nominees who are personally interested in corporate transactions. Such a provision would resemble the current rule X-14A-8, which requires corporate managers to include on their proxy statements a proposal of an issue to be taken up at the annual meeting. This suggestion would require that the proxies solicited by management have spaces for "yes" and "no" votes for the individual directors, much like a political ballot. This would only be required when the management slate was opposed; the shareholder nominee's name would be directly opposite the name of the man he is to replace.

56 Securities Exchange Act § 32(a) provides for criminal punishment for one who makes or causes to be made a false statement, if he cannot show good faith. This would not appear to apply to one not involved in making the report.
57 Definition, 17 C.F.R. 230.405(2); 17 C.F.R. 210.1-02.
59 If the stock is not listed, but the SEC expands its jurisdiction to cover corporations not listed on an exchange, the report to the corporation and the SEC would be sufficient. See Section IV supra.
62 Rule X-14A-8, supra note 61, appears to indicate that disclosure is not considered to be enough by the Commission. The stockholder is given an opportunity to voice his opinions as to matters which are proper for security holders' action. This rule does not presently apply to the election of officers.
63 If more than one nominee was suggested for a position, the vote of those dissatisfied with the existing management would be split. It would be better, perhaps, for the incumbent directors who are unopposed to select the candidate from the persons nominated for each
A regulation of this type appears to be necessary in view of the fact that the stockholder's derivative suit does not appear to be an effective means for curing corporate mismanagement. On the other hand, it has been said that the derivative suit is an easier way of ousting corrupt managers than is voting them out.\textsuperscript{64} The cost of waging a grass-roots proxy fight is usually prohibitive, and, if the person waging a proxy fight loses, the money spent must come out of his own pocket.\textsuperscript{55} The cost of this suggestion is not a serious factor; it would require the inclusion in the proxy statement of very little information not already required by the SEC.

The suggested proxy would have the advantage of placing before the shareholders at one time the names of both nominees for the directorship, and it would incorporate within the proxy all the information necessary for the shareholder to make an intelligent vote. Having the nominees and their qualifications on one ballot would encourage the stockholder to inform himself before voting, instead of making a blind, unthinking vote for mismanagement.\textsuperscript{66}

The apparent reason for current SEC proxy requirements make of proxy voting something like an old-fashioned shareholders' meeting. The above suggestion would add to the "meeting" an exchange of ideas and a more direct democratic election of directors. Under the present rules, proxies can be voted only for persons named on them; it does no good for a shareholder to stand up at the "meeting" and nominate his own director, or even to outline corruption in the incumbent management.\textsuperscript{67} Most voting is done in the homes of the shareholders before the annual meetings;\textsuperscript{68} the individual shareholder, dissatisfied with corporate management, has no inexpensive way to oust irresponsible corporate directors.

**Conclusion**

Although an occasional director enters into transactions with his own company, transactions motivated by self interest, transactions potentially inequitable to shareholders, there appears to be no evidence that corruption is widespread or such that immediate government regulation of all corporate directors is necessary. The directors of a corporation are elected by its shareholders; their duty is to run a business for its owners. Separation of ownership and control inevitably invites a certain looseness; the fundamental reality is that the manager is not dealing with his own interests. But this looseness is no more than is to be expected in any human situation involving delegated responsibility — be it agency, trust or political representation.

In the ordinary situation, the delegator has control over the delegate and abundant opportunity for direct, periodical accounting from the delegate. This is not the case in corporations; since the director is responsible to the corporation, and not to its owners; shareholder redress for particular misfeasance can be obtained only indirectly and in the corporate name. The needed reform, perhaps, is one which will give the owner of the corporation a direct avenue of redress for mismanagement — a device which will leave the shareholder some choice other than silence or withdrawal.

The owner of a business ought, on the other hand, be free to permit his manager to enter into transactions involving personal profit to the manager. The evil in these transactions lies not in the personal profit itself, but a lack of communication between the manager and his employer. It is not for government to decide the position, to fill the opposing place on the ballot. Admittedly, such a proposition could result in abuse, but the directors who are entrusted with the management of the whole corporation are perhaps best qualified to make the selection.

\textsuperscript{64} Fortune, March, 1954, p. 85.
\textsuperscript{65} Ibid.
\textsuperscript{67} See 17 C.F.R. 240.14a-4(d).
fairness of a director transaction; it is for the director's employer. But the employer can hardly be expected to decide the question if he is uninformed.

By its nature, the corporate form invites hidden director transactions never possible in agency or trust relationships. Shareholders, at least under prevalent corporate theory, supply capital; they do not control their business directly. Government action in this area should be directed at strengthening and clarifying owner control, not at substituting for it bureaucratic control. The regulatory scheme which will accomplish this with minimum interference in the engines of control is one which will insure information to the corporate investor.

A system designed to accomplish this should be tightly designed, lest ingenious management evade it. It should be laid under the present federal agency devoted to corporate control, the Securities Exchange Commission; this would involve expansion in the SEC sufficient to insure accurate and complete reporting.

The regulatory scheme should probably go beyond information and insure a workable and inexpensive method of shareholder redress, and one which will not hinder the director in dutifully performing his necessary function. A system of reporting under government compulsion, coupled with the present derivative remedy, would seem sufficient to protect the shareholder with an honest claim, while discouraging capricious lawsuits. Shareholder nominations on the management proxy will assist in the removal of dishonest directors and will provide an avenue of redress neither as expensive nor as risky as the derivative action.

If the director is compelled to make public his private transactions, and if the shareholder is given a swift and workable remedy for abuse, it is not likely that corporate management will extend its activity beyond that which is above reproach.

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Thomas J. Kelly

Unauthorized Practice of Law by Real Estate Brokers and Title Insurance Companies

Introduction

The legal profession in England was granted an exclusive right to the practice of law when, in 1292, Edward I "directed his justices to provide for every county a sufficient number of attorneys and apprentices from among the best, the most lawful and the most teachable so that king and people might be well served." The order is a landmark in English law as it expressly charged the justices with the duty of regulating the legal profession, a power which has been carefully guarded over the centuries by the judiciary, although in later years this protection has been partly shared with the legislature. This "monopoly" gains its value today not because of historical significance, but rather due to the concept of protection of the public from unqualified or unreliable practitioners. The lawyer is...
a highly trained individual, a member of one of the three learned professions, and bound by a very high code of ethics which the courts have zealously enforced.4

The protest against the practice of law by real estate agents and title insurance companies is not based merely on the monopoly rights of the bar, but also on the fact that such organizations are not the impartial parties that lawyers are.5 The danger is not necessarily that the officer of the title insurance company or the real estate broker will give incompetent legal service, but that they will give misleading and even dishonest advice so as to rush the sale to completion.6 This tendency is most apparent in states like Colorado, which by statute provides that the real estate broker has not earned his commission until the sale is consummated.7 The title company officer is also under the pressure of losing the fee for the company if the sale falls through, and especially so if he knows a broker's commission depends upon the closing of the deal. Furthermore, neither real estate brokers nor title insurance companies are subject to the strict sanctions of the bar and the courts for imprudent conduct violative of the lawyer's canons of ethics.8

This conflict between the bar and the various lay groups, such as real estate brokers and title insurance companies, has been a hard one to fight primarily due to the difficulty in drawing precise areas which could definitely be said to be the province of the bar or the lay group.9 The dividing line is shadowy at best, and, as the following discussion shows, is not capable of precise definition which will fit all areas of conflict. This note is not intended to espouse the cause either of the lawyer or of the real estate agent and title insurance company; it is an attempt to show what line has been drawn as to the practice of law in relation to these organizations. For this purpose, a logical and systematic examination of the more important cases in the field is attempted, primarily in light of the defenses which the lay organizations have interposed. This area of the law is far from being subject to definite rules. Rather, it evinces a case-by-case approach by the courts, on the basis of individual facts and circumstances, to strike an accord which will best serve the public in its relations with these organizations.

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4 In re Cohen, 261 Mass. 494, 159 N.E. 495 (1928) (Canons of Professional Ethics of American Bar Association specifically enforced). To attempt to refute the public policy behind the lawyers' "monopoly" by pointing out instances of "sloppy" practice or dishonesty serves merely to indicate that perhaps the guiding lines of the "monopoly" are not quite strict enough.


6 The courts are in clear disagreement as to whether much litigation results from allowing title companies and brokers to perform various legal services. Compare Washington State Bar Ass'n v. Wash. Ass'n of Realtors, 41 Wash. 2d 697, 251 P.2d 619, 621 (1952) ("constant stream of litigation arising from this source"), with Cowern v. Nelson, 207 Minn. 642, 290 N.W. 795, 797 (1940) ("rare instances of defective conveyances"). The simplicity of modern form conveyancing militates against the possibility of defective instruments. The greater danger is the possibility of "prejudicial advice" by the broker or title company at the time of execution of the instruments.

7 Colo. Rev. Stat. Ann. § 117-2-1 (1953). Most states hold that "in the absence of express agreement, the broker earns his commission if he is the effective cause of producing a customer willing and able to buy on terms acceptable to the owner." Casner & Leach, Cases & Texts on Property 619 (1951). But see Hulse v. Cruger, 363 Mo. 26, 247 S.W.2d 855, 861 (1952). The court pointed out that the broker has a definite interest in the transaction right up until it is closed, for it is only at this time that he actually receives his commission.

8 "Protection of the public is set at naught if laymen who are not subject to court supervision are permitted to practice law." Gardner v. Conway, 234 Minn. 468, 48 N.W.2d 788, 795 (1951); Lowell Bar Ass'n v. Loeb, 315 Mass. 176, 52 N.E.2d 27 (1943).

I. PRACTICE OF LAW

The dividing line between the work of lawyers and various lay organizations is often drawn by the deceptively simple question: Does it constitute the practice of law? Most courts have been reluctant to admit there is any one definition of the practice of law; at best they usually define it in broad generalities. The courts do agree, however, that the practice of law is not limited to the courtroom, but includes advice and counsel and the preparation of legal documents. Few legislatures have attempted to define comprehensively the practice of law, which is undoubtedly due to the court's position that such definition is merely in aid of their jurisdiction of the practice of law and not determinative of it. The cases indicate that such a priori generalizations, whether by the courts or the legislature, are little help in settling each controversy.

Corporations are prohibited from practicing law because to permit a corporation to make a "merchant's profit" on the work of its hired lawyers would destroy that relation of trust and confidence which exists between a client and his attorney, by putting the attorney in a position of divided loyalty. A corporation may, of course, hire salaried lawyers to do its own legal work when the corporation is not acting in a representative capacity. In cases where title insurance companies (usually corporations) are permitted to continue preparing legal instruments as an incident of their businesses, it would seem that, in reality, this is a corporation practicing law; but most courts which have considered the question say it is not.

Realtors, those real estate brokers and select real estate salesmen who are members of constituent boards of the National Association of Real Estate Boards, subscribe to a Code of Ethics which prohibits them from practicing law. According to the realtors, this means that they may fill out forms regularly used in the course of their business, but may not draw instruments not related to the conduct of a real estate transaction. The American Title Association, in its Code of Ethics, has no similar provision.

11 "We believe it is impossible to frame any comprehensive definition of what constitutes the practice of law. Each case must be decided upon its own particular facts." Arkansas Bar Ass'n v. Block, 323 S.W.2d 912, 914, cert. denied, 361 U.S. 836 (Ark 1959); Washington State Bar Ass'n v. Wash. Ass'n of Realtors, 41 Wash. 2d 697, 251 P.2d 619 (1952).
12 Fink v. Peden, 214 Ind. 584, 17 N.E.2d 95 (1938) (doing the work of an attorney); People ex rel. Ill. Bar Ass'n v. People's Stock Yards State Bank, 344 Ill. 462, 176 N.E. 901 (1931) (practice of law consists of advice or service which requires any degree of legal skill or knowledge).
13 Practice of law "includes legal advice and counsel, and the preparation of legal instruments . . . by which legal rights are secured, although such matter may or may not be pending in a court." Eley v. Miller, 7 Ind. App. 529, 34 N.E. 836, 837-38 (1893). For cases approving this definition see Annot., 151 A.L.R. 781 (1944).
15 See cases cited note 2, Supra.
16 E.g., Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 596, 179 S.W.2d 946 (1944); Opinion of the Justices, 239 Mass. 607, 194 N.E. 313 (1935).
17 Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 596, 179 S.W.2d 946 (1944).
18 See Cooperman v. West Coast Title Co., 75 So. 2d 818 (Fla. 1954); La Brun v. Commonwealth Title Co., 358 Pa. 239, 56 A.2d 246 (1948). Contra, Bar Ass'n of Tenn. v. Union Planters Title Guar. Co., 326 S.W.2d 767 (Tenn. Ct. App. 1959) (although the company was found to be practicing law, it was not enjoined on grounds of public policy).
19 There are approximately 67,000 active realtors out of approximately 500,000 people directly involved in the selling of real estate. Letter from the National Association of Real Estate Boards to the NOTRE DAME LAWYER, on file in the Notre Dame Law School Library.
20 Article 7 of the Realtor's Code of Ethics.
II. INCIDENT-TO-BUSINESS THEORY

The controversy over the practice of law by the real estate broker and the title insurance company centers around their right to prepare legal instruments in their business, instruments which transfer or affect the title to an interest in realty. Both the brokers and the title insurance companies declare that they have the right, in the absence of statute, to fill out legal documents for use in their businesses. The brokers claim that, as an incident of their selling function, they have a right to prepare instruments which both bind the parties in the first instance, as in a simple contract of sale, and effect the final transfer of title. The brokers advance several reasons for this, but primarily they state that public policy is in favor of allowing such practices, and secondly, that they cannot be expected to have an attorney with them at all times. Title companies use this same basic argument; they claim they have the right to draw all the necessary legal papers, including deeds, mortgages, releases, liens, and other instruments, necessary to perfect the title which they intend to insure.

A. Theory Accepted

Many courts have recognized the incident-to-business theory, provided there is no separate charge for instrument preparation, and hold that a person is not practicing law when he merely fills in simple blank forms, requiring no more legal ability than that possessed by the average man who deals in such matters. In *Cain v. Merchants National Bank & Trust Co.*, for example, the court was called upon to enjoin a trust company from preparing mortgages, bills of sale, and crop contracts which involved settlements in which the bank was interested. The court refused to grant an injunction, stating:

> [A] person who is not a member of the bar may draw instruments such as simple deeds, mortgages, promissory notes, and bills of sale when these instruments are incident to transactions in which such person is interested, provided no charge is made therefor. . . . The draw[er] of complicated legal instruments . . . practices law even though such instruments might, to some extent, be incident to a business.

The Supreme Court of Pennsylvania, in *La Brum v. Commonwealth Title Co.*, upheld the right of a title company to prepare, for compensation, legal instruments used in the company's business. After holding that the company had the right to examine instruments in the transfer of title and require corrections before it issued an insurance policy, the court said:

> Drawing the instrument correctly in the first place is no more unau-

24 To require an attorney to be at the beck and call of the broker whenever a sale was to be made would result in unnecessary expense, and possibly would make attorneys become real estate brokers in order to legally close a contract for the sale of real estate. Ingham County Bar Ass'n v. Walter Neller Co., 342 Mich. 214, 69 N.W.2d 713, 721 (1955).
26 In *Ingham County Bar Ass'n v. Walter Neller Co.*, 342 Mich. 214, 69 N.W.2d 713 (1955) (conveyancing as an incident to the broker's business permitted); *Cooperman v. West Coast Title Co.*, 75 So. 2d 818 (Fla. 1954) (title company permitted standard form conveyancing to arrive at insurable title); *Hulse v. Criger*, 363 Mo. 26, 247 S.W.2d 855 (1952) (form instruments may be prepared by real estate broker acting as a broker); *La Brum v. Commonwealth Title Co.*, 358 Pa. 239, 56 A.2d 246 (1948); *Cowern v. Nelson*, 207 Minn. 642, 290 N.W. 795 (1940) (public convenience necessitates that brokers have the right to prepare legal instruments incidental to transactions in which they are acting); *Cain v. Merchants Nat'l Bank & Trust Co.*, 66 N.D. 746, 268 N.W. 719 (1956); *Childs v. Smelter*, 315 Pa. 9, 171 Atl. 883, 885 (1934) (involved a public stenographer but contains dictum as to real estate brokers); *People v. Title Guar. & Trust Co.*, 227 N.Y. 366, 125 N.E. 666, 670 (1919) (concurring opinion), where Judge Pound stated: "The preparation of the legal papers may be ancillary to the daily business of the actor or it may be the business itself."
27 66 N.D. 746, 268 N.W. 719 (1936).
28 Id. at 723.
29 358 Pa. 239, 56 A.2d 246 (1948).
authorized practice of law than examining or approving it after it has been drawn, or returning it for correction after it has been found to have been erroneously drawn.\textsuperscript{30} The \textit{La Brum} case failed to consider the effect of legal advice given by the title company or even to comment on the fact that separate compensation was charged for the drafting of the legal instruments. The language used by the court reflects a liberal view towards what is not the practice of law, for the court went so far as to say that public conveyancing was permissible.\textsuperscript{31} The only other case involving a title company which has specifically relied on and upheld the incidental theory is \textit{Cooperman v. West Coast Title Co.}\textsuperscript{32} The court there held that title companies had the right, in the absence of compensation, to prepare necessary legal instruments.

[What the companies do] to accomplish a transfer of a title or interest of such kind that a policy of title insurance is warranted are not services the performance of which amount to unauthorized practice of law.\textsuperscript{33} The companies were forbidden to render legal advice and escrow services where they were not insuring the title, but the court did not consider the question of legal advice to insurance customers.

The theory, as applied to real estate brokers, was well stated in another Pennsylvania case, \textit{Childs v. Smeltzer},\textsuperscript{34} which involved a public stenographer. The court in recognition of the briefs filed by several real estate boards stated: There can be no objection to the preparation of deeds and mortgages or other contracts by such brokers so long as the papers involved pertain to and grow out of their business transactions and are intimately connected therewith. The drafting and execution of legal instruments is a necessary concomitant of many businesses, and cannot be considered unlawful. Such practice only falls within the prohibition of the act when the documents are drawn in relation to matters in no manner connected with the immediate business of the person preparing them. . . .\textsuperscript{35} Again the Pennsylvania court failed to consider the problems of legal advice and separate compensation for the preparation of such instruments.

The Missouri case of \textit{Hulse v. Criger}\textsuperscript{36} embodies the modern approach to the problem of unauthorized practice of law by the real estate broker \textit{via} acceptance of the incident-to-business doctrine. The court there held: (1) A real estate broker, in transactions where he is acting as a broker, may fill out standardized forms of contracts, warranty deeds, quitclaim deeds, trust deeds, notes, chattel mortgages and short-term leases, provided the forms were originally drawn or approved by counsel, but the broker may not create certain types of complicated estates; (2) A real estate broker may neither charge for such services, nor render them at all when he is not acting as a broker in the transaction; and (3) even in transactions where the real estate broker is acting as a broker, he may not give legal advice to the parties.\textsuperscript{37} The case completely covers most areas of broker-lawyer conflict and sets up certain workable and definite standards, more so than do most cases in the field. A subsequent case, \textit{Ingham County Bar Ass'n v. Walter Neller Co.},\textsuperscript{38} a very thorough opinion, followed the reasoning of \textit{Hulse} after an examination of most cases in the field. The court in the \textit{Ingham} case refused to stop real estate brokers from preparing legal instruments, and due to public policy considerations stemming from the customary handling of real

\textsuperscript{30} Id. at 248.
\textsuperscript{31} Id. at 249.
\textsuperscript{32} 75 So. 2d 818 (Fla. 1954).
\textsuperscript{33} Id. at 821.
\textsuperscript{34} 315 Pa. 9, 171 Atl. 883 (1934).
\textsuperscript{35} Id. at 885.
\textsuperscript{36} 363 Mo. 26, 247 S.W.2d 855 (1952).
\textsuperscript{37} Id. at 862.
\textsuperscript{38} 342 Mich. 214, 69 N.W.2d 713 (1955).
estate transactions in the state, it termed the plaintiff's claims "unrealistic and impractical." 39

B. Theory Substantially Modified

Several courts in cases involving real estate brokers have accepted the incident-to-business theory, but have limited its application to the initial contract of sale or an offer or acceptance. 40 In Keyes Co. v. Dade County Bar Ass'n, 41 the real estate broker was limited in the drawing of legal instruments "to those, such as a memorandum, deposit receipt, or the contract, as the case may be, recording his handiwork -- that is the bringing together of buyer and seller." 42

A recent case, Arkansas Bar Ass'n v. Block, 43 has gone even further and forbidden the real estate broker from preparing not only all types of deeds, options, easements, notes, leases, mortgages, releases, and legal notices, but also contracts for the sale of realty and loan applications, regardless of whether such instruments are prepared incidental to a brokerage transaction. The reasoning of the court was based on the idea that the practice of law, though difficult to define, included conveyancing, and since the real estate firms were either not licensed to practice law, or corporations which could not be licensed, they were engaged in the unauthorized practice of law. 44 However, simple offers and acceptances were excluded because they contemplate the subsequent preparation of a deed to the property involved, and possible other related instruments, which only a lawyer is competent to prepare. 45 Contracts and agreements for the sale of real estate obviously contemplate the same instruments, and loan applications also contemplate further mortgage papers, but the court felt that the public interest would best be served if these instruments were all drawn by lawyers.

C. Theory Rejected

The incident-to-business theory, as applied to title insurance companies, has often been rejected, 46 but as applied to real estate brokers no court has both completely rejected the theory and also enjoined the practice. 47 The landmark case, which rejected the incident-to-business theory, is Hexter Title & Abstract Co. v. Grievance Comm. 48 An injunction was sought against the title company to

39 Id. at 721.
40 Arkansas Bar Ass'n v. Block, 323 S.W.2d 912, cert. denied, 361 U.S. 836 (Ark. 1959); Keyes Co. v. Dade County Bar Ass'n, 46 So. 2d 605 (Fla. 1950); Commonwealth v. Jones & Robins, 186 Va. 30, 41 S.E.2d 720 (1947); cf. People ex rel. Ill. Bar Ass'n v. Schafer, 404 Ill. 45, 87 N.E.2d 775 (1949), noted at 25 NOTRE DAME LAWYER 367 (1950); Gustafson v. V. G. Taylor & Sons, 139 Ohio St. 392, 35 N.E.2d 435 (1941) (only legal instruments being drawn were simple contracts for the sale of realty).
41 46 So. 2d 605 (Fla. 1950).
42 Id. at 606. This reasoning was refuted in Hulse v. Griger, 363 Mo. 26, 247 S.W.2d 855, 861 (1952), where the court pointed out that the broker has a definite interest in the transaction right up until it is closed, for it is only at this time that he actually receives his commission. "Thus he is personally concerned in the transaction and actually he is acting partly in his own interest in getting a contract signed and the deal closed."
43 323 S.W.2d 912, cert. denied, 361 U.S. 836 (Ark. 1959).
44 Id. at 915.
45 Id. at 916.
47 See, e.g., Conway-Bogue Realty Inv. Co. v. Denver Bar Ass'n, 135 Colo. 398, 312 P.2d 998 (1957), where the court held that drafting of incidental legal papers and giving legal advice constituted the practice of law, but the real estate brokers were not enjoined from such practices because of public policy.
48 142 Tex. 506, 179 S.W.2d 946 (1944).
prevent its staff attorneys from drawing deeds, notes, mortgages, deeds of trust, mechanic liens, releases, and curing defects in titles which it insured but had no direct interest in as a party thereto. Such instruments were drawn in conjunction with the sale by the company of title insurance, and no separate charge was made for the instruments. The Supreme Court of Texas took an adamant stand against such practices, stating:

The work of preparing these papers is distinct from the searching and insuring of the title — the legitimate business for which the corporation is incorporated. It is not the business of the title insurance company to create a good title in an applicant for insurance by preparing the necessary conveyances, nor to cure defects in an existing title ... merely for the purpose of putting the title in condition to be insured. ... It may examine the title, point out the defects, and specify the requirements necessary to meet its demands, but it is the business of the applicant for the insurance to cure the defects.49

The court then went on to point out what would be the effect if corporations and lay agencies were allowed to use legal services as an inducement to purchase the primary service offered:

Ultimately most legal work, other than the trial of cases in the courthouse, could be performed by corporations and others not licensed to practice law. The law practice would be hawked about as a leader or premium to be given as an inducement for business transactions.50

An attempt to get around the result in the Hexter decision by an affiliated law firm was struck down by the Texas court in Rattikin Title Co. v. Grievance Comm.51 Similarly, the courts have disapproved of situations where lawyers have sought to "feed" their law business through wholly-owned real estate firms.52 The danger here is the conflicting interests which the attorney represents, plus the ability of the allied business to advertise the services of the lawyer, something the lawyer cannot do for himself.53

Within the last few years, important decisions concerning title companies have been rendered in Colorado,54 Nevada,55 Arkansas,56 and New Jersey,57 which have followed the Hexter case in rejecting the incident-to-business theory. In the Colorado case the court held that conveyancing was neither necessary nor incidental to insuring titles, and the title companies were enjoined from such practices except where they were direct parties to the transaction.58 The title companies had relied heavily on a statute, which, upon a literal interpretation, granted to them "the power and right to make, execute and perfect" title to real estate.59

The court rejected this reading and said that an interpretation of the statute to permit such activities would render it unconstitutional as authorizing corporations to practice law.

In the Nevada case, Pioneer Title Ins. & Trust Co. v. State Bar,60 the title company, in connection with escrow services it offered to purchasers of title insurance, prepared purchase and sale agreements, deeds, notes, chattel mortgages,

49 Id. at 952.
50 Id. at 953.
52 Hines v. Donovan, 101 N.H. 239, 139 A.2d 884 (1958) (attorney-real estate broker serving as both for client); In re L.R., 7 N.J. 390, 81 A.2d 725 (1951) (realty corporation owned by attorney offered a one-package system).
53 Affiliated businesses are violative of Canon 6 (adverse influences and conflicting interests) and Canon 27 (advertising, direct or indirect) of the Canons of Professional Ethics of the American Bar Association.
60 74 Nev. 186, 326 P.2d 408 (1958).
trust deeds, assignments, escrow agreements and instructions, and bills of sale, which were checked by the company attorney for legal sufficiency. The court did not object to the company's clerical preparation of such instruments or to its competency, but it was concerned with the company's exercise of judgment, through its own attorney, of the legal sufficiency of the instruments. Such action constituted unauthorized practice of law, and the company was enjoined from executing any of the above legal instruments, except purchase and sale agreements and escrow agreements and instructions. An exception to this rule could be made where the public interest by reason of practical necessity required it, either due to a paucity of lawyers, or where the incidental legal services are necessary to the providing of what is essentially lay counselling. It should not be enough that certain legal services can be said to be incidental or reasonably connected. It is not the public convenience in the providing of those legal services with which we are concerned in such a case. Rather it is that the lay services can continue to be effectively given in the public interest.61

The court in Beach Abstract & Guar. Co. v. Bar Ass'n of Ark.,62 in reliance upon the Pioneer decision, completely rejected the idea that conveyancing and curing of title defects was legitimately incidental to the sale of title insurance. The opinion stressed the fact that the public interest required that, in securing professional advice upon legal rights, one is entitled to absolute competency and integrity, which only a lawyer, with his undivided allegiance, can provide.

The most recent case espousing this view is State Bar Ass'n v. Northern N.J. Title Co.,63 where the court found three instances of unauthorized practice of law: (1) The drawing of bonds, mortgages, and mortgagors affidavits of title in transactions wherein the company itself was the mortgagee was enjoined as the practice of law, because the fees paid to the company for search and title abstracting were far in excess of the cost to the title company, and could be fairly interpreted as a separate charge for such services. (2) Filling in blanks in bond and mortgage forms in transactions where the company was acting for other lending agencies was also enjoined, as well as clearing of objections to titles the company insured.

D. Theory Rejected But Activity Not Enjoined

One Colorado case, Conway-Bogue Realty Inv. Co. v. Denver Bar Ass'n64 was unusual because, not only did it completely reject the incident-to-business theory as applied to real estate brokers, but it also refused to enjoin such activity due to public policy considerations. In refusing to enjoin the real estate brokers from preparing contracts for the sale of realty, deeds, deeds of trust and releases, and giving advice as to the legal efficacy of such instruments the court said:

We feel that to grant the injunctive relief requested, thereby denying to the public the right to conduct real estate transactions in the manner in which they have been transacted for over half a century, with apparent satisfaction, and requiring all such transactions to be conducted through lawyers, would not be in the public interest; that the advantages, if any, to be derived by such limitations are outweighed by the convenience now enjoyed by the public in being permitted to choose either their broker or their lawyer to do the acts or render the services which the plaintiffs seek to enjoin.65

The Tennessee Court of Appeals, in a case involving a title company, recently held that public policy required the court to hold that similar practices, while partially constituting the practice of law, were all legitimately inherent in the

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61 Id. at 412.
62 326 S.W.2d 900 (Ark. 1959).
64 135 Colo. 398, 312 P.2d 998 (1957).
65 Id. at 1007.
principle business of the company, and consequently should not be enjoined as the practice of law.\textsuperscript{66}

III. SIMPLE VERSUS COMPLEX

It is often advanced in these cases that the mere clerical filling out of standardized forms or drawing instruments of a generally recognized, stereotyped form, which affect or convey an interest in realty, is not the unauthorized practice of law.\textsuperscript{67} But, if the instrument is to be shaped from a mass of facts and conditions, which must be sorted and examined, it is not a simple instrument and the drafting of such can be enjoined.\textsuperscript{68} The theory received its most significant application in New York, in \textit{People v. Title Guar. & Trust Co.},\textsuperscript{69} where the court refused to enjoin a corporation which was, without giving legal advice, filling in blanks in bills of sale and chattel mortgages for its customers. In another decision, rendered the same day, the Court of Appeals limited this doctrine to those instruments drawn as an incident of the primary business.\textsuperscript{70} The \textit{Title Guarantee} case also contains the strongest support in opposition to the theory, for in a concurring opinion Judge Pound accepted the incident-to-business theory and rejected the majority reasoning saying in an oft-quoted passage: "I am unable to rest any satisfactory test on the distinction between simple and complex instruments. The most complex are simple to the skilled, and the simplest often trouble the inexperienced."\textsuperscript{71} Subsequently the test was repudiated by New York.\textsuperscript{72}

The theory is far from being dead or academic, for it is implicit as a limitation on the incident-to-business doctrine in many of the decisions presently being rendered.\textsuperscript{73}

IV. COMPENSATION

Another ancillary defense, often used with the incident-to-business theory, is the absence of separate compensation.\textsuperscript{74} The payment of separate compensation for the preparation of even incidental legal instruments constitutes unauthorized practice of law.\textsuperscript{75} In one case, where a statute allowed real estate brokers to charge for incidental drafting of legal instruments, this provision was struck down

\begin{thebibliography}{99}
\bibitem{66} Bar Ass'n of Tenn. v. Union Planters Title Guar. Co., 326 S.W.2d 767 (Tenn. Ct. App. 1959).
\bibitem{68} In \textit{re} Eastern Idaho Loan & Trust Co., 49 Ida. 280, 288 Pac. 157 (1930).
\bibitem{69} 227 N.Y. 366, 125 N.E. 666 (1919). \textit{Accord.}, Hulse v. Criger, 363 Mo. 26, 247 S.W.2d 855 (1952); Cowern v. Nelson, 207 Minn. 642, 290 N.W. 795 (1940); In \textit{re} Eastern Idaho Loan & Trust Co., 49 Ida. 280, 288 Pac. 157 (1930). \textit{Contra}, Pioneer Title Ins. & Trust Co. v. State Bar, 74 Nev. 186, 326 P.2d 408 (1958) (the exercise of judgement, not the simplicity or complexity of the service, distinguishes the practice of law); People \textit{ex rel.} III. State Bar Ass'n v. Schafer, 404 Ill. 45, 87 N.E.2d 773 (1949), noted at 25 \textit{Notre Dame Lawyer} 387 (1950); People v. Lawyers Title Corp., 282 N.Y. 513, 27 N.E.2d 30 (1940).
\bibitem{70} People v. Alfani, 227 N.Y. 334, 125 N.E. 671 (1919).
\bibitem{71} People v. Title Guarantee & Trust Co., 227 N.Y. 366, 125 N.E. 666, 670 (1919) (concurring opinion).
\bibitem{72} People v. Lawyers Title Corp., 282 N.Y. 513, 27 N.E.2d 30 (1940).
\bibitem{73} \textit{See, e.g.}, Conway-Bogue Realty Investment Co. v. Denver Bar Ass'n, 135 Colo. 398, 312 P.2d 998 (1957) (any common form instrument used in realty business); Cooperman v. West Coast Title Co., 75 So. 2d 818 (Fla. 1954) (standard form conveyancing).
\bibitem{74} The compensation test has been accepted by the courts as a limitation on the incident-to-business theory; \textit{e.g.}, Conway-Bogue Realty Inv. Co. v. Denver Bar Ass'n, 135 Colo. 398, 312 P.2d 998 (1957); Cooperman v. West Coast Title Co., 75 So. 2d 818 (Fla. 1954). \textit{Contra}, La Brum v. Commonwealth Title Co., 358 Pa. 239, 56 A.2d 246 (1948) (separate compensation permitted) (minority decision).
\bibitem{75} Hulse v. Criger, 363 Mo. 26, 247 S.W.2d 855 (1952); Commonwealth v. Jones & Robins, 186 Va. 30, 41 S.E.2d 720 (1947).
\end{thebibliography}
by the court.\textsuperscript{76} However, statutes which base their test of unauthorized practice of law on whether compensation was charged have not been favorably received by the courts.\textsuperscript{77}

Some courts in cases concerning title companies have held that the consideration does not even have to be a separate charge, but can be inherent in a premium rate charged by the insurer.\textsuperscript{78} In \textit{Hexter Title & Abstract Co. v. Grievance Comm.},\textsuperscript{79} the court adeptly perceived that the drafting of legal instruments was an inducement to employ the title company to insure the title. Furthermore:

\begin{quote}
The furnishing of such legal services constitutes a part of the cost of obtaining the business transacted by the defendant. Evidently it pays, or the practice would be discontinued. . . . There is therefore 'a consideration, reward, or pecuniary benefit' flowing to the defendant for the legal services so rendered.\textsuperscript{80}
\end{quote}

In a recent case which followed this view the court was impressed with the fact that, although no listed charge was made for the incidental drafting of legal papers, a deduction or refund was made to insurers who provided their own attorney for such functions.\textsuperscript{81} And in \textit{State Bar Ass'n v. Northern N.J. Title Co.},\textsuperscript{82} this concept of indirect compensation was extended to include certain legal papers to which the company was a party.

\section{Public Policy}

Since the unauthorized practice of law is said to be an evil, not because it takes business from the lawyer, but because it endangers the personal and property rights of the public, it is important in these cases for the courts to reach a decision which will best serve the public.\textsuperscript{83} This was found by the courts to be one of the primary factors in deciding several recent cases.\textsuperscript{84} Notable among these was \textit{Conway-Bogue Realty Inv. Co. v. Denver Bar Ass'n},\textsuperscript{85} where the facts showed that to enjoin the practices complained of (preparing of contracts, deeds, deeds of trust and releases, and giving legal advice) would be more harmful than beneficial, for in 20 counties in the state there were only 24 lawyers.\textsuperscript{86} Such transactions were often consummated at times when lawyers were not customarily available — evenings, Sundays, and holidays. Furthermore, the court was reluctant to grant an injunction which would change the manner in which the public had been handling their real estate transactions for over a half century.\textsuperscript{87}

One court found a state statute to be determinative of public policy,\textsuperscript{88} while another partially relied upon the statement of principles agreed on between the American Bar Association and the National Association of Real Estate Boards\textsuperscript{89}.

\textsuperscript{76} Cowern v. Nelson, 207 Minn. 642, 290 N.W. 795 (1940).
\textsuperscript{77} See Washington State Bar Ass'n v. Wash. Ass'n of Realtors, 41 Wash. 2d 697, 251 P.2d 619 (1952).
\textsuperscript{78} New Jersey State Bar Ass'n v. Northern N.J. Mortgage Associates, 32 N.J. 430, 161 A.2d 257 (1960); Beach Abstract & Guar. Co. v. Bar Ass'n of Ark., 326 S.W.2d 900 (Ark. 1959); In re Baker, 8 N.J. 321, 85 A.2d 505 (1951); Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 506, 179 S.W.2d 946 (1944).
\textsuperscript{79} 142 Tex. 506, 179 S.W.2d 946 (1944).
\textsuperscript{80} Id. at 952.
\textsuperscript{81} Beach Abstract & Guar. Co. v. Bar Ass'n of Ark., 326 S.W.2d 900, 903 (Ark. 1959).
\textsuperscript{82} 32 N.J. 430, 161 A.2d 257, 264-65 (1960).
\textsuperscript{85} 135 Colo. 398, 312 P.2d 998 (1957).
\textsuperscript{86} Id. at 1001.
\textsuperscript{87} Id. at 1007.
\textsuperscript{88} Cowern v. Nelson, 207 Minn. 642, 290 N.W. 795 (1940).
\textsuperscript{89} The statement is set out in \textit{3 Martindale-Hubbell Law Directory} 128A (1961).
as recognition of the public interest in allowing preparation of incidental legal instruments.\footnote{90}

In most cases, the public policy argument has not been accepted with so much vigor as in the \textit{Conway-Bogue} case. But its effect can be seen in all unauthorized practice of law cases, because the judges alone define practice of law, and even legislative enactments are merely in aid of this jurisdiction. Thus, the judges have had to turn — at least impliedly — to public policy, to help them in their definition of the practice of law.

VI. \textbf{Statutory Regulation}

Several states have enacted statutes which give real estate brokers and title insurance companies the right to draft legal instruments.\footnote{91} The courts have generally refused to approve these exceptions as to title companies, since the companies are mostly corporations and as such may not practice law.\footnote{92} The courts are able to do this because legislative acts relating to the legal profession have no binding effect on the court’s inherent power to regulate and define the practice of law.\footnote{93} But, as for real estate brokers, the exceptions have been approved; one case so held, reasoning that the statute represented public policy.\footnote{94} However, the unfavorable attitude of the New Jersey Supreme Court in \textit{State Bar Ass’n v. Northern N.J. Title Co.}\footnote{95} towards title companies indicates that the state’s statutory exception in favor of real estate brokers may in the future be overruled by the court.

The Texas legislature, drawing upon the inducement or incidental pecuniary benefit concept in the \textit{Hexter} case, enacted in 1949 an amendment to its Real Estate License Act, which provides:

\begin{quote}
Any license granted under the provisions of this Act shall be cancelled . . . upon proof that the licensee, not being licensed and authorized to practice law in this State, for a consideration, reward, pecuniary benefit, present or anticipated, direct or indirect, or in connection with or as a part of his employment, agency, or fiduciary relations, as licensee, draws any deed, note, deed of trust, or will, or any other written instrument, that may transfer or anywise affect the title or interest in land, or advises or counsels any person as to the validity or legal sufficiency of any such instrument above mentioned, or as to the validity of title of real estate.\footnote{96}
\end{quote}  

A literal interpretation of the statute would indicate that real estate brokers are prohibited from even filling in blanks of earnest money contract forms, although they would have the right to prepare offers and acceptances. However, it is doubtful that such an interpretation would be imposed on the brokers, due to the court’s right to define the practice of law, and the almost unanimous recognition by the courts of the convenience and necessity of brokers preparing such preliminary instruments. No other state has by statute attempted to go this far

\footnotesize{\footnote{90} Hulse v. Griger, 363 Mo. 26, 247 S.W.2d 855 (1952).  
\footnote{91} COLO. REV. STAT. ANN. § 31-11-7(1) (1953) (title companies); GA. CODE ANN. § 9-401 (Supp. 1958) (title companies); MINN. STAT. ANN. § 481.02, subd. 3 (1958) (specifically excepts real estate brokers, but title companies may also be excepted under certain conditions); N.J. STAT. ANN. § 2A:170-81 (1953) (title insurance companies and real estate brokers); WIS. STAT. ANN. § 212.02 (1957) (title companies).  
\footnote{92} New Jersey State Bar Ass’n v. Northern N.J. Mortgage Associates, 32 N.J. 430, 161 A.2d 257 (1960); Title Guar. Co. v. Denver Bar Ass’n, 155 Colo. 423, 312 P.2d 1011 (1957); \textit{cf.} Stewart Abstract Co. v. Judicial Comm’n, 131 S.W.2d 686 (Tex. Civ. App. 1939). The insurance commission rate schedule, which provided for fees for drawing the legal papers incident to a sale of title insurance, was held not to authorize practice of law by the title companies. \textit{Contra}, La Bruin v. Commonwealth Title Co., 358 Pa. 239, 56 A.2d 246 (1948).  
\footnote{93} See, \textit{e.g.}, Grievance Comm. v. Dean, 190 S.W.2d 126, 128-29 (Tex. Civ. App. 1945).  
\footnote{94} Cowern v. Nelson, 207 Minn. 642, 290 N.W. 795 (1940) (statute as modified by the court, was accepted as being a declaration of public policy); Morris v. Muller, 113 N.J.L. 46, 172 Atl. 63 (1934).  
\footnote{95} 32 N.J. 430, 161 A.2d 257 (1960).  
\footnote{96} TEX. REV. CIV. STAT. ANN. art. 6573a, § 17 (1960).}
in prohibiting the preparation of incidental legal instruments by the broker. Mississippi, under its real estate licensing law, prohibits the broker from acting as a general conveyancer, although he may use earnest money contracts, "as well as any other standard legal form used by the broker in transacting such business," provided they are approved by the local bar association and real estate board. The statute is based on the statement of principles entered into between the American Bar Association and the National Association of Real Estate Boards, and like the statement itself, is unclear as to exactly what instruments the broker may draw. Most states provide that "improper conduct," which undoubtedly would include unauthorized practice of law, will subject the broker to loss or suspension of his license.

Almost all states have general prohibitory language to the effect that drawing legal instruments by one not licensed to practice law is unauthorized. Most states do not specifically prohibit title insurance companies from practicing law, although they generally have express statutory prohibitions against corporations practicing law. On the other hand, some states have enumerated the powers of title insurance companies; conspicuously absent from these is the right to prepare incidental legal instruments.

Recently a model act providing procedures to aid in halting unauthorized practice of law has been promulgated by the National Conference of Commissioners on Uniform State Laws. The act states that the attorney-general of the state may, upon his own information or a complaint being filed with him, bring an injunctive action against unauthorized practitioners, and any organized bar in the state may intervene. In states, such as Maryland, which prohibit professional associations from conducting litigation which concerns the interests of its members, this law would be of great value.

VII. STATEMENT OF PRINCIPLES

The American Bar Association has formulated statements of principles with several lay organizations, including the National Association of Real Estate Boards, which was achieved by a joint conference of realtors and lawyers in 1942.

Article I, which is the heart of the agreement, provides:

1. The Realtor shall not practice law or give legal advice directly or indirectly; he shall not act as a public conveyancer, nor give (legal) advice or opinions . . . and he shall not . . . discourage . . . employing the services of a lawyer.

2. The Realtor shall not undertake to draw or prepare documents fixing and defining the legal rights of parties to a transaction. However, when acting as broker, a Realtor may use an earnest money contract form for the protection of either party against unreasonable withdrawal from the transaction, provided that such earnest money contract form, as well as any other standard legal forms used by the broker in transacting such business, shall first have been approved and promulgated.

103 Model Act Providing Remedies for the Unauthorized Practice of Law.
104 Id. at § 1.
106 The statement is set out in 3 Martindale-Hubbell Law Directory 128A (1961). The statement is also termed the "Memphis Agreement." Statements have also been formulated with accountants, trust institutions, collection agencies, insurance adjusters, life insurance underwriters, and publishers. 3 Martindale-Hubbell Law Directory 123A (1961).
Article II of the agreement seeks to limit the role of lawyers in real estate transactions, while Article III provides for continued working together by the two organizations.

Previous to the formulation of the statement, lawyers had claimed that real estate brokers could neither draft nor select instruments that affected a right or title to realty, unless the broker was a direct party to the transaction. Brokers, on the other hand, had claimed that they could prepare all legal instruments incidental to their business and render legal advice on them. Thus, the statement was a needed policy delimitation. However, its use by the courts has been quite limited, for only one case has taken judicial notice of the statement. The court there held that the broker could prepare the contract for the sale of realty and also other legal forms, such as warranty deeds and trust deeds, where a standardized legal form was used which had been originally approved or drawn by counsel.

The only legal instrument specifically mentioned in the statement is an "earnest money contract form," but the provision for "other standard legal forms" can be interpreted to mean that the broker may prepare all the necessary instruments to consummate the transaction he has procured. However, a prerequisite of this right is that the forms be approved by both the local bar association and real estate board. The American Bar Association presently claims that, to its knowledge, this has not been done anywhere and hence that real estate brokers do not have the right to prepare any instruments relating to the legal rights of parties to a transaction. Both the American Bar Association and the National Association of Real Estate Boards have sought to establish local joint conference groups, but the result has so far been sporadic. Although agreements such as this are helpful when followed by both sides, they are not binding upon the courts or the parties.

Conclusion

The reasons for judicial favor for real estate brokers, over title insurance companies, in regard to what constitutes unauthorized practice of law, are twofold: First, title companies are usually corporations, and, as such, cannot practice law; this has made it easier for the courts to declare their legal services unauthorized. Second, public policy is on the side of the real estate broker, for in most states the brokers can lay claim to a long-standing practice of drafting simple form instruments, fostered by public convenience and even necessity. In only three states,
Florida,\textsuperscript{116} Virginia\textsuperscript{117} and Arkansas,\textsuperscript{118} have the courts definitely forbidden the real estate broker to consummate the transaction he has arranged. On the other hand, in only three states have title insurance companies been expressly granted this right by the courts.\textsuperscript{119} Although states may enact legislation granting or withholding this right to prepare incidental legal instruments, the final arbiter of what constitutes the unauthorized practice of law is the court.

What constitutes unauthorized practice of law for real estate brokers and title insurance companies cannot be set down in one rule, rather it must be attacked on a case-by-case basis, with primary emphasis on the public interest. However, by reason of practical necessity it can unequivocally be stated that real estate brokers have the right to at least prepare a simple earnest money contract to bind parties they have brought together, provided there is no separate charge for such service. Although this instrument defines the legal rights of parties to a transaction, it only \textit{contemplates} those instruments which will effectuate the actual transfer of title. The public interest, except in extreme cases, is against permitting title companies or real estate brokers to prepare these latter instruments. Both brokers and title companies, unlike the lawyer, have a divided loyalty. Only the lawyer can assure that degree of competency and detachment to which parties to a real estate transaction are entitled.\textsuperscript{120}

\textit{George A. Pelletier, Jr.}

\textsuperscript{116} Keyes Co. v. Dade County Bar Ass'n, 46 So. 2d 605 (Fla. 1950).
\textsuperscript{118} Arkansas Bar Ass'n v. Block, 323 S.W.2d 912, \textit{cert. denied}, 361 U.S. 836 (Ark. 1959).
\textsuperscript{119} Bar Ass'n of Tenn. v. Union Planters Title Guar. Co., 326 S.W.2d 767 (Tenn. Ct. App. 1959); Cooperman v. West Coast Title Co., 75 So. 2d 818 (Fla. 1954); La Brun v. Commonwealth Title Co., 358 Pa. 239, 56 A.2d 246 (1948).