

Promoters, Prospectuses, and Pragmatism: Updating Fiduciary Duties in a Time of Economic Reform

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This article examines the law and economics of promoters' duties. It uses pragmatic philosophy to show how the doctrine developed in an anti-formalistic manner, which conformed to the instrumental goal of informing capital raising. Particularly notable in this respect is the flexible use of the separate legal entity concept. The article shows how promoters' duties form an efficient basis for the reform of the fundraising provisions, in particular for non-public offers by publicly-listed companies, and by small medium enterprises. A series of amendments are proposed in order to achieve that end more effectively, including a schedular approach to disclosure, changes to the role and tenure of the board, secondary default liabilities, a statutory damages action and a more liberal standing rule.

I. INTRODUCTION

Company law is organised around the poles of contract law and fiduciary duties. This antinomy between self interest and selflessness is a continual source of tension. In this country, over the last seventy years, the pendulum has swung towards the 'fiduciary' end, by means of a number of statutory provisions which constrain officers from acting in self interest. In the late 1990s, however, we are conscious of the possibilities of 'regulatory failure', the limits of effective regulation imposed by informational constraints on lawmakers, and the need for regulation to respond to the subjects to which it is directed.¹ These problems motivated the Corporate Law Simplification Taskforce, and its successor, the Corporate Law Economic Reform Program. Regulatory reform of fundraising and disclosure in large and small companies was, amongst other issues, a focus of the Taskforce, and is a priority of the Program.² Overlapping the domain of corporate law, these issues pervaded the recent Wallis Inquiry into the Financial System.³

Law and economics research has shown that the tension between fiduciary duties and contract is less profound than it first appears. By means of a highly instrumental view of doctrine, it suggests that fiduciary duties have an important part to play in the contracting process, although that part can vary significantly with the context. The purpose of this article is to relate this theme to the context of regulatory reform. My subject is the duties of promoters,

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¹ I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992) 4–5.

² See Part II.E.

³ S Wallis (chair), *Financial Systems Inquiry Final Report* (1997).

which, like directors' duties, are fiduciary in characterisation. I construct an analytical framework, based in economics and pragmatism, which explains the evolution of those duties, and clarifies the ends the doctrine serves. One finds that those ends — the disclosure of information which is likely to be underproduced in capital raising — shed illuminating light on the issues of current regulatory reform in capital raising. If one continues this approach a little further, one can redefine a role for the old law in the next century, and show how it might be supplemented to achieve its purposes. Part II develops a pragmatic theory of the fiduciary principle in capital formation. Parts III and IV address the law and economics of promoters' duties, and means by which they might be enhanced to function as a 'first tier' of a mandatory disclosure system. Part V concludes.

II. THE FIDUCIARY PRINCIPLE IN CAPITAL FORMATION

A. Outline of Part

This Part offers a theory of promoters' duties which is pragmatic and anti-formalistic. The immediate object of the inquiry is to clarify the economic and social ends that promoters' duties serve. I explain, first, where pragmatism fits into philosophical debate. By way of illustration, I contrast a pragmatic and a formalistic explanation of promoters' duties. I argue that the fiduciary principle was used for instrumental reasons to compel disclosure of information, and that there is no natural or logical correspondence between the fiduciary principle and promotions. The evolution of the doctrine demonstrates this point. I also address some efficiency arguments about disclosure.

B. Pragmatic Philosophy and the Law

Pragmatism as 'philosophy' does not mean much. This is evident in its attraction to theorists working across the political spectrum. Pragmatic philosophy rejects the dualisms of the Enlightenment between mind and body, object and subject, and the like. Pragmatic analysis of social institutions proceeds in a way which is not grounded, or even interested, in metaphysical foundations. Richard Posner says of early pragmatist thinkers that they:

deemed thought an exertion of will instrumental to some human desire (and we see here the link between pragmatism and utilitarianism). Social institutions — whether science, law, or religion — were the product of shifting human desires rather than of a reality external to those desires.⁴

The concept of 'truth' means little in pragmatic philosophy. However, why people in a society believe something to be true *is* important. Thought and belief are important because they serve needs, not because they approximate a larger external reality. When pragmatism is linked to the study of law, the first

⁴ RA Posner, *Overcoming Law* (1995) 390.

casualty is law's pretensions towards pseudo-scientific formalism.⁵ Formalism regards legal reasoning as a branch of exact inquiry, which produces right answers (in an apodictic sense) to legal questions. A pragmatist repudiates the idea that legal reasoning is defensible by some absolute standard of objectivity or logic. Legal reasoning does not have sound epistemological foundations that enable the objective derivation or application of legal concepts and rules.

An important premise of formalism is the notion that legal rules are fundamentally conceptual — that legal reasoning enables these rules to be derived in much the same way that one derives axioms in Euclidean geometry. By contrast, the pragmatist regards legal rules as instrumental. That is, they serve some purpose. Much of the jurisprudence of the last seventy years has been the further pursuit of these ideas. Pragmatism and economic analysis of law are linked because the latter provides models by which social behaviour can be predicted and controlled. That is, it provides a means for fitting means with ends, in instrumental and consequential fashion.⁶

C. A Pragmatic Theory of Promoters Duties

It is useful to compare formalistic and pragmatic analyses of promoters' duties. A formalistic theory begins with a metaphysical construct: the fiduciary relation. The law recognises certain relations as having particular doctrinal consequences, because they partake of elements common to the abstracted fiduciary construct.⁷ Those common elements determine the legal incidents of that relation. Since the promoter-company relation is an accepted fiduciary relation, one need not engage with the correspondence between the facts of a case, and the fiduciary concept. One need only determine the existence of a promotion.

The fiduciary duty is not a matter of unilateral status but is a bilateral relation between a fiduciary and some beneficiary. Because promoters are presumptive fiduciaries, one is inclined to wonder who the beneficiary actually is. One could either posit a relationship between the promoter and each shareholder, or between the promoter and the company. The former was never likely to be accepted, because, in the case of public share offerings, the identity of the beneficiary would not be ascertainable until much later. Such a floating fiduciary relation no doubt seemed rather messy. Additionally, the promoter-shareholder relation does not fit the fiduciary relation form very well. The fundamental relation between those parties is that of vendor and purchaser.⁸ After allotment neither need have anything to do with the other. Such a relation was unlike the relationship between a trustee and a beneficiary, or between partners, in which long term confidence was important.

⁵ See generally RA Posner, *The Problems of Jurisprudence* (1990).

⁶ Posner, *op cit* (fn 4) 15–16.

⁷ For a critical review of theoretical abstractions of fiduciary duties, see D A DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' [1988] *Duke LJ* 879. DeMott's analysis is decidedly pragmatic.

⁸ The analogy has been recognised: *Erlanger v The New Sombrero Phosphate Co* (1878) 3 App Cas 1218, 1244; *In re Cape Breton Co* (1885) 29 Ch D 795, 808–9.

The alternative means to configure promotion in fiduciary terms is to predicate the existence of a corporate beneficiary. The corporate entity is more germane to characterisation as a beneficiary, because of the analogy of principal and agent. The promoter appears to act on behalf of the company. The discharge of the promoter's agency seems to determine the company's fortunes, for instance, because of the assets the promoter procures for it, the directors appointed, or the contracts entered.⁹

Implicit in this analysis is that the company is an entity. The entity status of the company is a defining feature of Anglo-Australian corporate law, and has the reputation as a central construct of formalism in company law.¹⁰ It is often traced to the House of Lords' decision in *Salomon's case*,¹¹ but its invocation was needed long before that in order to make sense of the promoter's fiduciary relation. However, judges had trouble with the analysis. In promoters' cases, some judges talk of the company in pluralist terms as a 'they',¹² others talk of it in individualistic terms as an 'it'.¹³ Thus, the invocation of the corporate entity proceeded from no clear theory of incorporation — a fatal result for the formalist's claims to apodictic correctness. This indecisive understanding of the corporation in turn made it unclear what the promoter was obliged to do in cases of interested transactions. Was the promoter's duty, in the context of a 'conflicting transaction',¹⁴ an obligation to the company to disclose facts to 'its' independent board, or was it an obligation to disclose the nature of the transaction to the shareholders? If the latter was correct, the problem was to determine the particular shareholders to whom disclosure was to be made — a result that leads back, full circle, to the problems identified when discussing shareholders as the possible object of the duty.¹⁵

Clearly, formalism cannot offer us a theory that explains promoters' duties very well. How does pragmatism fare? A pragmatic theory must establish an end to which the doctrine is adapted. The only meaningful end which does not invite a circular answer is the informing of capital allocation. English industry exploded in the early nineteenth century, especially after the Bubble Act was repealed in 1825. There was a consequent need for capital. There were financial crises during this time, which were linked with frauds by promoters.

⁹ See, eg, *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109, 111.

¹⁰ See, eg, P Ireland, I Grigg-Spall and D Kelly, 'The Conceptual Foundations of Modern Company Law' (1987) 14 *J Law & Soc* 149; R Tomasic and S Bottomley, *Corporations Law in Australia* (1995) 37–9.

¹¹ [1897] AC 22.

¹² *Lindsay Petroleum Co v Hurd* (1874) LR 5 PC 221, 245; *In re British Seamless Paper Box Co* (1874) 17 Ch D 467, 474; *Erlanger v The New Sombrero Phosphate Co* (1878) 3 AC 1218, 1240; *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109, 110; *Emma Silver Mining Co v Grant* (1879) 11 Ch D 918, 936.

¹³ *In re British Seamless Paper Box Co* (1874) 17 Ch D 467, 479; *Erlanger v The New Sombrero Phosphate Co* (1878) 3 AC 1218, 1257; *In Re Olympia Ltd* [1898] 2 Ch 153, 169; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, 426. Observe the overlap in the cases.

¹⁴ The word 'conflicting' presupposes identifiable and ascertainable interests.

¹⁵ If the independent board solution was correct, this also shifts the inquiry, because the law would then have to identify the interests for whom the directors should be acting when testing the legitimacy of their validation of the transaction. I return to these issues in part II.

There were two reactions to these frauds. First, the *Companies Act 1867* and subsequent legislation obliged the disclosure of certain contracts and other details in a prospectus. Second, the fiduciary principle was used to compel similar disclosures.

Affirmative disclosure obligations are unusual in the common law.¹⁶ This is consistent with its motivation by the norms of classical liberal individualism and freedom of contract. However, the judges did not subscribe to these norms dogmatically. Although judges could not simply create affirmative obligations of disclosure in capital raising situations, they could use such doctrinal tools as were available to that end.¹⁷ The fiduciary principle was the obvious one, because it required that a self interested transaction be disclosed to a consenting beneficiary. Hence the development of the idea that a promoter is a fiduciary.

This pragmatic theory, in which promoters' duties developed as a response to extant concerns regarding capital formation, is opposed to the formalist abstraction that the relationship between the promoter and the company is naturally fiduciary. The pragmatic account holds that referring to a 'company' occurs only for instrumental reasons. The company as a legal entity has no interest in company formation, but subscribing shareholders do, as does the general public, given the efficiency consequences of capital allocation. Part III shows that the doctrine sustains the pragmatic account.

D. Economic Analysis — and an Alternative Treatment

The pragmatic theory advanced can be examined using economic analysis and relational contract theory. A fiduciary duty prohibits the fiduciary's right to maintain a personal interest which conflicts with the interest of the person owed the duty. Economists have shown how the duty suits the difficulties of contracting in the context of long term relationships, particularly those in which one party is conferred with an open ended discretion.¹⁸ In these relationships, often generically described as ones of *agency*, the 'principal' is faced with the difficulty of observing and controlling the manner in which the 'agent' exercises discretion.¹⁹ Given the high costs of specifying and enforcing contractual controls on an agent in a long term relationship, the formal contract will often be incompletely specified. The fiduciary duty supplements the formal contract by supplying a standard which fashions prohibitions as

¹⁶ Cf P Drahos and S Parker, 'Critical Contract Law in Australia' (1990) 3 JCL 30, 39; A Duggan, M Bryan and F Hanks, *Contractual Nondisclosure: An Applied Study in Modern Contract Theory* (1994) 5, 9.

¹⁷ *Bagnall v Carlton* (1877) 6 Ch D 371, 403.

¹⁸ See, eg, R Cooter and B Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 NYULR 1045; F H Easterbrook and D R Fischel, 'Contract and Fiduciary Duty' (1993) 36 *J L & Econ* 425.

¹⁹ M C Jensen and W H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *J Fin Econ* 305.

factual circumstances arise which create conflicting interests for the agent.²⁰ Two relationships in which fiduciary doctrine has been pervasive — those of director and company (representing shareholders' interests), and trustee and beneficiary — support this characterisation. In these relationships, the forms which opportunism by the agent (the trustee or director) might take are impossible to prohibit comprehensively by contract, given the range of the agents' responsibilities.²¹ In addition, those relationships lack opportunities for renegotiation, unlike, say, a loan, at which time the parties might 'settle up' in relation to opportunism.²²

The contract between shareholders and directors can be regarded as *relational*. Relational contract theory developed as a reaction to the formalistic premise that contracts are completely promissory. That is, exchange is referable only to the promises made at the time the contract is entered. Relational contract theory asserted that promise was not the only means by which exchange was projected into the future. In relational contracts, the specification of terms of exchange *ex ante* is often less important than establishing processes by which matters of exchange can be resolved on an ongoing, dynamic basis.²³

By contrast, the promoter-shareholder relationship culminates in a well defined, *discrete* exchange — the promoter sells residual claims in return for the investors money. There is only one important issue in these circumstances, and that is whether the promoter is selling something that is overpriced or not. Cotton LJ once described the promoter as being obliged not to make a profit secretly, and went on to say, 'I put it in that way rather than say anything about promoters being in a fiduciary position; because, although I quite concur in that, it is open to this observation, that they are not trustees as regards all matters nor at all times . . .'²⁴ The overpricing issue is different to the agency problems that the fiduciary duty is directed to. The fiduciary duty normally addresses the variety of opportunistic misuses of an open ended discretion. It very rarely applies to relatively discrete exchanges, simply because discreteness implies that exchange is not significantly projected into the future. Thus, there is no discretion capable of opportunistic misuse.²⁵

²⁰ The primary question a contractual theory of fiduciary duties poses is the extent to which the fiduciary obligation is susceptible to contractual variation: for varying analyses, see H D Butler and L E Ribstein, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65 *Wash L R* 1; J C Coffee, 'The Mandatory/ Enabling Balance in Corporate Law: An Essay on the Judicial Role' (1989) 89 *Colum LR* 1618; Easterbrook and Fischel, loc cit (fn 18); M J Whincop, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Law' (1997) 21 *MULR* 187. For further analysis, see Part IV.c.

²¹ Easterbrook and Fischel, loc cit (fn 18); J H Langbein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 *Yale LJ* 625.

²² O E Williamson, *The Economic Institutions of Capitalism* (1986) 304–6; E F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *J Pol Econ* 288.

²³ I R Macneil, 'Contracts: Adjustments of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law' (1978) 72 *NWULR* 854.

²⁴ *Bagnall v Carlton* (1877) 6 Ch D 371, 407.

²⁵ The only exception is where the promoter is permitted to function in management after capital formation. The law has regarded the promoter as continuing to be subject to fiduciary duties: *Twycross v Grant* (1877) 2 CPD 469, 541; *Emma Silver Mining Company Ltd v Lewis* (1879) 4 CPD 396, 407–8. That conclusion is unsurprising, given

This argument is confirmed by the lack of application of fiduciary duties to transactions for sale. We have seen that the law rarely obliges a vendor to disclose facts concerning the value of the thing sold.²⁶ In the context of transactions for the purchase of shares by directors from shareholders, the law has rarely imposed a duty of disclosure on the party.²⁷ With one exception,²⁸ the cases in Anglo-Australian law where the duty was recognised were decided in the last ten years.²⁹ This buy-out transaction is the logical opposite of the transaction involved in capital formation. In one case, the promoter sells residual claims in business assets; in the other case, the insider buys residual claims; in both cases, the promoter/insider will know information the other party does not know, and will derive profits from buying at a lower, or selling at a higher, price. Yet, historically, the law has treated the two situations in very different ways. The most likely explanation for a distinction is this: The shareholder, qua shareholder, has various rights to receive information about the company in the form of financial statements. There are no similar entitlements in the capital formation context, and the lack of an existing market in those securities implies the lack of an existing market for information about that company.³⁰ Hence, the greater need for a disclosure obligation.

Paul Mahoney raises a contrasting argument — mandatory disclosure is efficient because it addresses agency problems that arise between promoters and investors, and managers and shareholders.³¹ Mahoney's analysis is in some respects similar to my own; he supports mandatory disclosure oriented towards disclosing a promoter's interest, which I also support. Elsewhere, however, I have problems with his arguments. Mahoney assumes uncritically that the promoter is an agent, the agency problem being the ability

to sell property and services to the company without any arm's length bargaining or independent scrutiny. The problem is not merely that a better-informed party sells without disclosing what he knows about the sold items.

the promoters position becomes, at that point, substantially similar to a directorship. In the *Emma Silver Mining* case, the court said (at 407) that 'a person not a director may be a promoter of a company which is already incorporated, but the capital of which has not been taken up'. This emphasis on capital raising confirms the thesis in this article.

²⁶ See text accompanying n 16 supra. The only cases where that obligation relevantly arises is in the context of a pre-existing relationship which is itself fiduciary or, perhaps, where the relationship is characterised by trust and confidence: Duggan et al, op cit (fn 16) 179–89. Cf MJ Whincop, 'Precontractual Disclosure by the Insiders of Closely Held Corporations: The Economics of Restrained Self Interest' (1997) 11 JCL 177, 197–8.

²⁷ S Bottomley, 'New Directions in Corporate Governance for Small Proprietary Companies?' (1997) 7 Aust JCL 275; J Lawrence, 'The Coleman v Myers Fiduciary Relationship: An Australian Resurgence' (1996) 14 C & S LJ 428; Whincop, loc cit (fn 26).

²⁸ *Allen v Hyatt* (1914) 30 TLR 444. There was a supervening fiduciary relation in that case (agency).

²⁹ *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACLC 895 (duty recognised but not breached); *Glavanics v Brunninghausen* (1996) 19 ACSR 204 (duty breached). See also *Coleman v Myers* [1977] 2 NZLR 225.

³⁰ R Gilson and R Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Va L Rev 549, 592–613.

³¹ P G Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 U Chi LR 1047.

Rather, it is that the directors may not be, as the investors have a right to expect, faithful agents of the investors.³²

That problem apparently justifies the promoters' fiduciary duty (as well as statutory disclosure measures). The difficulty with this argument, as Part III shows, is partially historical. By 1900, courts recognised that there was no duty to appoint an independent board. Provided the disclosure duty was discharged, and the promoter did not exert any continuing influence over the company,³³ his or her duties were at an end. Agency problems concerning independence and the absence of conflicts were therefore subsumed within the disclosure issue. It is in this sense that Mahoney's description of this exchange as an agency relationship, rather than as a relatively discrete exchange to which a disclosure duty applies, is unappealing. It shows how even a law and economics argument can be influenced by formalism, such that Mahoney reasons in reverse from fiduciary duties to agency relations to agency costs, rather than starting with an apparent underproduction of information concerning asset overvaluation in exchange, and reasoning instrumentally towards disclosure obligations and fiduciary duties.

In a similar way, Mahoney's distinction between disclosure as a solution to agency problems, and as a solution to investor protection, is a false one. As lawyer-economists have asserted, the key question in corporate contracts is whether agency costs have been priced.³⁴ That is, are the welfare losses of the agency relationship reflected in the price the principal pays? The 'agency costs' in capital formation to which Mahoney refers, and to which promoters' duties respond, relate exclusively to the overvaluation of the assets the promoter is selling. The prohibition on secret profits forces the promoter to disclose how much of the issue proceeds is profit, and which persons are receiving it. There may be valid questions relating to whether ongoing corporate governance structures (including the duties of directors) are priced,³⁵ but in the capital formation context, the distinction between agency problems and security pricing dissolves. That conclusion is not changed by Mahoney's demonstration that early disclosure legislation focused on the promoter's interests, rather than all material information about the business. That observation is better explained by the greater efficiency of such a disclosure obligation, which Mahoney demonstrates. This efficiency issue is taken up in section E.

³² Id 1053.

³³ See fn 25 supra.

³⁴ See, eg, F H Easterbrook and D R Fischel, *The Economic Structure of Corporate Law* (1991) 17–22.

³⁵ Cf J C Coffee, Jr, 'No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies' (1988) 53 *Bro L Rev* 919.

E. Disclosure, Efficiency, and Australian Reform

Mandatory disclosure has long been controversial.³⁶ These controversies have been compounded by the lack of empirical evidence of a statistically significant relation between the cost of mandatory disclosure requirements and security returns.³⁷ However, the significance of mandatory disclosure may not be by way of security returns, but because it subsidises informed trading.³⁸ The market microstructure literature shows that informed traders are the primary engine for an efficient capital market.³⁹ Competitive informed trades cause security prices to move towards their unbiased value, as information becomes available. However, that says nothing about disclosure by companies whose securities are not traded. These points coincide with the criticisms of the inefficiency of the prospectus regime, generally and in its application to small and medium enterprises (SMEs) in Australia.⁴⁰

The need to reform capital raising law has been recognised widely. Clarificatory changes were proposed by the Corporate Law Simplification Task Force.⁴¹ The Corporate Law Economic Reform Program ("CLERP") has proposed a wider series of reforms.⁴² These were foreshadowed in the Liberal and National Parties' policies on small business at the 1996 federal election,⁴³ and by recommendations of the Wallis Inquiry.⁴⁴ CLERP's main proposals are, first, to retain the general disclosure standard in s 1022, and (with minor

³⁶ Although it is customary to begin critiques of disclosure legislation with the debates between Stigler, Friend, and Benston, they merely renewed an earlier disagreement between appellate judges in the nineteenth century in England: *Twycross v Grant* (1877) 2 CPD 469, where one judge criticised the legislation as 'paternal' (at 498, per Bramwell LJ), while another welcomed it as 'beneficial' (at 530, per Cockburn CJ). For a review of recent debate in Australia, see G Herder, 'Corporate Finance Theory and the Australian Prospectus Legislation' (1995) 7 *Corp & Bus LJ* 181; J Azzi, 'Disclosure in Prospectuses' (1991) 9 *C & S LJ* 205; M Blair and I M Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in G Walker and B Fisse, 'Securities Regulation in Australia and New Zealand' (1994) 264.

³⁷ See generally I M Ramsay and B Sidhu, 'Underpricing of Initial Public Offerings and Due Diligence Costs: An Empirical Investigation' (1995) 13 *C & SLJ* 186. Mandatory disclosure may nonetheless have value, especially for securities in less traded companies: C Simon, 'The Effect of the Securities Act on Investor Information and the Performance of New Issues' (1989) 79 *Amer Econ Rev* 295.

³⁸ Gilson and Kraakman, op cit (fn 30) 636-42; N Georgakopoulos, 'Why Should Disclosure Rules Subsidize Informed Traders?' (1996) 16 *IRLE* 417.

³⁹ N Georgakopoulos, 'Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation' (1993) 26 *Con LR* 1; N Georgakopoulos, 'Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud' (1995) 49 *U Miami LR* 671 ('Georgakopoulos, *Fraud-on-the-Market*').

⁴⁰ National Investment Council and Marsden Jacobs Associates, *Financing Growth: Policy Options to Improve the Flow of Capital to Australia's Small and Medium Enterprises* (1995).

⁴¹ Corporate Law Simplification Task Force, *Proposal on Fundraising & Trade Practices Act, s 52 and Securities Dealings* (1995).

⁴² Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment* (Paper No 2, 1997).

⁴³ Liberal and National Parties, *A New Deal For Small Business: The Coalition's Small Business Policy* (1996). Cf M J Whincop, 'Due Diligence in SME Fundraising: Reform Choices, Economics and Empiricism' (1996) 19 *UNSWLJ* 433.

⁴⁴ Wallis, op cit (fn 3), ch 7.

changes) the exemptions for personal offers and 'gold card' investors.⁴⁵ The general test is preferred to checklist disclosure. Second, it proposes that a corporation⁴⁶ may raise up to \$5 000 000 once in its life by means of an "offer information statement". This 'OIS' would require the inclusion of audited accounts, information about the company's business and the likely application of the finance. Disclosure obligations are limited to information 'known to the corporation'; that is, in effect, there is no obligation to undertake due diligence. Rights issues are treated in much the same way as they presently are under the combined provisions relating to continuous disclosure and transaction specific prospectuses. Third, as per the Wallis recommendations, CLERP proposes to rationalise under the due diligence rubric the defences available to potential defendants. Fourth, it limits the persons with general liability for the disclosure obligations to the corporation, its directors, and the underwriters. Experts only have liability for their own statements. Significantly, promoters are no longer to have *any* liability.

The difficulty with the CLERP approach, like the regime it proposes to amend, is that it takes an all-or-nothing approach. It is premised on the soundness of a general disclosure obligation, qualified by an ability to define efficient exemptions where there is no disclosure obligation. Thus, the issue for SME financing is when it should fall within an exemption. This paper seeks to transcend the debate by offering an updated version of the promoters' duty as a generally applicable duty of disclosure relating to a smaller subset of information. There are sound theoretical reasons for believing that this subset is one which is efficient, because of its verifiability and because it is likely to be of interest to all purchasers of securities. Other information (especially forward looking information) is left to private ordering.⁴⁷

Undoubtedly, firms would voluntarily disclose much of the information that mandatory disclosure statutes direct, and there are private law means by which firms might attempt to make the disclosure credible (for instance, by the verification of an expert, who bonds his or her analysis with reputational capital). One of the key concepts is *unravelling*. That is, firms which do not make certain disclosures, or which do not bond the quality of the disclosure, signal that the disclosure is adverse, or is of low quality. For instance, one can show that provided B knows how many apples are in a box that B is selling, and A knows that B knows the number, A will not pay for more apples than are in the box, and B will certify the number.⁴⁸ However, although an investor can be reliably certain that the promoter is making some sort of profit from the promotion, the number and identity of those sources will not be clear.⁴⁹ If one

⁴⁵ Curiously, the gold card exemption is widened, by allowing "the rich" (those whose gross income averages in excess of \$250000, or who have net assets of \$2500000) to invest without a prospectus. See *Corporate Law Economic Reform Bill* 1998, s 708(8).

⁴⁶ There is nothing in the text of the *Corporate Law Economic Reform Bill* which limits the use of OIS to SMEs: see s 709(4).

⁴⁷ The CLERP proposals sketch occasional bows towards "market forces": see *op cit* (fn 42), 18, 23. However, the proposals never recognise that market forces compel the disclosure of much of the information mandated by the general disclosure obligation.

⁴⁸ See D Baird, R Gertner and R Picker, *Game Theory and the Law* (1995) 89 ff.

⁴⁹ See, eg, *Gluckstein v Barnes* [1900] AC 240.

is disclosed, but not the others, that fact will not be unravelled unless it is costless to verify the absence of other sources.

There is supporting evidence of capital market inefficiency even in the context of traded securities.⁵⁰ This suggests that the market does not process information as efficiently as might make one sanguine about dropping disclosure requirements altogether for SMEs. The nineteenth century promoters' cases are anecdotal testimony to the overpricing of securities when promoters' interests are not disclosed.

The information a promoter must disclose under the 'fiduciary' duty is of a sort that can be regarded as relevant to all investors.⁵¹ The value of company assets is difficult to verify, even by historical cost accounting, given the possibility of 'loading' through sales from associates. Investors would therefore be interested in the last arm's-length sale price of the asset, and the quantum and distribution of the profits from the promotion, as information which is important to judge the veracity of the financial statements. By requiring the disclosure of what is essentially historical information, the discharge of the duty is inexpensive for a court to verify, compared with more universal disclosure obligations.⁵² Promoters, duties require disclosure of a type of information which should be costlessly available to a promoter: his or her interests. Therefore, they do not need to assume any implicit model of information production and verification, compared with, for instance, due diligence defences in prospectus provisions. Thus, as Mahoney also argues, promoters' duties make a logical legal rule compelling disclosure.⁵³

Given the very long history of promoters' duties, it would make sense to retain them as a 'mandatory core' legal rule applicable to fundraising even where fundraising is exempt from a prospectus obligation. On the other hand, we should not forget the implications of our pragmatic theory that fiduciary duties were used in the absence of something better. There may be, and I shall argue that there are, various anomalies attributable to the imperfect fiduciary analogy which could usefully be modified. The remainder of the article describes the content, evolution, and possible reform of promoters' duties.

⁵⁰ T Loughran and J Ritter, 'The New Issues Puzzle' (1995) 50 *J Fin* 23 (US evidence that securities offered in IPOs are overpriced); P Lee, S Taylor and T Walter, 'Australian IPO Pricing in the Short and Long Run' (1996) 7 *J B & F* 1189 (Australian evidence of same).

⁵¹ Cf B Black, 'Is Corporate Law Trivial?: A Political and Economic Analysis' (1990) 84 *NWULR* 542, 552-3.

⁵² See, eg, Easterbrook and Fischel, *op cit* (fn 34), 305-6.

⁵³ Mahoney, *op cit* (fn 31), 1090-3.

III. THE TRANSFORMATION OF A DUTY

A. Outline of Part

The last part argued that promoters' duties imperfectly adapt the fiduciary principle to the needs of capital formation. The imperfect adaptation complicates the identification of a beneficiary, as a means of giving content to the duty to act in that beneficiary's best interests. I have already outlined a tension between the shareholders and a separate, incorporated legal entity as the possible beneficiaries. This Part analyses this question in more detail. The resolution confirms the pragmatic quality of the jurisprudence, while raising some important related issues for economic analysis and possible reform.

B. The Separate Legal Entity Paradox

This section examines the influence of the separate legal entity concept on the promoters obligation. An important conclusion of this part is that *Salomon's* case, the case which in Anglo-Australian law is identified as the key authority concerning the separate legal entity, actually assisted a move in the doctrine towards the *shareholders*, not the entity, as the touchstone of the duty's content. This paradox destroys a formalistic theory of the separate legal entity, but it can be rationalised in pragmatic terms.

The milestones in the development of the law are the decisions of the House of Lords in *Erlanger v The New Sombrero Phosphate Co*⁵⁴ and *Gluckstein v Barnes*.⁵⁵ In both cases, a syndicate acquired property, which was sold to a company. In *Erlanger*, the syndicate did not disclose the interest of the promoters. In *Gluckstein*, the promoters did not disclose the profit on the acquisition of certain securities.⁵⁶ In neither case was there an effective or independent board. In *Erlanger*, the company sought rescission; in *Gluckstein*, the company sought an account of profits. The company succeeded in both cases. In *Erlanger*, the strongest theme that emerged was the need for the promoters' transaction to have the imprimatur of an independent board. Lord Penzance, for instance, said that:

Placed in this position of unfair advantage over the company which they were about to create, [the promoters] were . . . bound according to the principles constantly acted upon in the Courts of Equity, if they wished to make a valid contract of sale to the company, to nominate independent directors and fully disclose the material facts.⁵⁷

By contrast, Lord Hatherley stated that the sale of the assets to the company might have been valid had the promoters' interests been 'fully and fairly disclosed by the prospectus to everybody concerned, especially to the persons

⁵⁴ (1878) 3 AC 1218 (*Erlanger*).

⁵⁵ [1900] AC 240 (*Gluckstein*).

⁵⁶ Namely, those over the property that they sold to the company.

⁵⁷ (1878) 3 AC 1218, 1229. *Accord*, Lord Cairns LC (1236), Lord O'Hagan (1256), Lord Gordon (1284).

who were to be formed into a company'.⁵⁸ This approach conceives disclosure to shareholders as an alternative means by which a promoter might sustain a bargain. It equates the company with its shareholders. This contrasts with the entity approach of the other Lords: the promoter has an unfair advantage over the company, and must supply it with an independent executive, as its primary decision making body. Exchange is reconceived as dependency.

In the quarter of a century between the decisions, law and society did not stand still. Capital became shorter in supply, and economic growth in England slowed.⁵⁹ Meanwhile, *Salomon's* case documented a trend towards wider and more flexible use of the corporate form for private ordering. That flexibility is reflected in the cases. The Court of Appeal decisions in *Re Ambrose Lake Tin and Copper Mining Co; ex parte Taylor and Moss*,⁶⁰ and *Re British Seamless Paper Box Co*⁶¹ diminished the significance of entity conceptions. Both cases involved the sale of overpriced assets to a company without an independent board of directors. The court held in both cases that there had been no breach of promoters' duties, primarily because the profit made by the promoters was known to the shareholders — the promoters were the shareholders. In both cases, but particularly in *Re British Seamless Paper Box Co*, the analysis of the shareholders to whom disclosure must be made was sophisticated. Where the transaction was a prelude to going public, the approval of the shareholders for the time being would not suffice. There would have to be disclosure to the investors.⁶² Instrumentalism begins to dominate formalism.

On the other hand, these cases suggest a limitation of fiduciary analysis. Subsequent allotments or sales of shares do not invoke the promoters' duty, which applies only to transactions connected with an initial allotment of shares. A fiduciary duty can only really be implicated once, at the time of the transaction between the company and the promoter, whereas the need for disclosure obligations depends on the time of capital formation.

Reflecting the analysis in the earlier Court of Appeal decisions, *Salomon's* case⁶³ confirmed that there were comparatively few things the company could not be used for, provided due procedure was observed. There is a tradition of explaining this in formalistic terms, that is, a corporation was formed, and took on entity status, so entitling it to do various things, such as to enter contracts. On the other hand, it is just as easy to explain it as a use of corporate form as a means of facilitating private ordering. The separate legal entity status thus serves instrumental, pragmatic purposes. That the latter is the preferable explanation is confirmed by the relevance of the promoter issue to

⁵⁸ Id 1245. Lord Selborne seems to make a similar point as part of his analysis of the question of acquiescence (id 1262). Lord Blackburn also did not limit the possible means of validating the bargain (ibid, 1270). A similar approach to Lord Hatherley's was taken in the Court of Appeal: (1877) 5 Ch D 73, 113 (per Jessel MR), 123 (per Baggallay LJ).

⁵⁹ J Gold, 'The Liability of Promoters for Secret Profits in English Law' (1943) 5 *U Tor LJ* 20, 23–4.

⁶⁰ (1880) 14 Ch D 390.

⁶¹ (1881) 17 Ch D 467.

⁶² (1880) 14 Ch D 390, 397; (1881) 17 Ch D 467, 474, 477–8.

⁶³ [1897] AC 22; followed *Attorney-General (Canada) v Standard Trust Company of New York* [1911] AC 498, 505.

the case. There, the House of Lords rejected the conclusion that there had been any equitable fraud in the possible overpriced sale of Salomon's business to the company, on the basis that all shareholders knew and affirmed the transaction.⁶⁴ Unlike the earlier Court of Appeal cases discussed, there were no subsequent allottees or transferees of shares. Lord Lindley MR said in *Lagunas Nitrate Co v Lagunas Syndicate*⁶⁵ that it was impossible, after *Salomon*, to hold that an independent board was *required* as a means of sustaining a transaction in which the promoter had a conflicting interest.⁶⁶

In *Gluckstein v Barnes*, the promoters were held to be in breach of duty in both the Court of Appeal⁶⁷ and the House of Lords. In the House of Lords, the two lines of authority concerning independent boards and shareholder disclosure were finally drawn together. Lord Robertson said that, 'if by his own act, the promoter has weakened, or, as here, has annulled the directorate, his case on disclosure becomes extremely arduous — for he has to make out such disclosure to shareholders as makes directors unnecessary'.⁶⁸ Thus, the independent board and shareholder disclosure are alternatives. If a promoter does not establish an independent board, the disclosure obligation becomes more intense. The persons to whom disclosure must be made depend on the persons who will become shareholders. The reasoning in *Gluckstein v Barnes* also resonates in the later decision of the Court of Appeal in *Re Leeds and Hanley Theatres of Varieties Ltd.*⁶⁹ That case fitted the usual factual template, although the directors were not promoters but their nominees. The orientation of shareholders as being the objects of the promoters' duties is even stronger.⁷⁰

The movements of the doctrine on promoters' duties track its justification as the means by which disclosure is mandated in capital formation. The flexible invocation of the corporate entity does not fit at all well with the usual formalistic explanation of the corporate veil. The company is *not* treated as an entity in its own right, separate from its shareholders, officers and others, which is capable of contracting with them. The courts gradually equated the so-called corporate entity with its shareholders. More importantly, the identity of the shareholders to whom disclosure must be made depends on the promoters' plans. This ensures that the disclosure obligation serves its purpose.

The corporate entity's role in the doctrine actually serves a larger theme of the corporation-as-contract. In a case such as *Salomon*, it facilitated

⁶⁴ [1897] AC 22, 57.

⁶⁵ [1899] 2 Ch 392 ('*Lagunas*').

⁶⁶ Id 425. Lord Lindley said that relief in *Erlanger* was justified because the partiality of the board had not been disclosed. This was a novel reinterpretation.

⁶⁷ Sub nom *Re Olympia Ltd* [1898] 2 Ch 153, 170, 172, 174–7. Of particular note are the comments of Collins LJ concerning the ability to excuse any breach, based on the knowledge of the company's shareholders. Collins LJ invoked the analysis of Jessel MR in *Re British Seamless Paper Box* to hold that the company embraced 'all the persons who are to be contemplated as about to become shareholders.' (id 175)

⁶⁸ Cf *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109, 110 ('The company bought with their eyes open as to the price.')

⁶⁹ [1902] 2 Ch 809.

⁷⁰ Id 823, 832. See also *In re Darby ex parte Brougham* [1911] 1 KB 95, 103.

proprietors contracting with their creditors on terms of limited liability, so 'expanding' the choice of contractual terms available to these contracts.⁷¹ The promoters' cases supplied legal principles which facilitated the contracting process involved in capital formation by increasing the supply of information in a context where that information would likely be underproduced, and by decreasing transaction costs.

C. Standing to Enforce Promoters' Duties — The Entity Concept Revisited

1. *The Proper Plaintiff Rule*

Despite the expansive instrumental interpretations of the 'company' in these cases, the cases seem to assume that the company is the proper plaintiff to enforce any breach of duty.⁷² This point has been particularly controversial in the context of directors' duties. The need to reform the proper plaintiff rule, deriving from *Foss v Harbottle*, has been a premise of much of modern discussion of corporate rights and duties, and their enforcement.⁷³ Those who refer to 'problems' with *Foss v Harbottle* make certain assumptions about the control of the company. Control often changes after a share offering. If control changes, fewer difficulties arise from conferring the duty on the company, as the promoter and any board he or she appoints may no longer be in control of the company. The moral hazard problems ascribed to the proper plaintiff rule in *Foss v Harbottle* would not apply.

There are some practical justifications for the proper plaintiff rule in this context. The primary reason for reifying a corporate plaintiff is the changing aspect of the company's membership. Historically, most promoters' cases involved companies whose shares were to be tradeable. Fixing rights of action on the shareholder poses difficulty in identifying the point in time at which the plaintiff must have been a shareholder. Should it be when the offering is made, when the action is brought, or when judgment is given?⁷⁴ Such a jus-

⁷¹ M J Whincop, 'Overcoming Corporate Law: Instrumentalism, Pragmatism and the Separate Legal Entity Concept' (1997) 15 *C & S LJ* 411 at 417–21. See generally C Goetz and R Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms' (1985) 73 *Calif L Rev* 261.

⁷² The leading cases on the proper plaintiff rule, *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189 and *Burland v Earle* [1902] AC 83, involved promoters' duties.

⁷³ See, eg, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989); Companies & Securities Law Reform Commission, *Company Directors and Officers: Indemnification, Relief and Insurance* (1990); Companies & Securities Law Reform Commission, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (1990); House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991); Attorney-General (Cth), *Proceedings on Behalf of a Company (Statutory Derivative Action) Draft Provisions and Commentary* (1995).

⁷⁴ J C Coffee and D Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Colum LR* 261, 303. Cf Easterbrook and Fischel, *op cit* (fn 34), 322.

tification for a corporate plaintiff is offered by Rigby LJ in the *Lagunas* case.⁷⁵

A corporate plaintiff also permits capital formation to proceed by means of the 'independent board', which the later cases preserve as an alternative, although not as a requirement. If the duty was owed directly to the shareholders, that option would not be available. Nonetheless, it is important to think about standing in instrumental terms for the purposes of possible reform. When I turn to remedies in Part IV, I shall note the problems with the historical approach taken by equity courts. The rethinking of remedies compels the reworking of standing.

2. Application & Scope of Promoters' Duties

Related to the question of standing are the circumstances where the duty actually arises. Because of the proximity of the separate legal entity concept, the application of promoters' duties is directed towards the newly established company.⁷⁶ However, many security offerings will not necessarily fit that profile. The company may operate for years before it seeks external financing. Promoters' duties may therefore have no effect.⁷⁷ The cases studied above do not demonstrate any clear conceptual apparatus for determining when there must be disclosure to 'subsequent' investors as a precondition to a valid promoter's bargain.⁷⁸ Yet there is no substantial difference, as regards disclosure, between the private company seeking external funding and the archetypal promotion. Both involve the sale of residual claims. The only difference is that there *may* be fewer conflicting transactions to disclose in the established company situation, although that is uncertain.

I propose an updated promoters' duty as a generally applicable first tier of fundraising. A more extensive prospectus model would be the second tier. The second tier prospectus provisions should apply to companies that are, or by a share issue, will become, publicly traded. As noted above, such disclosure subsidises informed trading, and therefore share market efficiency. Prospectus disclosure should only apply where there is an 'offer to the public', as that term was used in the old legislation. Thus, a rights issue or a private placement would be a first tier issue, but an initial public offering would be a second tier. This distinction corresponds not only with the current law as approved by CLERP,⁷⁹ but with the issues which are substantially overpriced.⁸⁰ The first tier would also apply generally to companies whose securities are not traded,

⁷⁵ [1899] 2 Ch 392, 449 (dissenting on other grounds). To similar effect, see *Hichens v Congreve* (1831) 4 Sim 420, 428–9 and *Elders Trustee and Executor Co Ltd v E G Reeves Pty Ltd* (1987) 78 ALR 193, 222.

⁷⁶ *Elders Trustee and Executor Co Ltd v E G Reeves Pty Ltd* (1987) 78 ALR 193, 234.

⁷⁷ See, eg, *Re Coal Economising Gas Company (Govers case)* (1875) 1 Ch D 182.

⁷⁸ See especially *In re Ambrose Lake Tin and Copper Mining Co ex parte Taylor* (1880) 14 Ch D 390; *Re British Seamless Paper Box Co* (1881) 17 Ch D 467. See *supra* text accompanying fns 60–61.

⁷⁹ Corporate Law Economic Reform Program, *op cit* (fn 42), 28–30.

⁸⁰ See *supra* fn 50.

including SMEs.⁸¹ The use of a smaller subset of mandatory disclosures follows from our lack of knowledge about the financing practices of, and contractual arrangements used in, SMEs.⁸²

D. The 'Independent Board'

1. A Doctrinal Aberration?

We saw above that earlier decisions, such as *Erlanger*, required a promoter to establish an independent board to enable the company to make decisions concerning the transactions proposed by the promoter. Over time, that requirement was transmuted into an alternative to a disclosure obligation. Yet, that alternative obligation is the subject of remarkably little law. One case referred to above, *Lagunas Nitrate Co v Lagunas Syndicate*,⁸³ places the issue in an interesting, indeed perplexing, light.

The case involved the promotion of one company by another. The expressed object of the former was to acquire a nitrate business from the latter. The articles of the company indicated that it had been formed for that purpose, and that its directors were associated with the promoting company. Prior to flotation, the company's board ratified a contract for the purchase of the business at a price that was more than seven times the amount paid by the promoting company some years before. The prospectus did not disclose that price. The business was conducted for a time thereafter with some success. After the board came under independent control, it alleged breach of duty. The action failed at trial and on appeal. We saw above that Lord Lindley considered that after *Salomon*, the law could no longer require a promoter to incorporate a company with independent directors.⁸⁴ He also said that 'a company when registered is a corporation capable by its directors of binding itself by a contract with themselves as promoters if all material facts are disclosed.'⁸⁵ The constitution showed that the directors were members of the promoter company, and authorised the company to enter the transaction with the promoter. The fact of conflict was therefore in plain view. However, the extent of the promoters' interest in the sale of the property to the company was never in plain view,⁸⁶ and Lord Lindley specifically eschewed the conclusion that such nondisclosure formed the basis of relief in the case.⁸⁷ In this case, Lord Lindley did accept that the prospectus was misleading in its description of attributes of the property sold, and that the company had a right to rescind. However, that right was lost in consequence of the impossibility of restoring

⁸¹ It might be thought that this makes a strange equation between very large companies which are not make public offerings and very small ones. That is, however, not true, as public companies remain subject to the continuous disclosure regime in ss 1001A — D.

⁸² *Accord*, National Investment Council et al, loc cit (fn 40); Whincop, loc cit (fn 43).

⁸³ [1899] 2 Ch 392.

⁸⁴ Id 425. Lord Lindley said that relief in *Erlanger* was justified because the partiality of the board had not been disclosed.

⁸⁵ Id 422. Observe that this is the formalistic explanation: see supra text accompanying fn 63–64.

⁸⁶ Cf *Imperial Mercantile Credit Association v Coleman* (1873) LR 6 HL 189, 205.

⁸⁷ [1899] 2 Ch 392, 431.

the parties to their original positions. The case seems to say that provided one discloses the relationship between the promoter and the two boards, self interested transactions cannot be struck down. Yet that would be inconsistent with the approach in *Gluckstein*.⁸⁸ The reconciliation of the case with the other law is extremely difficult.

2. Legal and Economic Analysis

The use by the law of an independent board as a solution to conflicts of interest by the promoter has interesting properties. Where a promoter chooses to appoint such a board, he is, in effect, bonding his promises concerning the share issue. That is, the promoter makes the promises more credible by finding someone with reputational capital to invest it in the validity of those promises.⁸⁹ This implicit bond resembles a signalling effect, like that of underwriter or auditor prestige.⁹⁰ Economic analysis suggests that the quality of the board established will be reflected in the price of shares. Therefore, the promoter already has an incentive to establish such a board, if shareholders actually value it. The alternative nature of the board solution enables the promoter to determine whether or not it maximises value to appoint a board. The term is therefore better as a facilitative rule, as the cases hold it to be, than as a mandatory requirement.

In contrast, the rule has a substantial problem — it requires that courts be able to judge independence, typically in circumstances where the conflicting transaction proves a bad bargain. Determinations of independence in these circumstances are fraught with difficulty. Although self-appointment represents an easy case, the concept of independence is highly subjective in other situations. Independence can only ever be relative, since the promoter must be responsible for the appointment. One problem is the existence of cognitive bias in the boardroom, even by notionally independent directors.⁹¹ Many authors have examined the ‘process’ value of independent non-executive directors. The results are highly inconclusive.⁹² This supports the court’s move away from the independent board as a requirement, although at the same time it weakens its status as a means of upholding a promoter’s transactions in the absence of full disclosure.

Establishing a board, to whom transactions are submitted for approval, invokes the directors’ own fiduciary duties. Particularly relevant are the duty

⁸⁸ Including that of the same judges in the decision of the Court of Appeal: sub nom *Re Olympia Ltd* [1898] 2 Ch 153.

⁸⁹ See, eg, D Anderson, J R Francis and D J Stokes, ‘Auditing, Directorships and the Demand for Monitoring’ (1993) 12 *J Acctg & Pub Pol* 353.

⁹⁰ See, eg, S Ferris, J Hiller, G Wolfe and E Cooperman, ‘An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs’ (1992) 17 *J Corp L* 581.

⁹¹ See, eg, V Brudney, ‘The Independent Director — Heavenly City or Potemkin Village?’ (1982) 95 *Harv LR* 597.

⁹² See, eg, H Bird, ‘The Rise and Fall of the Independent Director’ (1995) 5 *Aust J Corp L* 235; R Romano, ‘Corporate Law and Corporate Governance’ (1996) 5 *Industrial & Corporate Change* 277.

of care, the duty not to fetter discretions, and the proper purposes rule.⁹³ In the 1990s, the duty to be informed before releasing a promoter from a fiduciary obligation would be an onerous one applying to every member of the board.⁹⁴ The board could be negligent if it failed to disclose to investors in the prospectus (as the case may be) the facts concerning the promotion that directors were, or could by the exercise of reasonable diligence have been, aware of.⁹⁵ The duty not to fetter discretions would require the board to refuse to give commitments to a promoter ahead of time (especially at the time the board members are appointed), and, in particular, not to do so until the details of those commitments are in clear view.⁹⁶ It therefore tends to preserve the directors' discretion. The duty not to make improper use of a corporate power is relevant where the board approves transactions proposed by the promoter. Acting in the promoter's interest would be an improper purpose.⁹⁷ In addition to their own fiduciary duties, the directors may also be subject to liability as knowing participants in the promoter's 'fiduciary' breaches under the rule in *Barnes v Addy*.⁹⁸

It is fashionable to question the effectiveness of directors' duties as an incentive for desired behaviours.⁹⁹ Doubts about the effectiveness of directors' duties reflect the difficulties of enforcement given common law restrictions on standing.¹⁰⁰ However, as noted above, the balance of control in the company may change as a result of capital formation.¹⁰¹ If so, the tenure of the 'promoter's board' will be insecure, and will depend on the continued support of shareholders. The possibility of enforcement after a board rearrangement may provide a sufficient incentive for directors' duties to 'bite'.

⁹³ A director who actually receives a side payment from the promoter will be liable to account for it: *In re Canadian Oil Work Corp* (1875) LR 10 Ch App 593; *In re Caerphilly Colliery Co* (1877) 5 Ch D 336; *In re Diamond Fuel Co* (1879) 13 Ch D 169; *Eden v Ridsdale Railway Lamp and Lighting Co Ltd* (1889) 23 QBD 368; *In re North Australian Territory Co* [1892] 1 Ch 322, 341.

⁹⁴ See generally J Hill, 'The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd*' (1992) 14 *Syd L Rev* 504; A S Sievers, 'Farewell to the Sleeping Director — The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence' (1993) 21 *ABLR* 111.

⁹⁵ See, eg, *Daniels v Anderson* (1995) 16 *ACSR* 607, 666–7; *Permanent Building Society v Wheeler* (1994) 14 *ACSR* 109, 159–60.

⁹⁶ *Thorby v Goldberg* (1964) 112 *CLR* 597.

⁹⁷ *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 *CLR* 34, 44–5. For a relevant modern review of the law, see *Permanent Building Society v Wheeler* (1994) 14 *ACSR* 109, 137–54.

⁹⁸ (1874) 9 *Ch App* 244. See also *Trade Practices Act 1974* (Cth) ss 52, 75B.

⁹⁹ See *supra* references in, and text accompanying fn 73.

¹⁰⁰ See also *supra* Part II(C). Traditionally, these restrictions derive from *Foss v Harbottle* (1843) 2 *Hare* 461; 67 *ER* 189. More recently, contrast *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 19 *ACSR* 483 and *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 23 *ACSR* 715.

¹⁰¹ As to the effect of a proprietor retaining control on a share issue, see M K Earp and G M McGrath, *Listed Companies: Law and Market Practice* (1996) 32, 108.

3. Two Possible Reforms

Apart from directors' duties, there are two means by which the board could be made more effective, and directors could be made to act as if they were more independent, in the context of promotions. These could be achieved by contract, but a statutory rule would very likely decrease the cost of contracting for them.

The first would change the security of the board's tenure. I have already said that a change in control after an offering of securities can be an important phenomenon. The change in the constitution of the board is a likely precondition to effective enforcement of any duties owed by promoters. It is therefore recommendable for legislation to include, as a default rule,¹⁰² a provision by which the directors at the time of capital raising retire at the next annual general meeting held after the issue of a certain proportion of equity (say, 20% of the existing capital). Unless excluded, the provision would influence the agenda of the next annual general meeting. The provision would direct the attention of members to the performance of the board, and whether its members should be reappointed. The necessary vacation would decrease the security of the directors' tenure, which may in turn provide for greater motivation and, perhaps, accountability to investing shareholders.

Such a provision would update reg 58 of Table A articles of the *Corporations Law*, which provides that all directors retire at the end of the first annual general meeting, and thereafter are subject to retirement by rotation. The origin of that clause is uncertain, but it would seem to have been used in the earliest of English companies, incorporated by charter, in the sixteenth century.¹⁰³ It has scarcely been seriously examined since then. The motivation for such a clause is a need to formally reconsider the adequacy of the initial arrangements for the corporation's governance, and in particular, the board. This concern with the adequacy of initial governance processes is also implicit in the curious rules applying to preincorporation contracts.¹⁰⁴ The inability to bind the company prevents promoters from securing ratification while the nascent governance processes of the corporation are ineffective. It is also implicit in the required statutory meeting for companies issuing prospectuses.¹⁰⁵ That, however, is a mandatory rule, although it does not apply at all to proprietary companies.

The problem with reg 58 is that the retirement of directors serves little or no

¹⁰² The default could be excluded by means of contrary provision in the articles. Legislation might prescribe further disclosure to the potential investors before opting out would be effective. There is no particularly good reason why the rule should be mandatory, especially where an investor contracts for other rights, concerning board representation. The offering of shares on terms excluding the default rule will itself be a signal to the investor concerning the governance the promoter is offering; see generally I Ayres and R Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale LJ* 87.

¹⁰³ R Van Witsen, 'Rotation of Directors', unpublished paper, Griffith University, 1997.

¹⁰⁴ For one of the few frank recognitions of these policy issues, see *Preston v Liverpool Manchester and Newcastle-upon-Tyne Railway* (1856) 5 HLC 604, 618, 10 ER 1037, 1043. See also J Gross, 'Pre-Incorporation Contracts' (1971) 87 *LQR* 367, 368-9.

¹⁰⁵ *Corporations Law* s 244.

value if incorporation precedes a capital offering by a substantial period, as may be the case for a company first incorporated as a shelf company, or for a company that seeks equity later in life. The suggested change provides for a default rule subjecting all directors to retire, rather than the usual rotation arrangement in which a third of the board retires at the next annual general meeting after a capital offering.

The second change is to require that any prospectus or document associated with a share offering to document relevant disclosures to the board. I have suggested that it may be practically difficult for a court to judge the relative 'independence' of the board. It therefore makes sense for the prospectus to document the minutes of any directors' meetings at which the promoters propose transactions to the board. As a record of what has occurred (which is therefore verifiable by those present), the disclosure obligation is less problematic. The need to document the reasons for a decision may direct the minds of those of the board to consider the sufficiency of both the questions directors ask, and the answers they receive. The value of a procedural focus on the board by corporate law is a premise of much modern policy.¹⁰⁶

To conclude, the doctrine's move away from independent boards to shareholder disclosure is likely to have been efficient — a triumph of pragmatism over formalistic entity concepts. Since shareholders may value independent boards of directors, either as a signal or as a bond by the promoter, it does not do to eliminate them altogether. On the other hand, they can be bolstered by placing on record the disclosures sought by and made to the board up until the time of capital formation, and by strengthening the accountability of the board through the vacation proposal.

IV. THE PROMOTER'S OBLIGATIONS

A. Outline of Part

Part III showed how the doctrine gradually emancipated itself from the grip of entity concepts, by evolving towards a principle of disclosure. This section explores the duty in more detail. If one accepts that disclosure of the promoters' interests is important information to investors in determining the value of securities offered, how well adapted is the doctrine towards the accomplishment of that ideal? To analyse this issue, I consider means by which statute might provide greater standardisation of the duty of disclosure as a means of decreasing its cost. I then consider the relevance of contractarian theory to promoters' duties: can one opt out of promoters' duties? Finally, I look at remedial issues.

¹⁰⁶ See, eg, I M Ramsay, 'Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance' (1987) 5 *C & SLJ* 129.

B. Aspects of Disclosure

Above, I suggested that the promoter's duty is likely to be an efficient duty, because it is oriented towards historical and therefore verifiable data. Moreover, its fiduciary origins have provided it with flexibility of application, especially in regard to the identity of the promoters.¹⁰⁷ It might be seen to resonate with the ideals of 'fuzzy' law, put forward by John Green.¹⁰⁸ Green proposes fuzziness to combat the exploitation of 'loopholes' in statutes. Although appealing in principle, Green never refers to the costs of a fuzzy law. Quite apart from embedding difficulties of inconsistency and vagary in judicial interpretation, imprecise laws, such as the disclosure requirement in s 1022, can be costly because they may induce overdisclosure, where there are sanctions attached to breach of the rule. When the value of that information is lower than its costs, the duty is inefficient.

It is difficult to know for sure whether promoters' duties are inefficient in this sense. However, a standardised list of the sort of information promoters' duties would require to be disclosed might in fact decrease the costs of the duty.¹⁰⁹ Easterbrook and Fischel argue that a standardised, routine duty of disclosure is likely to lower costs. Since the sort of information a promoter's duty compels is relatively uniform, a standardised duty could work well. As Mahoney shows, the disclosure of such information was the basic staple of the earliest disclosure statutes, notably the English *Companies Acts* 1900 and 1929¹¹⁰ and the American *Securities Act* 1933.¹¹¹ Some (including CLERP) have objected that 'schedule' disclosure often fails to give the most important information relevant to the value of the company securities.¹¹² However, if it is understood that the schedule is intended to provide a low cost means of standardising the disclosures compelled by promoters' duties, and so is not intended to provide all relevant information, that objection fails. Since this

¹⁰⁷ See, eg, *Whaley Bridge Calico Printing v Green* (1880) 5 QBD 109, 111; *Emma Silver Mining Co Ltd v Lewis & Son* (1879) 4 CPD 396, 407–8; *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, 242, 244–5.

¹⁰⁸ J Green, '“Fuzzy Law” — A Better Way to Stop Snouts in the Trough?' (1991) 9 *C & SLJ* 144.

¹⁰⁹ Apart from the details of the rights attached to the securities, a schedule of disclosures might sensibly include: (a) information about the identity of the company's proposed directors; (b) details of financial or other interests the directors have in the promotion, or the company's property; (c) details of the remuneration or other emoluments the directors will receive; (d) commissions payable to underwriters for procuring subscriptions; (e) information about pending or proposed contracts to acquire property for the company; (f) details of material contracts entered into by or on behalf of the company outside the ordinary course of business in the five years preceding the share issue (including those with promoters, directors, and their associates); (g) information about the identity of promoters; (h) details of financial or other interests the promoters have in the promotion, or the company's property; (i) information about the identity of the company auditor (including information concerning any relationship the auditor may have to the promoters or the directors). This list is substantially modelled on the *Companies Act* 1929, 19 & 20 Geo 5 ch 23 Fourth Schedule.

¹¹⁰ 63 & 64 Vict ch 48; 19 & 20 Geo 5 ch 23.

¹¹¹ 15 USC §§ 77a–77aa (1997); Mahoney, op cit (fn 30), 1077–88.

¹¹² See generally C Schneider, 'Nits, Grits, and Soft Information in SEC Filings' (1972) 121 *U Pa L Rev* 254, 264–8; H Kripke, 'A Search for a Meaningful Disclosure Policy' (1975) 31 *Bus Law* 293; C Saari, 'The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry' (1977) 29 *Stan LR* 1031, 1061–2.

enhanced version of promoters' duties is aimed in particular at the small numbers bargaining situations of SMEs, leaving the disclosure of other matters to private ordering is likely to be effective.¹¹³

Promoters might structure their affairs in a way which eludes the schedule. There is scope for the promoter's general duty to operate where a 'material' matter has not been disclosed which falls within the general equitable duty. Defining materiality is difficult, but a lead could be taken from the American securities cases, which attempt to equate the marginal costs and benefits of disclosure. In *TSC Industries Inc v Northway*, the Supreme Court said that an omission would be material 'if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote', and held that an omission was immaterial, as the information could have been inferred from the other data disclosed.¹¹⁴ In conjunction with a reasonably comprehensive schedule of 'interest' disclosures, this definition would be likely to catch only contrived attempts to evade the statute.¹¹⁵

C. Opting Out

Should a promoter's duties admit of variation or exclusion? Lawyer-economists propose a contractarian theory of the firm in which legal rules (including fiduciary duties) are regarded as 'defaults', which admit of contractual variation.¹¹⁶ The problems with the default rule concept, at least until ten years ago, was that scholars advanced no convincing normative theory of the formal requirements to opt out of defaults.¹¹⁷ Ayres and Gertner, in the first systematic theorisation of default rules, showed that some default rules functioned not merely to supply rules in respect of remoter contingencies, but compelled a party to disclose unobservable information relevant to the contract.¹¹⁸ A particular default rule may be value-decreasing for certain types of parties. The rule will induce those types to contract around it. By contracting around the rule, the party discloses information by signalling her type. The increased information leads to more accurate pricing. Ayres and Gertner describe such defaults as penalty defaults, because they supply the parties, *not* with a rule that they would have wanted, but with a rule that they would *not* have wanted.¹¹⁹ It follows that the formal requirements for contracting

¹¹³ Likewise, where a publicly traded company makes a first tier issue (eg a private placement), disclosure of other matters is left to the continuous disclosure obligations.

¹¹⁴ 426 US 438, 449 (1976). Followed in *Basic Inc v Levinson*, 485 US 224, 232 (198).

¹¹⁵ *Accord*, Easterbrook and Fischel, *op cit* (fn 34), 308-9.

¹¹⁶ See references in fn 20 *supra*.

¹¹⁷ See now Ayres and Gertner, *op cit* (fn 102); J S Johnston, 'Strategic Bargaining and the Economic Theory of Contract Default Rules' (1990) 100 *Yale LJ* 615; I Ayres and R Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 *Yale LJ* 729; R Craswell, 'Contract Law, Default Rules, and the Philosophy of Promising' (1989) 88 *Mich L Rev* 489; A Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *J Leg Stud* 271; R Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *J Leg Stud* 597.

¹¹⁸ Ayres and Gertner, *op cit* (fn 102).

¹¹⁹ *Id* 91.

around defaults need to be sensitive to the motivations for the form a default takes.

This informs one's conception of the promoter's duty as a default rule. The duty prohibits transactions in which the promoter is interested conditionally, not absolutely.¹²⁰ The conflict is not prohibited where there is disclosure to the shareholders of the nature and extent of the conflicting interest,¹²¹ or where an independent board is established and approves the transaction. Thus, the fiduciary duty is a default rule which prohibits transactions with the 'company' in which the promoter is interested.¹²² The promoter can contract around the prohibition by disclosing his or her interest.¹²³ The duty serves a function similar to that of a penalty default — it forces the promoter to reveal information as part of the contracting process.¹²⁴ Thus, disclosure itself is the means by which the parties contract out of the fiduciary prohibition. A similar conclusion, regarding opting out, applies to the use of a schedule as a means of standardising a promoter's disclosure.

Other attempts to try to exclude both the fiduciary prohibition and the disclosure are of questionable validity. The disclosure and (where relevant) approval requirements are the means of opting out of the default (the prohibition of interested transactions). It therefore makes no sense to speak of opting out of them. In *Gluckstein*, the promoters, foreseeing the problems with the undisclosed profit, stated in the prospectus that they did not intend to sell to the company any profits made by them from 'interim investments'. The contract of sale stated that it would not be impeached on the ground that the promoter stood in a fiduciary relation to the company. The promoters unsuccessfully relied on these provisions as excluding their fiduciary liability. The terms did not function as a substitute for disclosure. A court of first instance reached the same result in *Omnium Electric Palaces Ltd v Baines*.¹²⁵ This enhances the quality of the promoter's duty as a penalty default, since it implies that the court will only enforce transactions in which a promoter has an interest, where the investor has been fully informed.

D. Remedies

1. Optimal Sanctions and the Perils of Imprecise Analogical Reasoning

The remedies for breach of promoters' duties primarily take two alternative forms — an account of profits, and an order for rescission of contracts between the promoter and the company. The criterion of availability of an account of profits is whether or not the property sold to the company was its

¹²⁰ *Whaley Bridge Calico Printing v Green* (1880) 5 QBD 109, 112.

¹²¹ *Omnium Electric Palaces Ltd v Baines* [1914] 1 Ch D 332, 351.

¹²² Alternatively, one might say that the fiduciary duty gives the 'company' an option to rescind the agreement, so enabling the shareholders to avoid the bargain and to subject the promoter to the asset risk.

¹²³ The promoter can also opt out by selling the assets outright, rather than through a corporation: Mahoney, *op cit* (fn 31), 1093.

¹²⁴ Cf Whincop, *op cit* (fn 20), 203–5.

¹²⁵ [1914] 1 Ch D 332, 347.

property in equity at the time of the sale. To be the company's property, the promotion would have to subsist at the time the promoter first acquired the property.¹²⁶ This area is the least satisfactory part of the doctrine. A case, such as *Gluckstein*, in which the remedy of account of profits was exceptionally granted,¹²⁷ is difficult to distinguish from other cases on any principled basis.

The account of profits remedy is based on the application of conventional fiduciary analysis to determine the remedy applying to a failure to discharge the promoter's disclosure obligation. I would argue that the confusing aspect of the remedy derives from this uncritical application of fiduciary concepts. In Part II, I argued that promotion does not involve a relation which is analogously fiduciary — the fiduciary principle is merely applied for instrumental reasons to effect disclosure. It follows that focusing too intently on when that fiduciary relation 'began' is backsliding towards the metaphysical, away from the pragmatic. This is especially true when the distinction between the cases in which account is available, and those in which it is not, is so blurred. In general, the promoter's intentions at the time of the acquisition of the asset in the first instance are likely to be difficult for the plaintiff to observe, and for a court to verify. That criticism becomes compelling when one realises that for a court to deny an account of profits compels the plaintiff to rely on the rescission remedy, which is easily lost, as we shall see. Bowen LJ once said in an incisive dissent that the 'right to recover secret profit is in fact chiefly valuable in a case where the contract cannot be rescinded'.¹²⁸ The cases show greater willingness to make persons who act in subsidiary roles in the promotion disgorge gifts promised to them by the dominant figure in the promotion.¹²⁹ The only defence is full disclosure to the board or in the prospectus. It seems curious that the profits of minor functionaries are apprehended, but those of the promoter-entrepreneur often are not.

A remedy must reflect the need to deter the breach of the disclosure obligation which it purports to compensate.¹³⁰ An exiguous remedy makes for an exiguous duty. The law stated in *Gluckstein* was an effective sanction. First, in *obiter*, the liquidator would have been entitled to recover not only the undisclosed profits, but the disclosed profits as well.¹³¹ This compels the promoter to disclose all of the profits from the promotion, as partial disclosure is no

¹²⁶ *Erlanger v The New Sombrero Phosphate Co* (1878) 3 AC 1218, 1235; *In re Cape Breton Co* (1885) 29 Ch D 795, 804; *Ladywell Mining Co v Brookes* (1887) 35 Ch D 406, 408; *In re Lady Forrest (Murchison) Gold Mine Ltd* [1901] 1 Ch 583, 590; *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34, 43; *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, 239–40.

¹²⁷ See also *Hichens v Congreve* (1831) 4 Sim 420; *Lydney and Wigpool Iron Ore Co v Bird* (1886) 33 Ch D 85.

¹²⁸ *In re Cape Breton Co* (1885) 29 Ch D 795, 808.

¹²⁹ See, eg, *Emma Silver Mining Co Ltd v Lewis* (1879) 4 CPD 396; *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34; *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109; *Emma Silver Mining Co v Grant* (1879) 11 Ch D 918.

¹³⁰ R A Posner, *Economic Analysis of Law* (4th ed, 1992), 223–31. Specifically, a sanction should be inversely proportional to the likelihood of it being invoked. That is, the less likely a breach is to be detected and punished, the higher the sanction needs to be in order to deter the breach.

¹³¹ [1900] AC 240, 255.

better to the promoter than no disclosure at all. The remedy thus prevents the promoter from attempting to trade off the marginal cost of not disclosing a particular source of profit, against the profit itself. It does this by raising the marginal cost above the level of the profit. This encourages full, rather than strategic, disclosure.

Second, the House of Lords held that the promoters were jointly and severally liable to make restitution of the profits.¹³² That meant that the plaintiff could recover the complete profits from any one of the promoters, leaving that promoter to recover contribution from the others. The obvious problem for such a defendant is that recovery of contribution is costly and uncertain. This increases the ability of the sanction to deter breaches. By creating what is, in effect, an accessorial liability for the profits of other promoters, the remedy increases the extent to which the promoters will monitor each other, in order to ensure that they are disclosing the full range of gains that each, and all, of them are making.¹³³ The promoter will seek to bring into equilibrium the marginal cost of mutual monitoring with the marginal benefit of avoiding liability for undisclosed profits.

2. Rescission

Where an account is not available, the court may order rescission. The company will have to return the property and ask for the 'price' to be repaid.¹³⁴ In some cases, this may be an effective sanction, especially where the value of the property has dropped considerably. To generalise the analysis, the greater the volatility of the property's value, the more likely restitution is to deter breaches of the duty.¹³⁵ The capital commitment required of the promoter to effect restitution (ie to return the amount the promoter received) may also be costly. Likewise, returning securities included as part of the price may destroy a promoter's effective control of the company. However, where the asset becomes a 'specific' one, that is, it has an unsalvageable stream of quasi-rents associated with it because of its uniqueness to an exchange, as may be true of a number of business assets, the remedy is unlikely to be invoked where the business is still solvent.¹³⁶ Rescission would destroy these quasi-rents.

A prima facie right to rescission may be lost. The primary circumstance where this occurs is where it is no longer practically possible to effect *restitutio in integrum*, that is, to restore the promoter to his original position.¹³⁷ This usually means that the property sold to the company cannot be restored.

¹³² See also *Lindsay Petroleum Company v Hurd* (1874) LR 5 PC 221, 242–3; cf *Wheat Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34, 46.

¹³³ See also *Emma Silver Mining Co Ltd v Lewis* (1879) 4 CPD 396, 407–8.

¹³⁴ The liability of promoters, where more than one, to repay purchase money would seem not to be joint and several, but is limited to repaying one's 'share': *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, 245.

¹³⁵ More formally, a right to rescission confers on the company a put option. Put options are more valuable when asset volatility is higher: F Black and M Scholes, 'The Pricing of Options and Corporate Liabilities' (1973) 81 *J Pol Econ* 637.

¹³⁶ For a discussion of asset specificity and its economic significance, see Williamson, *op cit* (fn 22), 52–6.

¹³⁷ See generally *Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102.

Frequently this will be difficult where the asset sold is a business. Business assets change in form. The likelihood that restitution will be unavailable in these cases makes the promoters' duty a weak incentive for disclosure.

Rescission may also be lost where the company affirms or acquiesces in the transaction with knowledge of its circumstances, or similarly, where there has been delay to constitute laches.¹³⁸ Generally, affirmation or acquiescence will not occur where the promoter is still in effective control of the company, or where the facts are not known.¹³⁹ On the other hand, the cases do not make it clear what the courts would require the shareholders to do once they learn the facts concerning the breach. Would they be required to convene a general meeting, at which to raise the matter, and to sack the directors? If such a strategy failed, would they have to bring a derivative action asking for rescission, and alleging a fraud on the minority? Affirmation as a defence is inevitable,¹⁴⁰ but courts need to consider that there are substantial costs to shareholders in taking collective action to repudiate contracts.¹⁴¹ Unrealistic expectations of what shareholders should do serve the interests of promoters, and decrease the likelihood of disclosure.

An issue which is the subject of very little law is the ability of the company, which cannot seek an account of profits, or has lost the right to rescind, to recover either damages or equitable compensation for loss arising from breach of duty. There is authority consistent with the ability to recover damages.¹⁴² The forward-looking decision of the Court of Appeal in *Re Leeds* awarded a measure of damages that looked like the 'next best thing' to an account of profits.¹⁴³ One might also pursue equitable compensation for breach of fiduciary duty. Such an action is beset by fewer difficulties of causation.¹⁴⁴

3. Reform

Given the uncertainties of the doctrine, it would be desirable to rethink the remedies that should be associated with the breach of the duty. One possibility is to introduce a statutory strict liability for damages for material breach

¹³⁸ See, eg, *Lindsay Petroleum Co v Hurd* (1874) LR 5 PC 221; *Erlanger* (1878) 3 AC 1218; *Lagunas* [1899] 2 Ch 392.

¹³⁹ See, eg, *Erlanger* (1878) 3 AC 1218, 1261; *Lagunas* [1899] 2 Ch 392, 433.

¹⁴⁰ A cynic might suggest the curious result in *Lagunas* (supra fn 83-88) is itself a case of affirmation, given the lapse of time and the apparent inclination of shareholders to accept business risks.

¹⁴¹ The costs of collective action were seminally analysed in: M Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2nd ed, 1971). For application to corporate law, see B S Black, 'Shareholder Passivity Reexamined' (1990) 89 *Mich L Rev* 520; M J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994). For judicial recognition of these problems, see *Erlanger* (1878) 3 AC 1218, 1232, 1259.

¹⁴² *Jacobus Marler Estates Ltd v Marler* (1913) 85 LJPC 167, 167-8.

¹⁴³ [1902] 2 Ch 809. The quantum of damages was not discussed in detail, but it would seem to be referable to the sale of assets at overvalue. The amount of the damages was capped at the value of the available assets of the defendant.

¹⁴⁴ *Nocton v Lord Ashburton* [1914] AC 932; *Re Dawson* [1966] 2 NSWLR 211; *Hill v Rose* [1990] VLR 129; *Gemstone Corporation of Australia Ltd v Grasso* (1994) 13 ACSR 695; *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 162-7.

of the duty.¹⁴⁵ I would argue that where there has been a material breach of the disclosure duty, the law should confer a remedy on a shareholder that represents a measure of damages based on the shareholder's loss from investing in the securities.¹⁴⁶ Consider a case where the promoter buys an asset for \$10 000, sells it to the company for \$12 000, and sells securities based on that price using a prospectus which falsely states that the promoter bought the asset for \$11 500. The asset subsequently falls in value to \$8 000. A loss based measure would entitle the plaintiff to recover \$4 000, being the measure of the loss, and not just the \$2 000 profit.¹⁴⁷ The promoter effectively bears the risk of the asset. The logic of this remedy is the need to deter misstatements and concealment in the context of capital formation, because of the serious social costs of capital misallocation.¹⁴⁸ Because the further loss in value of the asset increases the sanction above the promoters gain it deters breaches, given that the probability of successful apprehension and prosecution is substantially less than one. In contrast, CLERP (which has little specifically to say about the measure of damages) states that sanctions for breach of a disclosure obligation "should [not] shift to fundraisers the investment risk properly accepted by investors in efficient securities markets."¹⁴⁹ That comment may be apposite where one accepts a poorly defined disclosure duty (as CLERP has). However, where one relies on a checklist as defining the principal ambit of a more restricted duty, compliance with which is much clearer, a sanction can be more severe.

The promoter might hold out that the asset's value in a year's time would be \$14 000. Should the measure of damages be calculated as \$6 000? Easterbrook and Fischel describe these as 'benefit of bargain' damages, and consider them generally inappropriate.¹⁵⁰ Such damages compensate for a loss of consumer surplus, that is, the value a particular consumer places on goods, over and above its price. However, shares lack consumer surplus. Because of arbitrage processes in competitive markets, marginal and average share values are identical. However, Easterbrook and Fischel acknowledge that this may not hold in cases of closely held corporations — a field that substantially overlaps with SMEs. In these cases, where shareholders often do not fully diversify,

¹⁴⁵ The following analysis is influenced by Easterbrook and Fischel's 'Optimal Damages in Securities Cases' (1985) 52 *U Chi LR* 611, revised as ch 11 in *The Economic Structure of Corporate Law*, loc cit (fn 34).

¹⁴⁶ This is not dissimilar to the current remedy in s 1005 of the *Corporations Law* for breach of the prospectus provisions. That in turn merely modernises a much older precedent: *Directors Liability Act* 1890, 53 & 54 *Vict c* 64 s 3.

¹⁴⁷ Assuming the profits could be recovered at all. \$2000, rather than \$2000 less the amount of disclosed profits, is the correct measure of recovery, following the authority of *Gluckstein v Barnes* (see text accompanying fn 131 supra). This principle is one which might conceivably be taken too far. One intuitively recoils from the notion that the disclosure of 99% of the profits entitles the investor to recover the full amount of the profits. The penalty is out of balance with any negative effects on capital allocation; there is also a problem with the fact that profits may vary according to accounting techniques, so making the precise figure that should have been disclosed debatable. In some cases, a defence of an immaterial nondisclosure may be an acceptable solution.

¹⁴⁸ Easterbrook and Fischel, op cit (fn 34) 336.

¹⁴⁹ Corporate Law Economic Reform Program, op cit (fn 42), 10.

¹⁵⁰ Easterbrook and Fischel, op cit (fn 34) 329.

marginal and average values may differ. There is scope, therefore, for recovering such damages in these cases.

The advocated remedy changes the profile of remedies completely, by abandoning conventional fiduciary concepts in favour of making sanctions reflect the doctrines instrumental justifications. A radically revised remedy also raises the question — who should be liable, and who has standing to enforce that liability? The conventional answers are the promoter and the company. The promoter as 'proper defendant' contrasts with the approach of the prospectus provisions in the *Corporations Law*, wherein a wide range of other parties associated with the prospectus are subjected to liability, although with particular defences.¹⁵¹ This has appealing possibilities in conjunction with this revised model of promoters' duties. I would argue that, with two exceptions, those provisions should apply as default rules. For example, the person named in the prospectus as the solicitor for the corporation should have a default liability. The liability could be excluded by a written statement in the prospectus indicating the nature of the solicitor's liability under the statute, and that liability is being excluded. To be valid, the exclusion would also require a true statement of all benefits received by the person seeking to contract around the liability. Thus, a director who received an undisclosed side-payment could not rely on a release.¹⁵² Although some may protest the default rule status, that regime allows firms to signal to the market the accuracy of the prospectus by bonding the promise with the liability of other parties. In economic terms, the excludability of the default allows *separating equilibria* to form, the highest quality prospectuses distinguishing themselves through the default liabilities remaining in place. Such firms are able to ask more for their securities. This is consistent with the general tenor of the economic theory of default rules that the information content of a contract is higher when rules are defaults.¹⁵³ I mentioned two exceptions. The first is the promoter's liability, for reasons already explained in Part IV(C) *supra*.¹⁵⁴ The second is the liability of directors, where the promoter claims that the transaction was approved by an independent board. That is, where the promoter relies on the independent board solution, the directors' liability should be mandatory.

CLERP by contrast proposes to restrict liability to the corporation, directors, and the underwriter, and to the extent of their own statements, experts. Liability for the promoter ceases completely. I would argue the superiority of my own approach. It may be that the expert is not an efficient risk bearer, except to the extent of his or her own statements. However, one cannot state that categorically — it depends on the company, the prospectus, and the position of the expert. It is difficult to contract *affirmatively* for a more extended

¹⁵¹ See *Corporations Law* s 1006(2) (defendants), ss 1008–1011 (defences).

¹⁵² Cf fn 93 *supra*.

¹⁵³ Baird et al, *op cit* (fn 48), 147–56.

¹⁵⁴ I also would not favour a due diligence defence for the promoter, given the smaller subset of information, which is primarily historical, that is required to be disclosed. I would favour a materiality defence in the sense described: see text accompanying n 114 *supra*.

liability for these persons, even if it did maximise value. It therefore makes more sense for the liability to appear as a default, with the exceptions noted. CLERP's emphasis on the corporation is curious, given the circularity of recovery — the plaintiff's damages are offset in part or whole by the decrease in value of the corporation if the plaintiff is still a shareholder. Moreover, the demise of the promoter is perplexing. The promoter is the principal entrepreneur in share offerings. Relying on the promoter's fiduciary duty,¹⁵⁵ as CLERP professes to do, when one has codified the disclosure obligation in statute is perverse.

Finally, who should have standing, and under what circumstances? CLERP has nothing to say on the subject. I would argue that a person subscribing for shares should be able to sue, as should any purchaser in the secondary market after the issue is made, but before the true facts are disclosed. There would be a general defence against persons acquiring the shares who knew the truth, as in s 1007. The most significant aspect of such a provision would be that standing and the cause of action do not depend on the proof of specific reliance on the prospectus. The assumption is that pricing occurs in a way which takes into consideration the information available to buyers in the market place.¹⁵⁶ Those buying under the prospectus should not have to prove reliance on the prospectus. Those acquiring in the secondary market should have the benefit of an assumption that the price paid reflects the information in the prospectus and any further information available in the market. However, where the price rises after the issue, the promoter should only be liable for the loss, vis-a-vis the higher price, where the promoter is responsible for the price rise, for instance, by releasing false information about the company. That is, the promoter's liability is for net loss.

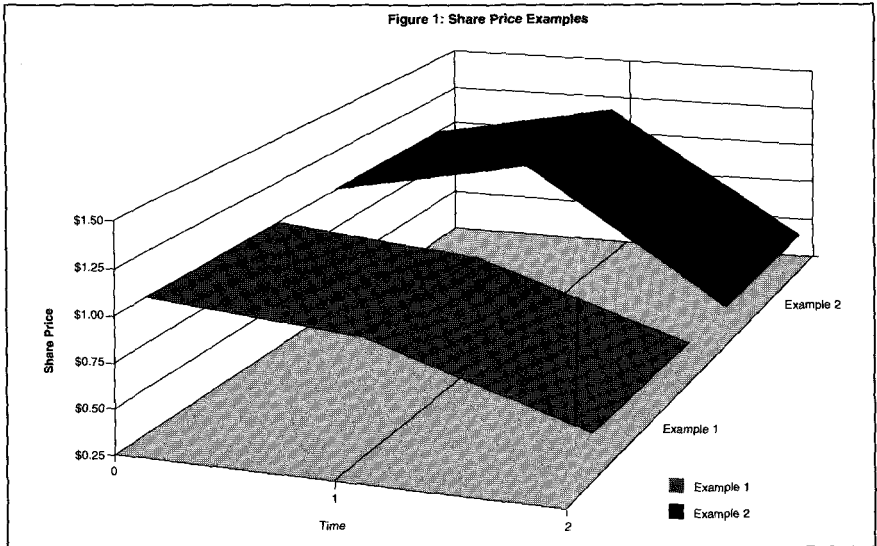
Consider an example. A promoter sells stock at time 0 for \$1.00, misrepresenting the price for which he bought the assets of the company. The actual price for which he bought them (which is also their value) is \$0.50. At time 2, the market value of the shares falls to \$0.50. However, at time 1, the value of the shares might rise above the price shareholders paid (say, \$1.25) or they might fall (say, \$0.90). Assume that A subscribes for shares at time 1, and sells to B at time 2. One can represent the possibilities thus:

In Example 1, A and B should be entitled to sue for their loss (\$0.10 and \$0.40 each). However, in example 2, B should only recover \$0.50, being the net loss, not \$0.75, unless the promoter is responsible for feeding the market with false good news (so distorting allocational efficiency), or it is an appropriate case in which to award benefit of bargain damages in that amount. Otherwise, B's loss is offset by A's gain.¹⁵⁷

¹⁵⁵ Corporate Law Economic Reform Program, op cit (fn 42), 46. CLERP also suggests that promoters might be caught if they became directors — an approach which seems remarkably circuitous.

¹⁵⁶ This assumption underpins much US securities fraud law: see, in particular, *Basic Inc v Levinson* 485 US 224 (1987). See generally Georgakopoulos, *Fraud-on-the-market*, loc cit (fn 39). The conferral of a remedy not based on reliance on a purchaser in the secondary market is only really significant where the shares trade.

¹⁵⁷ Easterbrook and Fischel, op cit (fn 34), 320–6.



V. CONCLUSIONS

Many pages of scholarly journals are devoted to examining the properties of the fiduciary duties, and to offering general theories. One of the problems with any theory, whether doctrinal, critical, or economic, is that it influences how one observes the phenomena supposedly the subject of the theory.¹⁵⁸ Theories offering, for example, power or dependence as the touchstone of fiduciary principles influence how one characterises relationships that have been classed as fiduciary. Thus, tagging promoters' duties as fiduciary makes one look for somebody over whom the promoter has power, or on whom the promoter depends. One 'finds' the corporation as the object of the search. The theory thus obscures the fact that the identified 'dependent' is a fiction, and that the economic substance of promotion involves an exchange of a high degree of discreteness. General theories prove both too little, and too much. Too little, because they fail to account for the considerable differentiation in application of what is supposed to be the same duty. Too much, because they imply a unity which the cases do not really demonstrate. Once one bypasses its booming rhetoric, and attempts at general theorisation, the fiduciary principle can be remarkably pragmatic in both application and extension.

Promoters' duties have been shown in this article to fail any test of analogy to established fiduciary relationships, but they succeed as a means of providing for disclosure in capital raising. As the suggested improvements imply, that success may not be complete. I have therefore suggested a series of

¹⁵⁸ See generally N R Hanson, *Patterns of Discovery* (1958).

changes to improve the functionality of the duty by recommending it as a general duty of disclosure applicable to share issues other than IPOs. The disclosure obligation is standardised, and material breaches of the duty are punishable by strict liability for net loss. Whether or not those changes are agreeable to all, I think it is less controversial to suggest that promoters' duties are the logical place at which to begin when reforming fundraising. The insights of the last century still have currency. As Santayana reminds us, those who cannot remember the past are condemned to repeat it.