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Constraints on Pursuing Corporate Opportunities

*Stanley M. Beck**

The question of corporate opportunity is one of the most difficult and, at the same time, one of the most interesting with respect to fiduciary duties. The Anglo-Canadian courts, and to an extent the American courts, have had a difficult time establishing any clear guidelines. The Canadian courts have taken a strict fiduciary approach. For example, the law of trusts for children has been applied in corporate opportunity cases, and such "simple" cases as *Keech v. Sandford*¹ (from 1726) and the later case of *Parker v. McKenna*² (from 1874) have been repeatedly cited by courts considering this issue.

The language of Lord Justice James in *Parker v. McKenna* was that the court was not entitled to receive any evidence as to whether the principal did or did not suffer an injury, for the "safety of mankind requires that no agent shall be able to put his principal to the danger"³ of such an inquiry. This led Lord Justice Roscoe to remark in a 1972 case that, although he agreed with the basic principle, in a nuclear age that might be a slight exaggeration. Nonetheless, he and the English courts continued to apply that test. If there was a taking of what was deemed to be corporate property, no inquiry was made into whether the corporation really did suffer an injury, what the nature of the benefit received by the principal was, or whether it would be unjust to allow the principal to obtain the benefit.

Instead, the basic rule of equity that no fiduciary may profit from his position as such (or the allied principle that no agent may be allowed to put himself in a position where his interest conflicts with his duty) is applied. Essentially, the courts have refused to ask the unjust enrichment questions: Has there really been a benefit conferred upon the principal? Is it at the company's expense? And if so, is it unjust in the circumstances to allow the agent to retain the benefit?

These questions have an appealing sound of simple certainty, but

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¹ *Keech v. Sandford* (1726), Sel. Cas. Ch. 61 (fol.), 25 E.R. 223, [1558-1774] All E.R. 230.

² *Parker v. McKenna* (1874), L.R. 10 Ch. App. 96.

³ *Ibid.* at 125.

loss and gain can be complex factors. There is no simple analysis here. Each branch has to be seen in relation to the others and these relationships often involve very complex fact situations. The difficulty with this rigid approach is that it leads to some tough results. In those cases, fiduciaries who have shown initiative, taken risks on behalf of the company, and produced a commensurate gain are required to give up their profits. A constructive trust may even be imposed upon their property.

The essential question is whether that approach is necessary. Is the "blinkered application of fiduciary doctrine" necessary to protect investors from self-regarding activities of corporate managers? What are the costs of such an application? Will fiduciaries (executive managers) be deterred from engaging in activity that will both enrich them and have a positive economic impact on the corporation as well? If they are deterred, will there be a greater incentive to seek surreptitious gain? I've always liked Professor Dodd's characterization of corporate executives as exemplifying the peculiar idea of vicarious acquisitiveness. An economist might say that this is a result of fiduciaries showing expense preference and finding ways to seek gain other than the bargained-for compensation. The question might also be asked whether economic opportunities will go undeveloped if those who possess information, expertise, and incentive are barred from participating.

On the other hand, one can refer to the benefits of retaining a strict trust approach. That type of strict fiduciary rule is efficient in the sense that it avoids the costs of shareholder policing. There is a clear line which fiduciaries must not cross, even at the cost of occasional unjust results. If one is talking about compensation, then why not openly bargained-for and disclosed compensation? There are many forms which it could take. For instance, in three or four (rather cryptic) lines of its last few proxy statements, the Cadillac Fairview Corporation, Canada's largest public real estate company and a large player in the American real estate market, has announced that in order to compensate its executives it has acquired "phantom interests" in listed real estate developments in Canada and the United States. A "phantom interest" is a profit-sharing scheme. The executives are given as compensation a percentage of the new real estate developments that Cadillac Fairview is entering into, presumably as a spur to look for wealth-maximizing developments for the company.

Is it not a better rule to have that kind of bargained-for and disclosed compensation for executives rather than relaxing equity's strict rules? Equally important, is it not to the advantage of the enterprise to have managers who are devoted solely to its welfare rather than to their own (possibly in competition)? As for economic opportunities, will they not be developed by others if in fact they are viable propositions? The answer to those questions is probably "yes."

Let me move now from those essential questions to some of the cases, because it is only in the context of the cases that we can ask the

difficult questions. *Regal (Hastings), Ltd. v. Gulliver*⁴ is the classic Anglo-Canadian example (it was a House of Lords decision adopted by the Supreme Court of Canada). This decision was the law in Canada until the 1974 Supreme Court decision in *Canadian Aero Service Ltd. v. O'Malley*.⁵

In *Regal (Hastings)*, the company was in the theater business; it owned one theater and wanted to acquire leaseholds on two others and then sell the three as a going concern. To pick up the leaseholds of the other two, it formed a wholly-owned subsidiary. The owner of the other theaters was willing to lease, but would not do so unless the subsidiary had a paid-up capital of £5,000 or unless the directors gave their personal guarantee. This proposal was made to the board at a meeting at which some of the directors were willing to give their guarantee, but the majority was not. They looked at the financial situation of the parent and found it could afford only £2,000. The solicitor had the idea that the directors might provide the remaining £3,000. In fact, five of the directors put £600 each into the capital of the subsidiary. The subsidiary then had £5,000 of paid-up capital and the agreement was completed.⁶

Later, the sale of the three theaters as a going concern fell through. However, another purchaser came along and, while it did not purchase the assets, it did purchase shares in the parent and in the subsidiary. A handsome profit was made by all, not just the directors (the directors' profit on their 3,000 shares was some £7,000), and *Regal* was owned wholly by a new controlling shareholder. But then the new controlling shareholder took a closer look at the facts (or its smart solicitor looked at the corporate history) and decided there had been a breach of fiduciary duty.⁷

An action was begun alleging the taking of a corporate opportunity. The Court of Appeal said no corporate opportunity was taken; rather, the agreement was to the advantage of the company.⁸ There was no possibility of the company taking up the opportunity and everybody had profited. Moreover, to rule in favor of the purchaser/plaintiff would be to provide him with an unbargained-for windfall.

The House of Lords unanimously reversed. It went back to the language of *Parker v. McKenna* and *Keech v. Sandford*—the child trust language—and said that the opportunity came to the directors in the course of the execution of their office. While trying to expand the business of *Regal*, they took part of the opportunity for themselves. In those circumstances it was corporate property that was improperly taken; the directors must account for these takings.⁹

⁴ *Regal (Hastings), Ltd. v. Gulliver* (1942), [1942] 1 All E.R. 378 (H.L.).

⁵ *Canadian Aero Service Ltd. v. O'Malley* (1973), [1974] S.C.R. 592.

⁶ *Regal (Hastings)*, *supra*, note 4 at 378, 380.

⁷ *Ibid.* at 385 (Russell L.J.).

⁸ *Ibid.*

⁹ *Ibid.* at 380-81.

The difficulty, of course, was that the purchasers received in one hand part of what had been paid out by the other. Only Lord Porter recognized this difficulty, although he still went along with the court's decision.¹⁰

The House of Lords said the profit rule is of "vital importance" to the honest conduct of a fiduciary.¹¹ The essential question, however, is whether a prophylactic rule is necessary. Unfortunately, the court did not discuss what might be characterized as two unjust enrichments (if that is in fact what happened): unjust enrichment in the "new" Regal, which recouped part of its purchase price, and also unjust enrichment with respect to the directors who took up the shares in the subsidiary.

Regal (Hastings) should be examined more closely. The five directors were the controlling shareholders. Their position, which does not seem to have been doubted, was that the company could not afford to take up an extra £3,000 worth of shares.¹² (One can recognize the *Irving Trust Co. v. Deutsch*¹³ discussion of financial incapacity to take up an opportunity.) Several questions arise here: Was it proper for the directors to make the decision if they were in a controlling situation? If they wanted to put their own money into the venture, was there not an obligation for them to ask the other shareholders if they would care to participate? One of the directors was in charge of the corporation's finances. What effort was made, or ought an effort be required in those circumstances, to go out and raise money? Would that have been reasonable? The whole financial incapacity question is one of the most difficult questions in corporate opportunity. *Regal (Hastings)* places sharp focus on these difficult questions.

The other factor involved was that once the directors contributed £3,000 of the £5,000 of capital into the subsidiary, Regal no longer controlled the subsidiary. The directors were in the controlling position, with all that that implies and at that point were in some sense competing with Regal. Although the minority shareholder was still Regal, and that which was advantageous to the subsidiary would also have been advantageous to the parent, there were possibilities for conflict.

A 1978 case in the Appellate Division of the Alberta Supreme Court involved a not unusual situation. In *Abbey Glen Property Corp. v. Strumborg*,¹⁴ a development company was formed by two individuals who had been real estate developers for some time. They formed a company called Terra Developers Ltd. and ultimately took it public to the point where, although they were the chief executive officers, they only

¹⁰ *Ibid.* at 394-95.

¹¹ *Ibid.* at 385 (Russel L.J.), 391 (McMillan L.J.), 394 (Wright L.J.).

¹² *Ibid.* at 378, 382.

¹³ See *Irving Trust Co. v. Deutsch* (1934), 73 F.2d 121 at 124 (2nd Cir.), *cert. denied*, (1934), 294 U.S. 708.

¹⁴ (1978), 85 D.L.R. (3d) 35, [1978] 4 W.W.R. 28, 9 A.R. 234 (Alta S.C.A.D.) [hereinafter *Abbey Glen* cited to D.L.R.].

held 10% of the shares. At the same time, they retained some real estate interests themselves, essentially consisting of raw land on the periphery of Edmonton. It was understood "to some indeterminate extent" that they had real estate interests of their own and that no accounting would be required.¹⁵

Like all real estate companies, it needed a lot of financing from larger companies. The Stumborg brothers, who were the parties in interest, wrote to Traders Finance, one of Canada's largest finance companies, and suggested entering into joint ventures with Terra Developers Inc. Two Traders officials flew to Edmonton to look at Terra's lands, which were presented as a Terra development. The Stumborgs duly drove them around the outskirts of Edmonton, showed them the Terra land, and also showed them their own land. They were, in effect, driving around looking at available real estate. Their own lands were not discussed. Subsequently, the brothers were invited to Toronto to discuss a further development; again, only Terra's lands were considered.¹⁶

Some four months later, Traders wrote to the Stumborgs and said it would not deal with Terra; it wanted to deal with the Stumborgs, and since they controlled only 10% of Terra, Traders refused to deal with Terra. Traders was interested in the two parcels of land owned personally by the Stumborgs and wanted to join in their development. The development went ahead as a joint venture.¹⁷

Again, there was the same situation as in *Regal (Hastings)*. Terra was sold to a company called Western Realty and a new company emerged, Abbey Glen, which was wholly controlled by a single new shareholder.¹⁸ Again, the lawyers looked at the transactions and saw a cause of action against the Stumborg brothers. Essentially, the trial court found that the Stumborgs had acted in perfect good faith.¹⁹ They had used their best efforts to get the Traders development for Terra but were not able to do so. The court held, nonetheless, that an accounting was necessary, citing *Regal (Hastings)*.

Why was an accounting necessary? Because when Traders was first shown the land, it was shown by the Stumborgs who were acting on behalf of Terra, notwithstanding that Traders refused to develop that land with Terra and turned down the Stumborgs' proposition to finance Terra in the development. The Stumborgs were acting "in the course and execution of their office" because when they wrote to Traders they wrote on Terra's letterhead and when they drove around they were driving around on behalf of Terra. The Stumborgs, therefore, had to give back the gains from the opportunity they exploited.²⁰

¹⁵ *Ibid.* at 54-55 (Clement J.A.).

¹⁶ *Ibid.* at 55-57 (Clement J.A.).

¹⁷ *Ibid.* at 40 (McDermid J.A., dissenting).

¹⁸ *Ibid.* at 37 (McDermid J.A., dissenting).

¹⁹ *Ibid.* at 42, 53 (McDermid J.A., dissenting).

²⁰ *Ibid.* at 60-64 (Clement J.A.).

There was a dissent in the Court of Appeal that relied on the decision of the U.S. Supreme Court in *Bangor Punta v. Bangor & Aroostook Railway*.²¹ The dissent claimed that this was a case of unjust enrichment. There was a new controller here and the new purchaser should not profit by what is considered a breach of corporate opportunity.²²

Abbey Glen raises some of the same questions as *Regal (Hastings)*. In both, there was an honest refusal by a third party to deal with the principal. The question is: What should be the position of the fiduciary agent in those circumstances? That raises a difficult question of disclosure, which is clearly what the court was insisting on and which the *Regal (Hastings)* and other courts have said is the medicine that cures the breach.²³ But disclosure is not without its problems. To whom is disclosure made in those circumstances?

In the *Regal (Hastings)* situation, the interested directors were the controllers. What good will it do to make disclosure to the board under those circumstances? Should the rule be that disclosure ought to be made to the shareholders in those circumstances? And in *Abbey Glen*, should the Stumborgs have made disclosure to the board and asked the board's permission? One must also ask the question: What constitutes full disclosure under these circumstances? Are there dangers in saying that there only has to be disclosure to the board depending on the relationship of the executives involved to the board, particularly in a public company? What incentive is there for the board, and particularly for outside directors, to police executive management in these circumstances?

Furthermore, if one is talking about disclosure to shareholders, then one is again talking about the level of disclosure and how much is disclosed. One is also talking about the control of proxy machinery and all that that involves. Is it the interested directors who control the proxy machinery (remembering the natural tendency of shareholders to go along with management)? Finally, if what we are talking about is "corporate property," can any majority of shareholders sanction the fiduciary's taking it? If the analogy is to giving away corporate property, then is not the rule one of unanimity?

Also clearly raised in *Abbey Glen* is the issue of competition. Should executive officers in the public company ever be allowed to put themselves in a position where they are competing with their principal? That happens in real estate development and, as in the next case to be discussed, it happens in junior resource development, both in Canada and in the United States. Those who are promoters of junior oil and gas companies and mining companies regularly promote many concerns. They are always being offered properties. They put them in one company or an-

²¹ *Bangor Punta v. Bangor & Aroostook Railway* (1974), 417 U.S. 703.

²² *Abbey Glen*, *supra*, note 14 at 49-51 (McDermid J.A., dissenting).

²³ See *Regal (Hastings)*, *supra*, note 4 at 386, 391 & 394-95.

other that they are running and for which they are raising the finances. Who are they acting for? What hat are they wearing at any one time? Junior public companies are being floated constantly on the Denver Exchange and on the Vancouver Exchange. How does the law deal with that sort of problem?

The next case to look at is *Peso Silver Mines Ltd. v. Cropper*, which also went to the Supreme Court of Canada, and is exactly the above type of situation.²⁴ Peso was a silver mining company with extensive claims in the Yukon area of northern Canada. A gentleman named Cropper, along with a colleague named Walker, were the chief parties in interest and the promoters. Dr. Aho, a geologist, presented Peso with new claims—the “Dickson” claims. Some of these claims were contiguous to Peso’s existing claims, and some were further away. The board considered the claims but decided to turn down the opportunity, since the company already had over a thousand acres at stake and was running out of money.²⁵

Within six weeks Cropper, Aho, and Walker, along with two other directors, formed a new company to pick up the Dickson claims. At the same time, Walker wrote to the Superintendent of Brokers in charge of securities trading in British Columbia to explain their actions. He explained in the letter that “we” are interested in that property and want to protect “our” position and therefore formed a new company to pick up the claims. “Our position” referred to the position of Peso Silver Mines.²⁶

Once again, the same situation arose as in *Abbey Glen and Regal (Hastings)*. Peso Mines was sold to Charter Oil, which then became the sole controller of Peso, and an action was brought against Cropper, Walker and the others for breach of fiduciary duty. This time the trial court said there was a bona fide rejection by the board. When the directors and others picked up the claims six weeks later, they were not acting in the course or in the execution of their office as directors. Their actions were approved both in the Court of Appeal and the Supreme Court of Canada.²⁷

The difficulty with this decision was that Cropper, who was the chief operating officer, was in New York at the time these transactions took place. He was raising finance capital for his own interest in the new company. But if Peso was interested in the new claims, and wanted to “protect its position,” then why could not Cropper raise more money for Peso rather than for the new company? Another difficulty is that the court found that Peso really did have all the land it needed. It really was short

²⁴ *Peso Silver Mines Ltd. v. Cropper* (1965), 56 D.L.R. (2d) 117 (B.C.C.A.), aff’d (1966), [1966] S.C.R. 673.

²⁵ *Ibid.* at 120-21.

²⁶ *Ibid.* at 132-33.

²⁷ *Ibid.* at 140-46.

of funds and it did not make sense to raise funds for land it did not want.²⁸ The problem is whether the courts ought to put themselves into the position of sorting out that type of question.

Still another difficult point is that when the Dickson claims were purchased, they were put into a new private company and subsequently vended into a public company which did a new issue. That is a common scenario, except that Cropper and Walker were then running the new public company. How do they protect Peso's interest now that a new public company has the contingent Dickson Claims? What about the interests of the new public shareholders? These questions raise the difficult problems that arise out of competing situations. There are also other scenarios, such as where another geologist comes along, as they often do, with claims on lands that are contingent to both claims. How do the chief executive officers and the directors/fiduciaries handle that situation?

One other issue which needs to be mentioned is that while Regal was a private company, Peso and Abbey Glen were public companies. Should there be different rules? Are there different expectations in the shareholders of a private company with respect to what their fiduciaries might do, given the state of their knowledge at the time they enter into the private company? That was the situation in *Burg v. Horn*.²⁹ What were the reasonable expectations of the parties at the time? Is that the question that the court ought to ask or ought the court to insist on contractual terms? That is, should those expectations be reduced to writing, and if they're not, should the "familiar fiduciary learning" principle be applied whether it is a private company or a public company?

There is something to be said for different rules for the private company situation as opposed to the public company situation. Professors Brudney and Clark's position is that, with respect to the public company, there ought to be a categorical approach.³⁰ The opportunities available to a public company are infinite. This is especially true today, with the growth of conglomerates. Everything is within the ken of a public company and, therefore, corporate opportunity is as large as economic opportunity can make it. For the private company, however, a selective approach should be adopted, a more traditional approach that uses an interest or expectancy line of analysis. That is, what was the bargain of the private parties with respect to the private company? Questions like these have yet to be resolved.

A final case which should be examined is a 1974 Canadian Supreme Court decision, *Canadian Aero Service Ltd. v. O'Malley*,³¹ in which the

²⁸ *Ibid.* at 129, 130.

²⁹ *Burg v. Horn* (1967), 380 F.2d 897 (2d Cir.).

³⁰ See V. Brudney & R.C. Clark, "A New Look at Corporate Opportunities" (1981) Harv. L. Rev. 997.

³¹ *Canadian Aero Service Ltd. v. O'Malley*, *supra*, note 5.

court broke away from some of the language in *Regal (Hastings)*. How far it has broken away remains to be seen. The facts in *Canadian Aero Service* were unexceptional. Two senior officers in the company worked on a particular development for a five-year period. They left the company and within one month formed their own company and took up the contract they had been working on. The astonishing thing about the case is that both the trial court and the Court of Appeal reached the same result: the fiduciaries were allowed to leave the company and take up the opportunity. Both courts said they had resigned their offices and they were employees, not appointed executive officers. The Supreme Court of Canada, however, said that that made no difference. They were active as officers whether they were appointed or not. The Court said that they could not simply resign and take up an emerging opportunity that they had been working on for a five-year period.³²

An interesting aspect of the case concerns capacity. The reason the two officers left was that the company they worked for was a wholly owned subsidiary of an American company, Litton Industries. They were working on a mapping project for Guyana, which was going to require Canadian foreign aid. It was the Canadian government's policy that foreign aid would not go to a company that was foreign owned. The two officers then left to set up their own company and successfully bid on the mapping project. Though this aspect of the case is not often discussed, it does present an interesting question.

In reversing the appellate court's decision, the Supreme Court said it was a mistake to place the corporate opportunity doctrine of *Regal (Hastings)* in a "strait jacket" of special knowledge acquired while acting as a director or senior officer.³³ It was also a mistake to limit it to benefits acquired by reason of, or during the holding of, those offices. The Court said that that was simply too narrow a view, particularly concerning a public company.³⁴

One must look at the entire context, at least in the public company context, of moving towards a positive obligation to advance the interests of the corporation. That is, opportunities do not come to directors while they are sitting in the board room. They come to them because they are businessmen in a particular line or lines of business. Whether they get the information on the golf course, at lunch, or on the weekend, does not make a great deal of difference; the essential question is whether it is an opportunity that ought properly to be within the development scope of the company.

What, then, should replace the *Regal (Hastings)* strait jacket? In *Canadian Aero Service*, Chief Justice Laskin examined the American cases in some detail and concluded that what emerges from them is "an

³² *Ibid.* at 606.

³³ *Ibid.* at 619.

³⁴ *Ibid.*

imprecise ethical standard.”³⁵ Although he was not too happy with that standard, it is really where his judgment ends up. He said that the most the Court could do was set out a number of factors to be considered, rather than set out a single test. He articulated the factors as follows: “[T]he factor of position or office held, the nature of the corporate opportunity, its ripeness, its specificity [sic] and the director’s or managerial officer’s relation to it, the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or, indeed, even private. . . .”³⁶

That is the “laundry list” of factors to be considered and I regard it as a useful approach. I do not think that this is an area where a single test is helpful, or even useful, given the nature of the problem. I think that the most one can do is list types of factors and apply them.

Two interesting issues surround these factors. First, the factors may be too vague as a guide to conduct. Are corporate executives not entitled to demand from the law some reasonably certain rules? But if the answer to that is yes, does that not lead back to a rigid test? My answer to that is the factors set out by Justice Laskin are not all that vague or difficult to apply. They simply recognize the complexity of commercial life. Executives and other fiduciary officers know when they are crossing the line and when they are not.

Secondly, there also may be a “loosening factor” in Justice Laskin’s judgment. That is, it does not necessarily follow from his judgment that he would, applying those factors, reach the same conclusion in *Regal (Hastings)* as the House of Lords did. If one looks at all those factors, it might be the case that a different result would be reached in both *Regal (Hastings)* and *Abbey Glen*. That at least seems to me a possibility.

Lastly, I would point out two recent legislative developments in Canada. Canadian corporation law was dramatically reformed at the federal level in 1975 by the new *Canada Business Corporations Act*. (In Canadian law there is incorporation at the federal as well as at the provincial level.) The federal *Act* has been followed by all provinces except British Columbia, which closely follows its most important aspects. It has introduced a great deal of uniformity into Canadian law.

Its reforms include a much broadened shareholders derivative action as well as a new open-ended oppression remedy. Both of these provisions allow for ease of access to the courts by aggrieved shareholders. In the derivative action, no security for costs may be ordered. Indeed, interim costs may be granted to the applicant. It is highly unlikely in the context of the wording of the legislation that the business judgment rule would be applied with respect to litigation committees.

The derivative shareholders’ action has been broadened with greater ease of access. The oppression remedy is extraordinarily broad and gives

³⁵ *Ibid.* at 612 (quoting Note, “Corporate Opportunity” (1961) 74 Harv. L. Rev. 765).

³⁶ *Ibid.* at 620.

an equitable, roving jurisdiction to the court. Finally, the question of ratification is handled by simply making it a piece of evidence that is to be weighed by the court. Interested directors may vote in their capacity as shareholders. Although this will be an important factor in weighing the ratification, it will not be determinative of the matter at the outset.

