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INSIDER TRADING IN ISRAEL AND ENGLAND

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INSIDER TRADING
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ISRAEL AND ENGLAND

Present law and suggestions for new theories of liability

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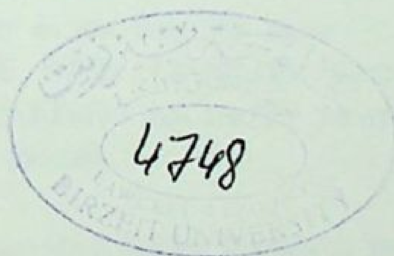

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THE INSTITUTE FOR LEGISLATIVE RESEARCH AND COMPARATIVE LAW
OF THE HEBREW UNIVERSITY
In cooperation with
THE ISRAEL LAW REVIEW ASSOCIATION
Jerusalem, 1972

By 1999-1-28 Hebrew University 20 NIS invoice no. 1437 date 17-1-99
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TO MY PARENTS

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Revised edition of a two-part article which first appeared in:
(1972) 7 Israel Law Review

Printed in Israel
at Alpha Press, Jerusalem

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FOREWORD

The author was unduly modest in selecting his title. For this book is nothing less than a study of the present status — not in Israel and England alone but in the common law world generally — of the "calamitous decision" (as he calls it) in *Percival* v. *Wright,*[1] which has had a remarkable career for a *nisi prius* case.

It has long seemed to me that that case — holding as it does that a director's fiduciary obligation to the ghost that we call the corporation does not extend to the flesh-and-blood persons who *own* the corporation — is a monument to the ability of lawyers to hypnotize themselves with their own fictions. As the eminent Judge Learned Hand said in 1951:

> For many years a grave omission in our corporation law had been its indifference to dealings of directors or other corporate officers in the shares of their companies. When they bought shares, they came literally within the conventional prohibitions of the law of trusts; yet the decisions were strangely slack in so deciding. When they sold shares, it could indeed be argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale...[2]

It is abundantly clear that the American Bench generally shares this sentiment. For, although the only specific reference to "insider trading" in the extensive arsenal of federal securities legislation is a provision on the automatic *corporate* recapture of short-term trading profits made by directors, officers and ten percent stockholders, the courts have merrily built a substantial jurisprudence of civil liability on the part of "insiders" generally to the "outsiders" with whom they deal. This they have done under the famous Rule 10b-5 of the Securities and Exchange Commission — a rule that outlaws deceptive

[1] [1902] 2 Ch. 421.

[2] Gratz v. Claughton, 187 F. 2d 46, 49 (2d Cir. 1951), *cert. denied,* 341 U. S. 920.

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practices, misstatements and half-truths by "any person... in connection with the purchase or sale of any security" in magisterial generalities almost as Delphic as the underlying sec. 10(b), which was described by the Administration's spokesman in 1934 as saying simply: "Thou shalt not devise any other cunning devices." [3]

First the federal courts, running with a ball that has lost much of its bounce in its country of origin, implied a private right of action for violation of the rule, primarily on the ground that certain types of unlawful conduct are tortious *per se*.[4] Then, having emancipated themselves from the necessity of applying state law, they overruled *Percival*, in effect, as a matter of interpretation of the SEC rule.

This has now been carried to the point where it is not easy to distinguish a federal-law action under Rule 10b-5 from an ordinary action for corporate mismanagement under state law when (as is frequently the case) a security is incidentally involved. Indeed, it is now commonplace to speak in this sense of a "federal corporation law." In short, the common law, which had begun to pull away from *Percival* v. *Wright* in many states even before the SEC, has been left far behind by a horse called 10b-5 — a steed that may be of dubious pedigree but is very fleet of foot.

Yet the common law is nothing if not virile. "Like the fertile octogenarian," it has been observed, "state law has made a belated comeback" [5] quite recently in the form of a holding by the highest

[3] Stock Exchange Regulation, Hearing before House Com. on Int. & For. Commerce on H. R. 7852 and H. R. 8720, 73d Cong., 2d Sess. (1934) 115.

[4] When the Supreme Court finally got to the question, having earlier sustained a private right of action for violation of the SEC's proxy rules under the same statute, it was able to say without elaboration: "It is now established that a private right of action is implied under sec. 10(b)." Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co., 404 U. S. 6, 13, n. 9 (1971); J. I. Case Co. v. Borak, 377 U.S. 426 (1964). Contrast Williams, The Effect of Penal Legislation in the Law of Tort, 23 Mod. L. Rev. 233 (1960), with Am. Law Institute, Restatement of Torts 2d sec. 286 (1965). Interestingly enough, the Law Commissions in England and Scotland would codify the doctrine, as the author reports has been done in Israel. The Interpretation of Statutes, Law Com. No. 21, Scot. Law Com. No. 11 (1969) para. 38, 78, 81(c); Israel Civil Wrongs Ordinance (New Version) sec. 63, discussed in Yoran 69 et seq.

[5] The apt figure of speech is from a case note in 55 Va. L. Rev. 1520, 1533 (1965).

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court of New York State to the effect that a director who sells in the market just before the publication of an unfavorable earnings report has a restitutional duty to restore his "profit" to the company just as if he had converted a physical asset.[6] And now The American Law Institute is struggling with this whole development in connection with its preparation of a Federal Securities Code for submission to Congress.[7] So we may hope that the jurisprudential superstructure will be properly legitimated.

All this is not to say to jurists in Israel or England or anywhere else: "Go thou and do likewise." One may venture to guess that ultimately the advanced corporate societies will in fact move in much the same direction. But one may guess also, with even more safety, that they will hardly follow the same path; for the legislative-administrative-judicial alchemy that has made a genuine fiduciary out of the corporate "insider" in the past thirty years via Rule 10b-5 is at least as awesome as the structure of the British Commonwealth, and probably no more exportable.

It *is* important, nevertheless, that jurists in other countries be familiar with this major contribution of the SEC to what is really company law in the guise of market regulation. And that is the measure of the value of this book, which is a partial outgrowth of a doctoral dissertation at the Harvard Law School prepared by one of a series of exceptional Israeli scholars who, happily for that institution, have spent varying lengths of time there since the establishment of the State.

The pity is that, since Hebrew is "Greek" to most people in the common law world, American and Commonwealth jurists will not be able either to follow or to comment on the reaction of the Knesset and the Israeli courts to the American and British developments in this area unless — as this very readable work gives good reason to hope — the author and his colleagues continue to publish from time to time in the English language. Meanwhile he is to be highly commended for what he has already done.

Louis Loss
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[6] Diamond v. Oreamuno, 24 N. Y. 2d 494, 248 N. E. 2d 910 (1969).

[7] See Am. Law Institute, Federal Securities Code, Parts XIII, XIV (Tentative Draft No. 2, 1973).

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PREFACE

This book is based on a portion of an S.J.D. dissertation, submitted to the Harvard Law School in December, 1970. The area covered herein was presented in substantially the same form in the April and July, 1972 issues of the Israel Law Review. This book, however, reflects several developments that took place since the appearance of the articles in the Israel Law Review. Of foremost importance are the decision of the United States Supreme Court, upholding a private right of action under Rule 10b-5, and the publication of a report by *Justice* (the British section of the International Commission of Jurists) on Insider Trading. Developments in Israel include a draft law to amend the Company Law Ordinance, contained in which are provisions relating to insider trading. Since the fate of the draft law is uncertain, however, I thought it preferable to annex as an appendix to this book a translation of the relevant parts of a Hebrew article in which I analyse and criticize the draft law.

Without the help of a number of people, this book would not be a reality. I wish to convey deep appreciation to my supervisor at Harvard, Professor Louis Loss for his help and encouragement in writing the dissertation. I would like also to express my thanks to the Harvard Law School for the fellowship grant which made this work possible and for the courteous hospitality I was shown. I am also grateful for the assistance given by Mr. Richard E. Laster and Miss Gretchen Hovemeyer for their work in polishing the language of the dissertation and in general for their editorial assistance. Kind thanks are also due to Mrs. Betty Yoffey, editor of the Israel Law Review, for her work in preparing the dissertation for publication. Finally, I wish to thank the Law Faculty of the Hebrew University for their financial support in publishing this work, and a special word of thanks to Professor Izhak Englard, Director of the Institute for Legislative Research and Comparative Law, for his help in the book's publication.

Aaron Yoran
Jerusalem 1972

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INTRODUCTION

It is generally assumed that English directors have a *carte blanche* privilege to engage at arm's length in transactions involving securities of a corporation which they manage.[1] Thus directors of English corporations may utilize inside information for their personal benefit at the expense of their trading partners.[2] This assumption is derived from the calamitous decision of *Percival* v. *Wright*[3] which, subject to illusory limitations imposed by *Allen* v. *Hyatt*,[4] is still believed to be the law in England today.[5] Israeli directors, it is believed, share this *carte*

[1] The following statement from the report of the Jenkins Committee is illustrative: "The case of *Percival* v. *Wright* provides authority for the proposition that no fiduciary duty is owed by a director to individual members of his company, but only to the company itself and *a fortiori* that none is owed to a person who is not a member. The result is that a director who has by reason of his office acquired in confidence a particular piece of information materially affecting the value of the security of his company (or any company in the same group) will incur no liability to the other party if he buys or sells such securities without disclosing that piece of information." *Report of the Company Law Committee*, Cmnd. 1749, Para. 89 (1962) (hereinafter cited as the *Jenkins Report*).

[2] Mr. Charles Clore testified before the Jenkins Committee that it was his experience that directors of target companies trade on the market before the bid is announced, sometimes in order to foil the takeover. Minutes of Evidence to Jenkins Committee, pp. 531-32. See also K. W. Wedderburn, *Company Law Reform* (1965) 10.

[3] [1902] 2 Ch. 421.

[4] (1914) 30 T.L.R. 44, P.C.

[5] Rules 5, 30, and 31 of the City Code on Take-overs and Mergers, February 1972 (obtainable from the Secretary, The Issuing Houses Association) are designed to eliminate this result in take-over situations. Whether these extralegal rules have sufficient teeth is a controversial matter. See M. A. Weinberg, *Take-overs and Mergers*, 129-30 (3rd ed. 1971).

The Stock Exchange Rules do not in so many words prohibit trading on inside information, yet attempt to curtail the practice by several provisions. First, the annual report must include particulars of the shareholdings of the directors and their associates in the company and its subsidiaries, distinguishing between beneficial and other interests in the shares. General Undertaking, Sch. VIII, Part A, Para. 6(d). Second, a statement of the se-

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blanche privilege with their English counterparts.[6] This belief derives from the fact that Israeli courts resort to English jurisprudence, when necessary to fill in the gaps which are found to exist in Israeli law.[7]

This book questions the validity of the above assumptions. It is an attempt to evaluate whether or not an English or Israeli director, or other insider, may indeed utilize inside information to trade in the securities of his corporation without regard to rules governing fiduciary relationships and other legal principles, which, it is submitted, the English [8] judiciary and bar have thus far overlooked.

curities transactions of directors and their associates must be prepared for shareholders' inspection before and during the annual meeting. *Id.* at Para. 7(a) (1). The requirement of Para. 6(d) is waived if the aggregate interest of all directors and associates does not exceed 5% either of share capital or of voting control. A statement to that effect suffices. If the directors register under the Companies Act, 1967, reflects all the transactions under Para. 7(a) (1) a reference to the register can substitute for the 7(a) (1) statement. Third, prompt release of material information by the company is commanded. Communications Memorandum Paras. 1-8. Furthermore the rules recommend that no information be supplied to inquiring shareholders unless the board satisfies itself "that it will not be placing anyone in a privileged position." *Id.* Para. 10.

6 See A. Felman, *Company Law in Israel* (1960, Hebrew) 316, 338 citing *Percival* v. *Wright*, which is incorrectly described as a damage action. *Id.* at 338.

7 Suffice it to say that as a result of the Israel legislature's endorsing an importation clause enacted by the British during their mandate of Palestine, the principles of English Common Law and Equity prevail in Israel when there is a lacuna in the other sources of Israel law. See generally Yadin, "Sources and Tendencies of Israel Law" (1951) 99 U.Pa.L.R. 561 and Ginossar, "Israel Law: Components and Trends" (1966) 1 Is.L.R. 380; Jacobson, "The Legal System of Israel" (1954) 40 A.B.A.J. 1067; Gurney: "American Precedent in the Supreme Court of Israel" (1955) 68 Harv.L.R. 1194. As more areas are covered by Israeli laws the application of the importation clause is being gradually restricted.

8 As we shall see, the other theories of liability stem from the fact that trading on undisclosed inside information is a crime. It has been a crime in England since 1939, but has become one in Israel only as of 1969. See *infra* n. 177. It is the belief of the writer that concealment of material information, even by an insider, does not constitute a crime under sec. 3 of the Penal Law Amendment, (Deceit, Blackmail and Extortion) Law 1963, ((1963) 17 L.S.I. 153). Sec. 3 provides: "A person who obtains anything by a trick, or by deliberately taking advantage of another person's error, such trick or taking advantage not amounting to deceit, shall be liable to imprisonment for a term of two years." The term "error" is

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I. *CHARACTERISTICS OF INSIDER TRADING*

When an individual trades in the securities of a corporation of which he is an insider, his conduct is subject to regulation under several different legal theories. The director, first of all, owes fiduciary duties to this company. If he uses information received as a result of his inside capacity for personal profit, he is obliged to disgorge his gains to the corporation. Profits derived from insider trading are subject to this rule. An American court has recently applied this principle to directors who sold their shares before information, unfavourable to the corporation, had become public knowledge.[9] Although

not defined in the Law. We believe that the hapless outsider who was not aware of the concealed fact was not in error concerning it. "Error" connotes reference to a certain fact and belief in the opposite of the real situation. See generally Tomkiewicz, "Aspects of the Law of Deceit," (1969) 25 *HaPraklit* 416, continuing 570 (Hebrew). A proposed amendment to the Companies Ordinance ((1971) *Hatzaot Hok* No. 976) would add secs. 9C and 9D to the Penal Law Amendment (Deceit, Blackmail and Extortion) Law, 1963. Sec. 9C states "a director or a managing director of a company, who takes advantage of information he possesses for his personal benefit or for the benefit of any person other than the company will be punished by imprisonment for a year or a fine of IL20,000." Sec. 9D(1) provides "a director or a managing director of a company who had, directly or indirectly, a personal interest in securities of his company and entered into a transaction in such securities, not for the benefit of the company, will be punished by a fine in the amount of three times the subject matter of the transactions." Sec. 9D(1) by virtue of sec. 9D(2) applies not only to transactions in the securities of the company but also to transactions in the securities of a holding company or a sister company. The extent to which secs. 9C and 9D make trading on inside information an offence is however far from clear. The writer criticizes the provisions for their inadequacy and lack of clarity in an article published in (1972)4 *Mishpatim* 167, (Hebrew), an English translation of the relevant parts thereof appears as Appendix A to this book. Damage to the company may be a necessary element both under secs. 9C and 9D. Further, it is doubtful whether a civil remedy for the trading party of the director may be inferred from secs. 9C and 9D which seem to be designed to protect the company and not the shareholders.

9 *Diamond* v. *Oreamuno* 24 N.Y. 2d 494, 248 N.E. 2d 910 (1969), *aff'g* 29 A.D.2d 285, 287 N.Y.S.2d 300 (1968). A Delaware court ruled so earlier,

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there are no English or Israeli decisions squarely on this point, it is believed that the rule in those countries is no different.[10] Only a slight uncertainty as to this led the Canadians[11] to include an express provision to this effect in their revision of the law.

The second relevant aspect of a transaction involving insider trading is the special relationship which exists between the director of a corporation and a stockholder thereof. Whether or not this relationship is fiduciary in nature is a thorny question. The majority view in the United States was once that expressed in *Percival* v. *Wright*, that the directors owe loyalty only to the corporation itself and not to the individual shareholders thereof (the "majority rule").[12] Two strong

but there the directors also appropriated a corporate opportunity. *Brophy* v. *Cities Service Co.* 31 Del Ch. 241, 70 A.2d 5 (1949).

10 Gower, *Modern Company Law* (3rd ed., 1969) 547 [hereinafter cited as Gower]. Yoran, "Limiting Fringe Benefits" (1972) 28 *HaPraklit* 15 (Hebrew). Recommendation 99(a) (ii) of the Jenkins Committee (see *supra* n. 1) would, perhaps unwittingly, prevent such recovery because it would allow an action by the company against the director only when he used inside information for himself "at the expense of the company". Sec. 111 of the abortive Draft Companies Bill of Israel, 1957 (See *infra* p. 43) would codify the corporate action: "A director shall be bound to account to the company for all profits made by him in consequence of a breach of duty or by taking unfair advantage of his position as a director of the company or of any information obtained thereby".

11 Report of the Attorney General's Committee on Securities Legislation in Ontario [hereinafter cited as the *Kimber Report*], Para. 225 (see also *infra* n. 449). The Kimber Committee thought that the *Zwicker* case (*Zwicker* v. *Stanbury* [1953] 2 S.C.R. 438), strengthened the proposition that the director is accountable to the company at common law for profits made from trading on inside information. *Id.* With all due respect, it is our view that this result does not follow from *Zwicker*. There the directors purchased a mortgage on their company from the mortgagee company at a discount. The mortgagee also turned over the common shares in the mortgagor company to the directors because it had written off its investment in the mortgagor company. The Supreme Court of Canada held that the directors had to deal with the mortgagee for the *benefit of their company*. Therefore, it ordered them to turn in the shares to the company for cancellation and allowed them to recover on the mortgage only the discount price and not the face value. Unlike a case of insider trading, the directors in *Zwicker* enriched themselves *at the possible expense* of the company. See *infra* pp. 38, 39.

12 *E.g.*, *Carpenter* v. *Danforth* 52 Barb. 581 (N.Y. 1868); *Ryder* v. *Bamberger* 172 Cal. 791, 806, 158 P. 753 (1916), where the court stated: "The officers are not bound to acquaint a stockholder willing to sell his

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streams of cases, however, have developed in the United States, which would allow recovery by the shareholder either in special circumstances (the "special circumstances rule") [13] or as a general rule (the "minority rule").[14] The line of distinction [15] between these two streams of

shares with facts which would enhance the price of the stock. The officers are trustees for the shareholders only as to the management of the corporation and not in their private dealings". *Id.* at 807, 158 P. at 759. See cases Annot., 84 A.L.R. 615 (1933).

13 A doctrine stemming from a decision of the Supreme Court of the United States in *Strong* v. *Repide* 213 U.S. 419 (1909).

14 This rule, also called the "trusteeship" or "fiduciary" rule flourished in the less industrial states. E.g., *Oliver* v. *Oliver* 118 Ga. 362, 45 S.E. 232 (1903); *Stewart* v. *Harris* 69 Kan. 498, 77 P. 277 (1904). It is now making its triumphant entry into industrial states, *Cf.*, *Brown* v. *Halbert* 76 Cal. Reptr. 781 (1969); *Jones* v. *Ahmanson & Co.* 1 Cal. 3d 93, 460 P. 2d 464 (1969).

15 In *Buckley* v. *Buckley* 230 Mich. 504, 508, 202 N.W. 955, 956 (1925) the Michigan court defined special circumstances as any "fact or condition enhancing the value of the stock, known by the officer or officers, not known by the stockholder, not to be ascertained by an inspection of the books". In *Brown* v. *Halbert* 76 Cal. Reptr. 781, 787-788, the California Court of Appeals observed that the "majority view" ... "has become so eroded by exceptions and statements of fiduciary obligations in more recent decisions (especially those involving fraud, concealment, looters and incompetents) that it can be said it no longer exists". The *Brown* court upheld a *direct* class action by minority stockholders against the controlling stockholder to disgorge the control premium he made on the sale of his stock to *outsiders.* While Draper, presiding justice, based his decision upon the special facts doctrine, the majority of the court (per Judge Brown) established a rule as follows: "It is the duty of the majority stockholder-director, when contemplating the sale of the majority stock at a price not available to other stockholders and which sale may prejudice the minority stockholders, is [sic.] to act affirmatively and openly with full disclosure so that every opportunity is given to obtain substantially the same advantages that such fiduciary secured and for the full protection of the minority". *Id.* at 793, 794. This is a significant extension of the duty of the insider *to the individual shareholders,* because he not only does not act on behalf of the corporation, he also does not *deal* with the shareholders. But note that there are several factors in this case which might limit the reach of its holding: (a) the insider told the minority shareholders to sell cheaply to the takeover buyer, (b) prejudice to the minority shareholders was foreseeable, because the new management did not intend to pay dividends for a very long period. All the same the Supreme Court of California espoused shortly thereafter a similar proposition in *Jones* v. *Ahmanson & Co.* 1 Cal. 3d 93, 460 P. 2d 464 (1969).

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decisions has been blurred and together they are coming to be the prevailing law in state after state.[16] This trend stems from a growing realization that there is an inherent contradiction in a set of rules which requires corporate directors to manage the corporation in good faith for the interest, welfare, and advantage of the corporation, the ultimate test of which is the interest of the shareholders as a whole,[17] and yet at the same time allows the directors to antagonize the shareholders individually. The fetish of a separate corporate entity must be removed in order to deal with the merits of the situation. The directors have control over the subject matter of the shareholders' rights—the net assets of the corporation. They can directly affect the value of the shareholders' rights by their acts and decisions (to pay dividends, merge, etc.).[18] Hence a fiduciary relationship should be established, at least in special circumstances, and the directors should disclose their inside information or forego trading in company shares.

Whether or not a shareholder who purchases shares has a common law action against a director who withheld unfavourable information from him is unclear in the United States. It is arguable that the director owes a duty only to present shareholders and hence can sell shares

[16] L. Loss, *Securities Regulation* (2nd ed. 1961 and Supp.) 1447 [hereinafter Loss].

[17] In *Greenhalgh* v. *Arderne, Ltd.* [1951] Ch. 286, 291, C.A. Evershed M.R., refering to the duty of a controlling shareholder voting in a general meeting, stated: "The phrase 'the company as a whole' does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators; it means the corporators as a general body. That is to say: the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit". This test is applicable also to directors in the discharge of their duties. Gower at 521 n. 34. See the formula endorsed by the investigator in the takeover bid of the Savoy Hotel that the "interests of the company" means the interests of shareholders present and *future,* balancing a long term view against the short term interests of present members. *The Savoy Hotel Ltd. and the Berkeley Hotel Company Ltd.: Investigation under Sec. 165(b) of the Companies Act, 1948: Report of Mr. E. Milner Holland, Q.C.* (Her Majesty's Stationery Office, 1954), discussed in Gower, "Corporate Control: The Battle for the Berkeley" (1955) 65 Harv. L.R. 1139. See also the test of Romilly M. R. in *The York & North-Midland Ry. Co.* v. *Hudson, infra* p. 32.

[18] *Oliver* v. *Oliver* 118 Ga. 362, 45 S.E. 232, 235 (1903).

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or, perhaps, buy bonds in arm's length transactions without revealing material information.[19] We shall return to this point later.

The reasons which have led to the imposition of liability upon directors are equally pertinent in the case of controlling shareholders, even those who do not sit on boards of directors. Presumably, the special circumstances and strict trusteeship jurisdictions would indeed so hold.[20] *Percival* v. *Wright*, it is believed, forecloses the development of a body of fiduciary duties owed by insiders to individual shareholders in England. We shall re-examine this decision as well as *Allen* v. *Hyatt*, which is often cited as the only restraint on *Percival* v. *Wright*, in order to see whether those cases do indeed stand for the broad proposition which negates a director's fiduciary duty to shareholders.

The fiduciary element of the transaction does not exhaust all of its relevant aspects. Inducing the sale or purchase of a security by dishonest concealment of material facts is a crime in England.[21] Such

[19] Judge Learned Hand in *Gratz* v. *Claughton* 187 F. 2d 46, 49 (2d Cir. 1951), observed that the very transaction in question makes a purchaser of shares a beneficiary of the director, and "...it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a fiduciary, although he was forbidden to do so, once the buyer had become one". This observation was by way of *dictum*. There are, however, no reported cases in which a buyer succeeded at common law on the allegation of non-disclosure *per se*. *Oliver* v. *Oliver* itself contains also an *obiter*: "...and to say that a director ... may ... buy from *or sell to* one whom he is directly representing without making a full disclosure ... would offer a premium for faithless silence, and give a reward for the suppression of truth". (emphasis added), 45 S.E. 232, 235 (1903).

[20] Loss at 1446 n. 4.

[21] Sec. 13 of the Prevention of Fraud (Investments) Act, 1958 [hereinafter, sec. 13] reads as follows:

(1) Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person—

(a) to enter into or offer to enter into—

(i) any agreement for, or with a view to, acquiring, disposing of, subscribing for or underwriting securities or lending or depositing money to or with any industrial and provident society or building society, or

(ii) any agreement the purpose or pretended purpose of which

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behaviour is a crime in Israel even if the concealment is not dishonest.[22] A question arises as to whether or not the criminal nature of the concealment has any effect on the legal rights between the insider and the other party to the transaction. In the United States the "crime-tort doctrine" was employed to imply a tort from the criminal anti-fraud provisions of the Securities Acts. Federal courts, moreover, have gone further than state courts in "minority rule" jurisdictions. Since one of the anti-fraud provisions (sec. 10(b) [23] of the Securities Exchange Act of 1934 and Rule 10b-5 [24] thereunder) is applicable to buyers as well as to sellers and covers transactions in all securities, the questions noted above about actions by bondholders or purchasers of shares have been resolved by the implication doctrine. The federal courts appear at present to be on the verge of imposing an affirmative duty on *outsiders* [25] to speak in security transactions.

is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities, or

(b) to take part or offer to take part in any arrangements with respect to property other than securities, being arrangements the purpose or effect, or pretended purpose or effect, of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of the property or otherwise) to participate in or receive profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of such property, or sums to be paid or alleged to be likely to be paid of such profits or income,

(c) to enter into or offer to enter into an agreement the purpose or pretended purpose of which is to secure a profit to any of the parties by reference to fluctuations in the value of any property other than securities,

shall be guilty of an offence, and liable to imprisonment for a term not exceeding seven years.

(2) Any person guilty of conspiracy to commit an offence under the preceding subsection shall be punishable as if he had committed such an offence.

22 Securities Law, 1968, sec. 54 (1968), 22 L.S.1 280 [hereinafter sec. 54].

23 Securities Exchanges Act, 1934, 15 U.S.C. Sec. 78(j) (6) (1964) [hereinafter 1934 Act].

24 17 C.F.R. 240, 10b-5. Rule 10b-5 is set out *infra,* n. 438.

25 See *S.E.C.* v. *Great American Industries* 407 F. 2d 453 (2d Cir. 1968). In this case, a seller of property in exchange for shares did not disclose to the issuer the fact that 2/3 of the shares were given to finders. The S.E.C. seeking an injunction argued that the seller and the finders violated Rule 10b-5. Judge Friendly (with whom Judge Waterman concurred) found that there were statements which amounted to half truths

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It is the theme of this book that there is much room for a similar development in Israel and in England. The implication of tortious conduct from a criminal statute in the United States led to the overriding of explicit statutory restrictions on private actions, an anomaly which must not occur in other countries. We shall strive to show that the English and Israeli penal sections provide more appropriate frameworks from which civil remedies can be implied than similar penal statutes in the United States. Another development in the law of torts which will be explored in this context is the availability to defrauded shareholders of an injunction, even where no actionable tort can be implied from an insider's criminal acts.

Aside from the questionable tortious consequences of a criminal statute prohibiting insider trading, there are contractual [26] aspects that are also involved. If the transaction has not been consummated, it seems clear to the writer that the insider cannot bring an action to enforce the contract. The Privy Council, moreover, has decided that the victim of a crime—the innocent party to the contract—may bring a suit in quasi-contract for money had and received, even if no

and did not dispose of the S.E.C's contention. Judge Kaufman held that "in not revealing the percentage of the purchase price that was destined for the finders, the defendants failed to disclose a material fact", but hastened to add "that it should not be inferred from what I have said that I am expressing any view on the propriety of a private action for damages". *Id.* at 463. Judge Hays found that the finders were not mere outsiders, but rather quasi fiduciaries, and therefore under a duty to disclose their proceeds. A vigorous dissent was written by Judge Moore. He referred to the contention of a seller's duty to disclose as "an astounding proposition of law" (*Id.* at 470) and regarded the finders' duty to disclose as one that "only an Alice in a legal Wonderland could conceive of". Judge Kaufman's statement is, of course, not the ratio of the case even regarding an injuction action by the S.E.C. But his opinion, plus the observations of Judge Friendly (*Id.* at 460) and Judge Hays might be the seeds of a new tree of liability based on Rule 10b-5.

26 It is the opinion of the writer that the Israeli Sales Law, 1968 (22 L.S.I. 107) is not germane to concealment of material facts in securities transactions. Although sec. 4 (a) of the Sales Law declares that the law, which is primarily concerned with movables, shall apply also to a sale of rights, the section of non-compliance, (sec. 11) finds a seller to be in default only if his consideration did not amount to something *agreed* upon in the sale contract. See generally, Arnovsky, "Comments on the New Law of Sales" (1969) 4 Is.L.R. 141.

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tort can be implied from the criminal act.[27] This decision opens the floodgate for inroads to be made into the rule negating fiduciary duties of directors to individual shareholders by means of an action for unjust enrichment.

[27] *Kiriri Cotton Co. Ltd.* v. *Dewani* [1960] A.C. 192, P.C.

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II. *CONTRACT Uberimae Fidei?* — *REVISITING* Percival *v.* Wright *and* Allen *v.* Hyatt

We turn first [28] to a re-examination of the decisions in *Percival* v. *Wright* and *Allen* v. *Hyatt*. The decision in the first of these cases was stated in very broad terms:

> I am therefore of the opinion that the purchasing directors were under no obligation to disclose to their vendor shareholders the negotiations which ultimately proved abortive. The contrary view could place directors in a most invidious position as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company. I am of the opinion that directors are not in that position.[29]

However the scope of the decision's *ratio decidendi* can be no broader than the underlying facts of the case itself. In *Percival* v. *Wright*, while negotiations for a sale of the company's assets were pending, certain shareholders, unaware of the negotiations, approached the directors and sold their stock to them at a price fixed by the stockholders. The negotiations, however, never reached the stage of a firm offer to be put before the shareholders; [30] therefore, when the pending merger did not go through the shareholders suffered no damages nor did the directors reap any profits. In light of these circumstances, a court willing to distinguish a case before it from *Percival* v. *Wright* would have ample grounds for so doing. The astonishing fact is that the passage of 70 years has not produced such a decision.

The *Percival* court itself, moreover, made a restriction on its otherwise sweeping grant of freedom to directors. Thus, if they themselves approach the shareholders their freedom might be seriously curtailed. In the words of the court:

28 As to the duty of directors to individual shareholders, before the fetish of separate corporate entity set in to deny the duty, see Hossie, "The Civil Liability of Directors of a Corporation" (1951) 30 Can. Bar. R. 908; E.E. Palmer, "Directors' Powers and Duties" in Ziegel, *Canadian Company Law* (1967) 365, 380.

29 [1902] 2 Ch. 421, 426, per Swinfen Eady J.

30 The editor of the report tells us "...no firm offer was ever made which the board could lay before the shareholders, and the negotiations ultimately proved abortive. The court was not in fact satisfied on the evidence that the board ever intended to sell". *Id.* at 422. The court, however, did not rest its decision on this fact.

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> There is no question of unfair dealing in this case. The directors did not approach the shareholders with the view of obtaining their shares. The shareholders approached the directors, and named the price at which they were desirous of selling.[31]

It should also be noted that the issue before the court was a very narrow one. Plaintiff's counsel had unfortunately conceded that the directors had no duty to disclose inside information relating to ordinary corporate business, *e.g.*, a large casual profit, the discovery of a new vein, or the prospect of a good dividend in the immediate future. He assumed that the shareholders impliedly released the directors from the duty of disclosing any information acquired in the ordinary course of management. The only point urged by counsel for plaintiff was that a line ought to be drawn at the point where negotiations commence for the sale of the undertaking, but the court was unable to adopt that view:

> The true rule is that a shareholder is fixed with knowledge of all the directors' powers, and has no more reason to assume that they are not negotiating a sale of the undertaking than that they are not exercising any other power.[32]

One must admit that, if this assumption is accepted, the proposition is indeed sound. Thus, we have an example here of a bad argument making bad law.

To summarize this discussion of *Percival* v. *Wright*, it is submitted that any of the following narrow holdings are in order. First of all, the information withheld was not material. Secondly, directors do not owe the individual shareholder the same duty which a trustee owes to his fiduciary; every transaction between a trustee and his beneficiary is rescindable at the option of the latter; directors need account only for *unjust* enrichment, and only where there is unjust enrichment will the shareholder have any remedy including rescission. Thirdly, when negotiations or any other transactions are pending and the directors are approached by the shareholders, they can deal with them without special disclosure. The proposition that they should either disclose or forego the transaction is not proper in these circumstances, for disclosure might endanger the pending transaction and the refusal to sell might have the same effect by giving rise to specula-

[31] *Id.* at 426-7.
[32] *Id.* at 426.

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tion. The purchase of the shares by the directors might be the best way to quiet the market. The answer to this apparently vicious circle is, of course, to have the directors make the deal and then disgorge their profits, but the *Percival* court was faced with a rescission suit where no profits were made, not an action for the return of profits. It is also worth noting that the court assumed that a director owes the same duty to the stockholder whether he is buying or *selling*.[33]

Allen v. *Hyatt* is usually cited as the sequel to *Percival* which limited the scope of the earlier case. Speaking about England, Professor Gower has cited *Allen* v. *Hyatt* to suggest: "... there is more judicial authority than is generally realized for a similar development (*i.e.*, for the establishment of a special circumstances test) in this country as well".[34] The present writer believes, however, that whatever inroads can be made into the principle of *Percival* v. *Wright* can more easily be made from within that case itself than by utilization of the opinion in *Allen* v. *Hyatt*. *Allen* v. *Hyatt* stands for the proposition that when directors purport to be acting on behalf of individual shareholders, an agency is formed and the directors become accountable to the shareholders, *qua* agents, not *qua* directors. In the words of the Privy Council in *Allen* v. *Hyatt*:

> It might be that in circumstances such as those of *Percival* v. *Wright* they could deal at arm's length with a shareholder. But the facts in the present case were widely different from those in *Percival* v. *Wright*, and their Lordships thought that the directors must here be taken to have held themselves out to the individual shareholders as acting for them on the same footing as they were acting for the company itself, that is, as agents.[35]

A director, like anyone else, may of course become an agent for an individual shareholder, therefore the finding of liability in *Allen* v. *Hyatt* does not present progress in an attempt to formulate a duty upon directors as such. When the parties to a stock transaction deal through undisclosed or partially disclosed agents (as, for example, on

[33] "A director purchasing shares need not disclose [favourable information] ..., and similarly a director selling shares need not disclose [detrimental information]". *Id.* at 426. The equal treatment for the purposes of exempting from a duty might, perhaps, extend to the situation of "unfair dealing" where the *Percival* court would find liability.

[34] Gower, "Investor Protection in the U.S.A." (1952) 15 Mod. L. R. 446, 452-453.

[35] (1914) 30 T.L.R. 444 at 445.

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the stock market), no notion of an agency between the director and the shareholder can be injected into the picture. That, however, was the very situation in *Strong* v. *Repide*.[36] It is therefore submitted that in this context *Allen* v. *Hyatt* is of little significance. All that the court did there was to treat the options as proxies since they were given "... on the representation that it was necessary for the directors to secure the consent of a majority of the shareholders in order to effect the amalgamation".[37]

Careful reading of the facts of *Allen* v. *Hyatt*, moreover, shows that this was not a case of complete silence on the part of the directors, for statements were indeed made by them. The summary of the finding of facts by Lord Chancellor Viscount Haldane in the Privy Council reads as follows:

> That general and similar representations were made by the appellants to each of the respondents, to the effect that the former as directors wanted the options from the shareholders in order to deal on behalf of all the shareholders with the representatives of the Dominion Company; that the appelants expected to realize the par value of the shares and the 7 per cent interest, and that all the shareholders, including themselves, were to share *pro rata* in the amount realized ...[38]

To say the very least, this is a case involving half-truths.

[36] 213 U.S. 419 (1913). Repide was labelled an agent by virtue of his treble capacity (general administrator, chief negotiator, and dominant stockholder) and not by virtue of special authorization.

[37] (1914) 30 T.L.R. 444 at 445.

[38] *Id.*

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III. *A CRACK IN THE* Percival *v.* Wright *WALL IN SOUTH AFRICA?*

Several commentators [39] have suggested that the *Pretorius* [40] case in South Africa might lead to a reversal of *Percival* v. *Wright*. In *Pretorius,* the court held that a company had a duty to disclose to prospective buyers of its shares, the existence of a land purchase contract, provisions of which were material to the proposed sale of shares. The court, however, did not grant rescission because the buyers' conduct could be interpreted as an election to stand by the contract and also because they lost the right to rescission by laches.

The court concluded that the buyers had a right to rescind at common law, adopting a proposition that even if the contract were not *uberimae fidei,* such a right exists whenever a legal relationship is "characterized by the involuntary reliance of the one party on the other for information material to his decision".[41] Analogizing from the duty of a seller to disclose a latent defect of which he has knowledge, the court concluded that the company had a duty to disclose a provision in the land purchase contract. The provision provided for cancellation by the seller if the company did not begin to build on the property within a specified time and carry on without undue delays until completion. The court's analogy was appropriate because each block of shares was assigned a specific flat in a building to be erected by the company.

It is submitted that the *Pretorius* decision is of little value in solving the problem of insider trading for three reasons. First, the concealment of a latent defect rationale was employed only because the shares represented rights to a specific piece of property. But in the usual securities transaction such rationale cannot be invoked. Secondly, the directors acted on behalf of the company in selling the shares and not *qua* individuals [42], and the company was found to be under

[39] Levin, "Insider Trading" (1967) 30 T.H.R.—H.R. 137, 142-143; R. Hahlo, *Company Law* (2nd ed., 1969) 316.

[40] *Pretorius* v. *Natal South Sea Investment Trust* (1965) (3) S.A. 410 (N).

[41] *Id.* at 318, citing Millner, "Fraudulent Non-Disclosure" (1957) S.A.L.J. 177, 189.

[42] See *Northern Trust Co.* v. *Essaness Theatres Corp.* 348 Ill. App. 134, 108 N.E. 2d 443 (1952) for the proposition that when the director acts on behalf of the company, he may have a duty of disclosure to the shareholder even if he can trade at arm's length for himself.

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a duty of disclosure, not the directors. Thirdly, the existence of a duty of disclosure under South African common law was only one of the grounds for the court's decision. The court also held that the proper law of the contract of issuance was the Rhodesian law and there was a statutory duty to disclose under Rhodesian company law.

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IV. *AFFIRMATIVE DUTY TO DISCLOSE AT COMMON LAW IN ISRAEL*

If one were to judge the integrity of Israeli corporate directors by redress sought in the courts against insider trading, these men would appear as honest as their English counterparts and as an example to their American brethren. Yet it is not to suggest that insider trading does not take place in practice. It is not an unknown phenomenon in Israel that heavy activity in certain stocks *precedes* public announcement of an important news regarding these stocks. The financial press has drawn attention to these phenomena and attributed it to insider trading. The Stock Exchange conducted internal investigations but the occurrence of insider trading was never verified by it nor by any other body. Not one Israeli decision deals *squarely* with the problem of insider trading, but the question as to whether directors owe a fiduciary duty to individual corporate shareholders has arisen in other contexts. An important case decided by the District Court of Tel Aviv, *Hameshavek* v. *Kupler,*[43] in dealing with a director's duty to a stockholder, affirmed the principle enunciated in *Percival* v. *Wright*. *Hameshavek* was an action for accounting brought by sellers of shares of a closely held corporation against both the company and the surviving shareholder, Kupler, who was the managing director of the company. After selling to defendant Kupler, the plaintiffs found cause to suspect him of concealing profits made by the business while they were shareholders. Plaintiffs prayed, (1) for the company and Kupler to account for concealed profits, (2) for a disgorging of these profits, and (3) as ancillary relief for the difference between the actual value of the stock and the price they received. Kupler argued that the plaintiffs were not entitled to an accounting and alternatively, that since the ancillary relief sought to uphold the sale rather than rescind it, the plaintiffs were not entitled to accounting. The court accepted the first defence, citing *Percival* v. *Wright,* and ruled that neither the company nor Kupler owed a fiduciary duty to the individual shareholders. Hence, the latter were not entitled to the equitable relief of accounting, which is conditioned on a fiduciary duty. The court began by disposing of the second defence in the following manner:

[43] (1958) 15 *P.M.* 372.

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> I think that the action against Kupler *qua* purchaser of the shares, allegedly for a lower price due to deceit or fraud *by concealment of the facts,* should not be defeated only because the redress seeks to uphold the sale and not to rescind it. The ancillary relief is not relevant to the present stage of litigation. After obtaining an accounting, if it would be ordered, the plaintiffs might see fit to seek other remedies, not payment of the difference in price. (emphasis added).[44]

Thus, admittedly in *obiter*, the court remarked that an action could be sustained against the buying director who concealed material facts.[45] The only rationale which might reconcile this *obiter* with the declaration that a director does not owe a fiduciary duty to the individual shareholer, the apparent holding of the case, is that the court thought that in managing the company a director owes duties only to the company, but in buying and selling shares he owes a duty to the shareholders. But if that proposition be accepted, then the court actually rejected the holding in *Percival* v. *Wright* which it purported to apply. The value of this *obiter* for the present theme is weakened, however, by the fact that Kupler, as it was alleged, not only withheld material information, but also conducted a scheme to defraud the other shareholders, which was only culminated by buying them out. Thus even the *obiter*, it might be argued, does not stand for an affirmative duty to speak up.

The Supreme Court of Israel dealt with the fiduciary duty of a director to a shareholder in the quite extraordinary case of *Hess* v. *Laslo & Battery Manufacturing Ltd.*[46] Hess and the deceased husband of Mrs. Laslo were the managing directors of a private company in which Mrs. Laslo, her husband and the defendant Hess held all the shares. The board of directors was composed of the three shareholders and one additional person. During the period of mourning after Mr. Laslo's death, Hess had Mrs. Laslo sign a prepared decision of the board, which appointed him sole managing director. Although the decision was defective as a board resolution,[47] the defendant tried to uphold it as a unanimous decision of the general meeting. Mrs. Laslo

[44] *Id.* at 375, in free translation from the Hebrew. All translations from the Hebrew, unless otherwise designated, are unofficial.

[45] It is surprising that the legal writers just ignore this *dictum* and if *Hameshavek* v. *Kupler* is cited at all, it is for the proposition it purported to apply. See Barak, *infra*, n. 53, at 117.

[46] (1962) 17 *P.D.* 758.

[47] The other director was not notified; there was no meeting.

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then brought this action to set aside the nomination, alleging that undue influence was exercised upon her. The Supreme Court (per Mani J.), quoting the famous statement from Lord Chelmsford in *Tate* v. *Williamson*,[48] decided that only if a confidential relationship could be established between the parties would the equity rules of undue influence apply. The crucial question then was whether such a relationship could be established and the court answered in the affirmative, stating:

> In the case of *Yenidje Tobacco Co., Ltd.* the court treated the members of a company of similar composition to the one before us as partners managing their business in the cloak of a limited company. It is well known that the foundation of a partnership is in a mutual trust between the partners. For this reason, the relations between partners *inter se* are often described as a fiduciary relationship requiring absolute sincerity and disclosure. As said above, Mrs. Laslo was a shareholder and a member in the company, and therefore Hess owed her a personal duty to treat her as a fiduciary.[49]

The court goes on to quote from a statutory company case, *The York and North-Midland Ry. Co.* v. *Hudson*,[50] per Romilly M. R.:

> The directors are persons selected to manage the affairs of the company for the benefit of the shareholders; this is an office of trust, which if they undertake it is their duty to perform fully and entirely.

The *Hess* court concluded:

> Because of the relationship between Hess and Mrs. Laslo and because Mrs. Laslo, as the district court found, had no business experience . . . and, was in disturbed mental condition four days after the death of her husband, Hess had a twofold duty to explain to her the meaning of the resolution and its drastic consequences and to let her consult an independent person before signing.[51]

It is, of course, striking that *Percival* v. *Wright* was not cited at all. The *Hess* court pierced the corporate veil and treated the company as a partnership, relying on *In re Yenidje Tobacco Co.*,[52] which case,

48 [1866] 2 Ch. App. 55.
49 (1962) 17 *P.D.* 758, 764.
50 [1845] 51 E.R. 866, 868.
51 (1962) 17 *P.D.* 758, 764.
52 [1916] 2 Ch. 426.

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with all respect due to the court, is not dispositive of the problem in *Hess*. The *Yenidje* court applied partnership rules to a closely held company only for the purpose of deciding what constituted a "just and equitable" cause for liquidation. Nothing logically follows from a proposition expressed in a liquidation proceeding that should affect the legal relationship between directors and shareholders.[53] The *York* case, it is submitted, also does not stand for the proposition for which it was cited. *York* was a corporate action and the court only used the "benefit of the individual shareholder" as a test to determine benefit to the company. This point is made clear in another passage from the *York case*: "The shares are left to be disposed of by the directors, according to their judgment and discretion, as they may consider best *for the interest of the company;* that is, for the interest of the shareholders of the company".[54] (emphasis added). The court in *Percival* v. *Wright*, itself observed that *York* does not impose a duty of directors to individual shareholders.[55] One would hope for a more stately burial for *Percival* v. *Wright*, but it might be that an abortive birth [56] leads to an abortive death.

Even if the court's reasoning in *Hess* v. *Laslo* is insupportable, the result is to be welcomed. But *Hess* was not a case involving trading, and later decisions might limit its holding to situations of undue influence. It can also be argued that the ratio of the decision is that the cumulative effect of the legal relationship between Hess and Mrs. Laslo *and* her special mental condition created the fiduciary duty. Even if the courts were willing to extend the duty to cases of insider trading, such an extension would, presumably, not protect buyers nor, arguably, would it apply to a controlling shareholder who is not a director and does not run the company through puppets. The decision applies, apparently, only to private companies. All the same, *Hess* v. *Laslo* is a significant move. Once a court is ready to pierce the corporate veil as the *Hess* court did, the road is open to the development of a fiduciary duty of directors to individual shareholders. The fact that the decision rests also on the mental condition of Mrs. Laslo can be used as an anchor to develop a special circumstances test.[57]

[53] See Barak, notes from his lectures on Corporations in the Faculty of Law of the Hebrew University of Jerusalem, (1968) 117.

[54] [1845] 51 E.R. 866, 870.

[55] [1902] 2 Ch. 421, 425.

[56] See *supra* p. 24.

[57] One should not be too worried about the binding force of *Percival* v.

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V. *DERIVATIVE SUIT BY AN ENGLISH OR ISRAELI SHAREHOLDER*

Assuming, *arguendo,* that a director is deemed to have breached his duty of loyalty to the corporation when he profits from dealing in the securities of that corporation, there remains to be seen what equitable results a recovery by the corporation will produce and the deterrent effect of a corporate suit. When the corporation recovers from the director, the increase in corporate assets benefits all of the present stockholders ratably. A stockholder who bought from the disloyal director recovers only his proportionate share, and a seller defrauded by the director may recover nothing if he is no longer a shareholder of the corporation. The selling shareholder should be benefited more than the buying shareholder, however, because he was the ultimate beneficiary of the corporate trust, while the latter gained this position only by the very transaction in question.

What follows from the above analysis is that corporate recovery is not an equitable solution to the problem of insider trading. Furthermore, the larger the number of shareholders of any given corporation, the smaller the slice of recovery that falls to the buyer. Yet the larger the public investment in a corporation, the more opportunities there are for abuse in two respects. First of all, in a large public corporation the relations between the shareholders and the directors, if at all, are less intimate, and secondly, a shareholder's ability to obtain first hand knowledge of corporate affairs is reduced.

A corporate action, even though it does not make the defrauded

Wright in Israel. First of all, even *Oliver* v. *Oliver,* itself, was a Georgia declaration of English common law because Georgia has an "adopting statute", adopting English common law prior to 1776, where there are lacunae in Georgia law. Cont. Art. 12 Sec. 1 Para. 3 (1945). GA. CODE ANA. Sec. 2—8003 (1933). See *Eady* v. *Newton Coal & Lumber Co.,* 123 Ga. 565, 51 S.E. 661, 664 (1905); Georgia courts look at later English decisions to the extent that they declare the common law prior to 1776. *Brooks* v. *Ready Mix Cement Co.,* 94 GA. App. 791, 96 S.E. 2d 213, 214, (1956). Such was the situation in *Oliver* v. *Oliver.* Secondly, the Supreme Court of Israel is not bound by its own decisions. See The Courts Law, 1957, Sec. 33(b) (1957, 11 L.S.I. 157). Once it accepts *Percival* v. *Wright,* it can immediately overrule it. This fact led to a growing independence of Israeli courts from English precedents. See Procaccia, "Problems of Legislation in Company Law" *Studies in Israel Legislative Problems, Scripta Hierosolymitana* (Jerusalem, 1966) 155, 156-7.

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parties whole, squeezes the profits from the insider. Its deterrent and prophylactic effect is as effective as that of an individual action. Moreover, in instances where an individual action is not forthcoming —e.g., where the insider trades on the stock market and cannot be traced, or bought small holdings of many shareholders none of whom it pays to sue and no representative action is brought—a corporate action is the *only* way to prevent unjust enrichment.[58]

Yet a suit by the corporation, for what it is worth, will not occur, practically speaking, except after a takeover or on liquidation. In the case of a takeover, the buyers will receive a windfall (*i.e.,* reduction of the acquisition price) from the disloyal directors. During liquidation, profits disgorged from insiders will go to the corporation's creditors. Therefore, in neither instance is the recovery channelled to the appropriate parties.

In essence, the only plausible solution to the problem is the creation of some technique which will enable corporate suits to be brought while the insiders are in the saddle. The two techniques, which exist, in one way or another in the Commonwealth, are an action on behalf of the company, by some administrative agency[59] adequately manned and equipped for this task and a derivative action by an individual shareholder[60] to redress wrongs to the company committed by the directors.

The English agency which can bring actions on behalf of corporations is the Board of Trade. The provisions of sec. 210 of the 1948 Companies Act and sec. 37 of the 1967 Companies Act outline the situations in which the Board of Trade can institute a corporate action. Sec. 210 contains more restrictive conditions than sec. 37 for such an action.

The three preconditions for a sec. 210 action (petition) are: a) the gist of the petition must be that the affairs of the corporation are

58 *Kimber Report* Para. 2.24; *Diamond* v. *Oreamuno* 24 N.Y. 2d 494, 502-503; 248 N.E. 2d 910, 914-915 (1969).

59 Like the Companies Registrar in Ghana, Companies Code Act, 1963, 170, sec. 210 (4), or the Securities Commission in Ontario. Ontario Securities Act, 14 & 15 Eliz. 2, c. 142 part XI sec. 114 (1966).

60 The derivative suit by a shareholder can be a successful device only if the legal system contains sufficient incentives for the individual to bring such a suit. Loss, "The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States" (1970) 33 Mod.L.R. 34. For a derivative action by a minority director, see Note, "Directors Statutory Duty in New York" (1961) 36 N.Y.U.L.R. 190.

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being conducted in a manner oppressive to part of the members;[61] b) the Board of Trade must form an opinion that condition "a" is met on the ground of specified sources of information;[62] c) the remedy of the court is discretionary and will be granted only in cases where it finds that the facts justify a winding-up order on the ground that it is just and equitable, however, such an order unfairly prejudices the oppressed part of the members. If these three conditions are met, the remedial power of the court is very broad. It can make any appropriate order "...whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by the members of the company or by the company... or otherwise".[63]

We entertain grave doubts whether any of the three preconditions are met in a case involving insider trading. First of all, even assuming that trading on inside information is an oppressive conduct,[64] the section applies only to a continuing course of conduct, not to an isolated act. Moreover it can forcefully be argued that the director's personal dealings do not at all affect the *affairs* of the corporation.[65] Secondly, leaving condition "b" aside for a moment, it is inconceivable that trading on inside information *per se* might give rise to an action for a winding up. Therefore, it would appear that a Board of Trade action under sec. 210 is not a solution to our problem. Furthermore, the Board of Trade has never exercised to date its power to bring a Sec. 210 action.[66] Sec. 210(1) enables also any member who is oppressed by alleged oppressive conduct to petition the court for relief. Yet conditions "a" and "c" are prerequisites to this petition as well.

[61] Secs. 210 (1) & 210 (2) (a).

[62] Secs. 210 (1) of the 1948 Act and 35 (2) of the 1967 Act.

[63] Sec. 210 (2) (b).

[64] For the definition of oppression for the purpose of sec. 210, see *Scottish Cooperative Wholesale Society* v. *Meyer* [1959] A.C. 324, H.L. *In Re Jermyn St. Turkish Baths Ltd.*, [1971] 1 W.L.R. 1042, C.A.

[65] *Cf. R.* v. *Board of Trade, ex p. St. Martins Preserving Co. Ltd.* [1965] 1 Q.B. 603.

[66] Rajak, "The Oppression of Minority Shareholders" (1972) 35 Mod. L. Rev. 156, 169. See generally S. Magnus and M. Estrin, *Companies Law and Practice* (4th ed., 1968) 220-1 for an analysis of a sec. 210 action. As to some types of oppressive conduct not reached by sec. 210, see Afterman, "Statutory Protection for Oppressed Minority Shareholders: A Model for Reform"(1969) 55 Va.L.R. 1043, 1056-66.

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Sec. 37(1) of the 1967 Act enables the Board of Trade to bring an action on behalf of the company when it thinks that it is in the public interest to do so. We withheld comment on "b" of a sec. 210 action because it is also a condition to the Board's action based on sec. 37(1) of the 1967 Act. It suffices here to say that the only [67] specified source of information which might exist in a case of insider trading is a report submitted under sec. 168 of the 1948 Companies Act by an inspector appointed by the Board of Trade to investigate certain matters. The fact that the report must be submitted under sec. 168 is crucial. A report by an inspector who investigates contraventions of sec. 25 (prohibition of option dealings by directors) or sec. 27 (directors' duty to report their securities dealing) of the 1967 Act is submitted under sec. 32(4) of the 1967 Act and not under sec. 168 of the 1948 Act. Thus the Board's power to investigate under sec. 32 the above-mentioned contraventions cannot lead to an administrative corporate action by it. An investigation into the ownership of a company under sec. 172 of the 1948 Act is culminated in a report under sec. 168. Yet it is very unlikely, especially in light of the existence of sec. 32, that the power under sec. 172 will be interpreted to embrace investigation of directors' undisclosed dealings. It is questionable whether the other powers of the Board to conduct investigations, which will lead to a sec. 168 report, cover a situation involving insider trading *per se*. Either upon application of minority stockholders under sec. 164, or on its own initiative when certain conditions are met, under sec. 165, the Board can appoint inspectors to investigate the *affairs* of a company. We have already expressed our doubts whether the affairs of the company include securities transactions of directors. Furthermore when the investigation is instituted on the initiative of the Board the grounds enabling investigation are narrow. Of the three grounds enumerated in sec. 165(b) only two may be applicable. Section 165(b) (ii) provides, "that persons concerned with... the management of... (the company's) affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards... its members". Section 165(b) (iii) provides, "that... (the company's) members have not been given all the in-

67 Another specified source of information is a document or information obtained under the power of the Board to require production of the books and papers of the corporation. Secs. 37 & 109. However, it is inconceivable that a corporate document will reveal *trading* on inside information.

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formation with respect of its affairs which they might reasonably expect". As to sec. 165(b) (ii) it is an open question whether a transaction by a director on inside information can be said to occur in connection with the management of the company. As to sec. 165(b) (iii) it takes a bold argument to bring a director's concealment of inside information in his transaction under the umbrella of this section. In the absence of cases on this point it will be sheer speculation to predict if the courts will allow the Board of Trade to bring an action under sec. 37 to make directors disgorge profits to the company derived from trading on inside information. Would a common law derivative suit be available?

Decisional rules for derivative actions in England (misleadingly named representative actions) [68] do not encourage minority suits. The basic rule is that if the director's act is ratifiable by the general meeting no derivative action can be brought.[69] Unratifiable acts are only those which are *ultra vires* or which constitute a fraud on the minority.[70] In the context of insider trading, defrauding the minority may be found to exist only [71] if the utilization of the inside information

[68] Naming both the direct (non-derivative) class action and derivative action, "representative" fails to convey the idea that the last mentioned suit is brought on behalf of the corporation.

[69] There is one illusory exception to this rule. When the directors act out of proper motives to achieve an improper (collateral) result their action is ratifiable by the general meeting and yet a derivative action can be brought. However, the court will stay the action, refer the matter to the general meeting and if the latter approves the act, will dismiss the action. *Hogg* v. *Cramphorn Ltd.* [1967] Ch. 254. Approved in *Bamford* v. *Bamford* [1969] 2W.L.R. 1107 C.A. affg [1968] 3 W.L.R: 317: See Barak, "Ratification by the General Meeting" (1970) 5 Is. L.R. 249, and also K. W. Wedderburn, "Note on *Hogg* v. *Cramphorn,* Shareholders Control of Directors Powers: A Judicial Innovation" (1967) 30 Mod.L.R. 77: Wedderburn. "Going the whole Hogg v. Cramphorn?" (1968) 31 Mod. L.R. 688, 692-3; Wedderburn, "Unreformed Company Law" (1969) 32 Mod.L.Rev. 563. See generally Wedderburn, "Shareholders Rights and the Rule in *Foss* v. *Harbottle*" (1957) C.L.J. 194, continued in (1958) C.L.J. 93. See Boyle, *infra* n. 76 at 197-202 for an analysis of the unimplemented recommendations of the Jenkins Committee to widen the minority's remedy.

[70] See Gower at 588 for the list of conduct which constitutes fraud on the minority.

[71] The writer entertains considerable doubt whether an additional argument can be made. Such an argument, that a ratifying decision of a general meeting cannot be passed in the interest of the company, starts where the "misappropriation of assets" argument fails. It proposes that

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can be categorized as a misappropriation of corporate assets. Note, the question is not whether confidential information is a corporate asset, but whether utilization of confidential information for insider trading is a misappropriation of a corporate asset. The difference is not one of semantics but of substance. Undoubtedly intangibles which are valuable to the company are corporate assets.[72] A list of customers, knowledge of a source of financing, a secret process or a patent may be the most important of the company's income producing assets. If the director expropriates one of these intangibles a derivative action will certainly lie. But our case is different. When the director trades on inside information, what he misappropriates is useless to the company because the company cannot itself trade on the confidential information. This is not to say that the information is not a corporate asset. For example, as long as it remains unknown, the knowledge of the fact that the company has discovered oil, is an asset to be used by the company to purchase adjacent lands. If the director would buy the adjacent lands for himself he would have to disgorge his profits to the company because he would be exploiting a corporate opportunity. But if he buys securities on the market without disclosing the discovery, he deprives the company of nothing, since it cannot buy its own shares.[73] The same principle is applicable where the director sells his securities without disclosing unfavourable confidential information. If the company issues shares concealing material information, the purchaser is able to rescind the transaction. As a matter of pure logic, the insider has not misappropriated any-

because the information *as used*, was useless to the company, ratification by the shareholders is not in the interest of the company, but for a collateral purpose—to absolve the insiders. The *obiter* in the *Regal* case (see *infra* p. 40) that ratification would have protected the directors, can be distinguished by arguing that there, the directors' purchase of the shares in the subsidiary was in the interest of the company. See *Re W. & M. Roith, Ltd.* [1967] 1. W.L.R. 432 and Gower at 566.

72 There are many cases which have held that certain pieces of corporate information are corporate assets, e.g., *Measures Bross* v. *Measures* [1910] 1 Ch. 336, aff'd [1910] 2 ch. 248, C.A. regarding lists of customers; *Bell Houses Ltd.* v. *City Wall Properties Ltd.* [1966] 2 Q.B. 656 regarding knowledge of a source of financing and *Peter Pan Manufacturing Corp.* v. *Corsets Silhouette, Ltd.* [1964] 1 W.L.R. 96 regarding a design of product. See the discussion in Gower at 535-547 and 564-566.

73 Since it would amount to a reduction of capital. *Trevor* v. *Whitworth* [1887] 12 App. Cas. 409, H.L.

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thing from the corporation when he either buys or sells and conceals material information.[74]

Yet it does not necessarily follow from this that the director should escape liability when he trades on inside information. Liability should be based on the principle of unjust enrichment and not on breach of trust or a notion of misappropriation of assets.[75] But, unfortunate-

[74] A similar situation arises when the company is financially or legally (i.e., the opportunity is *ultra vires* the company) unable to utilize an opportunity and the director grasps it. But in the case of financial inability it is to be remembered that the directors are the fund raisers for the company. A rule which enables them to use corporate opportunities when the company is unable to do so might have adverse effects on their efforts to find sources of capital. In the case of the *ultra vires* opportunity, it might be said that it is the directors' duty to initiate an amendment of the memorandum. *Cf. Fine Industrial Commodities* v. *Bowling* [1954] 79 R.P.C. 253, at 288. Insider trading is, thus the purest case in which the company loses nothing. It is equal to a case of absolute legal and financial inability of the company.

[75] A restitionary action can succeed even if the plaintiff suffered no loss (minus) if the defendant obtained a profit (plus) to which the plaintiff has a higher claim. "The point is not whether a definite something was taken away from the plaintiff and added to the treasury of the defendant. The point is whether the defendant unjustly enriched himself by doing a wrong to the plaintiff in such a manner and in such circumstances that in equity and good conscience the defendant should not be permitted to retain that by which he has been enriched". *Federal Sugar Refining Co.* v. *United States Sugar Equalization Board, Inc.* 268 F. 575, 582 (S.D. N.Y. 1920). This is also the law in England and in Israel: *Reading* v. *A.G.* [1948] 2 K.B. 268, aff'd C.A. [1949] 2 K.B. 232, aff'd H.L. [1951] A.C. 597; *Aviam* v. *The State of Israel* (1971) (I) 25 P.D. 665. The fiduciary relationship between the director and the company is the base of establishing the company's higher claim to the director's profit, obtained by him by virtue of his office. G. Jones, "Unjust Enrichment and Fiduciary Loyalty" (1968) 84 L.Q.R. 472, 476-8. The gist of the action is significant not only to the question of a minority suit but also to the question of recovery against "tippers" and tippees". If the director sells the information, the company can recover his profits even on the grounds of unjust enrichment. In most cases the tip will be accompanied by some profit to the director, on a short or long term "back scratching" arrangement. But when the director tips and makes no profit, the company can recover from him only if he expropriated a corporate asset. We do not base this conclusion on the fact that the "tipper" in the *Regal* case (Gulliver) was not made accountable. In that case it can be said that Gulliver did not breach his duty to the company, because he brought the "tippees" in, to assist the company. See H.P. Crawford, "Insider Trading" (1965) 8 Can. B.J.

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ly, according to the present state of the law in England, a derivative suit, the gravamen of which is anything but conversion, will not stand. One would hope that the courts would dispense with a 19th century heritage in this field [76] and examine the problem anew. They would then recognize that the importance of a derivative action against an insider who trades on corporate information is in its prophylactic and deterrent effects, essential for the protection of investors.[77] Until this hope materializes, can one establish a proprietary cause of action, or does the law follow the "pure logic" previously expressed?

In *Regal (Hastings) Ltd.* v. *Gulliver,*[78] directors, in order to benefit their company, bought shares in a subsidiary when the company had no funds to do so. The purchase was necessary, for if the subsidiary had no minimum equity capital, the parent could not obtain a desired lease. The court held the directors accountable to the company for profits they made on the sale of shares. But the basis for the court's holding was under a theory of quasi-contract rather than proprietary rights, as is demonstrated by several aspects of the case. The court

400, 405. Our conclusion stems from the fact that in the absence of a "plus" to the director there would never be a breach of duty on the theory of unjust enrichment. The company will have an action against a buyer of the information because he participated in a breach of duty by the director. However the "tippee" proper will not have to disgorge his profits to the company because, again, in the absence of a profit to the director, there was no breach of duty by the director. If the director is deemed to misappropriate property, the company can recover against the "tippee", if the latter had notice that he was tipped, on the basis of a "constructive trust". Gower at 556.

[76] Stemming from *Foss* v. *Harbottle* [1843] 2 Hare 461, 67 E.B. 189, which, carrying over from the unincorporated company, held that when ratification by the majority is valid, it cures the director's wrong and precludes a minority suit. The court in *Foss* supplemented the rule of no interference, by stating that an incorporated company, being a separate legal entity, should itself redress its wrongs. See Boyle, "The Minority Shareholder in the Nineteenth Century" (1965) 28 Mod.L.R. 817 and Boyle, *Shareholders Derivative Action in Anglo-American Law* (1968) (Unpublished thesis in Harvard Law School Library).

[77] G. Jones, *supra* n. 75, at 473 argues convincingly that the question of accountability of the director to the company should be decided by rules of policy and not by the inquiry, paralleling the formula of *Cook* v. *Deeks* [1916] 1. A.C. 554 at 563 P.C., where the director acquired property "which, though his own at law, in equity belonged to the company".

[78] [1967] 2 A.C. 139 N; [1942] I All E.R. 378.

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held that the company's attorney who also bought shares in the subsidiary was not accountable because the board of directors consented to his acquisition of the stock. If the information was a corporate asset, the company would be able to trace the profits to the attorney, because it is not in the power of the board of directors to legalize corporate waste. One of the directors, Gulliver, who saw to it that three other persons, namely, two corporations in which he had a slight minority interest, and a friend, also acquire shares in the subsidiary was absolved too, again on the basis that he was not unjustly enriched. On the theory of "constructive trust" the shares themselves, not only the profits in them would be recoverable.[79] Moreover, the court remarked in a *dictum* that "they [the directors] could, had they wished, have protected themselves by a resolution (either antecedent or subsequent) of the Regal shareholders in general meeting".[80]

But in a later decision in the leading case of *Phipps* v. *Boardman*,[81] where an agent (solicitor) of a trust (estate) profited from an opportunity which was *ultra vires* the trust and was held liable for his profits, the Lords spoke in a variety of versions about the thrust of the action.[82]

A Canadian case,[83] assumed the proprietary character of inside

79 L.S. Sealy, "The Directors As Trustees" (1967) C.L.J. 83, especially at 98 n. 83.

80 [1942] I All E.R. 378 at 389 per Lord Russell. See also per Viscount Sankey at 382 and per Lord Wright at 394. See the discussion in Wedderburn, "Shareholders' Rights and The Rule In *Foss* v. *Harbottle*" *supra* n. 69 at 99-106.

81 [1967] 2 A.C. 46 H.L. affirming sub nom. *Phipps* v. *Boardman* [1965] Ch. 992 (C.A.), affirming [1964] I.W.L.R. 993 (Ch. D.).

82 See the eloquent discussion in Gower at 555-556. See also the statements of Lord Denning, M.R. in the Court of Appeal [1965] Ch. 992, 1019, 1020.

83 In *Peso Silver Mines, Ltd.* v. *Cropper* [1966] 58 D.L.R. 2d 1, the board of directors (*bona fide*) rejected an opportunity to purchase shares. Then some directors purchased the shares themselves. The Supreme Court of Canada observed that if recovery would be allowed, it would be for the shares. But the court decided that the directors did not use confidential information and that the purchase after the board rejected the offer was not made in their corporate capacity, but as members of the public. The value of this observation, as well as the speeches of those Lords in *Phipps v. Boardman,* who stressed the proprietary nature of the information and the fact that in *Zwicker* v. *Stanbury* (1953) 2 S.C.R. 438, a minority action was sustained, is weakened somewhat by the

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information in circumstances similar to *Regal (Hastings) Ltd.* v. *Gulliver*. In the New York case of *Diamond* v. *Oreamuno*, the directors were held accountable to the company for trading on inside information. The Appellate Division based its decision on misappropriation of property.[84] On appeal, the New York Court of Appeals, while paying tribute to the asset notion,[85] seems to have rested its decision on principles of unjust enrichment.[86] The question has not yet been settled in England [87] and if the courts insist on applying the historical rules of non-interference even to an action complaining of insider trading they can classify the director's breach of duty as "misappropriation of corporate assets".

theoretical possibility of loss to the company (or trust) in these cases. See *supra* n. 74. *Cf.* Sealy, *supra* n. 79, at 93, n. 83.

84 "They [the directors] are being charged because they converted into money to their own use something belonging not to them but to their corporation—inside information". 287 N.Y.S. 2d 300, 303-304 (1968).

85 "A corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset to his own use even though in so doing he causes no injury to the corporation". 29 N.Y. 2d 494, 498, 248 N.E. 2d 910, 912 (1969).

86 "The primary concern, in a case such as this, is not to determine whether the corporation has been damaged but to decide as between the corporation and the defendants, who has a higher claim to the proceeds derived from his exploitation of the information". *Id.* 248 N.E. 2d at 912. In another passage the court makes the point even clearer: "Sitting as we are in this case as a court of equity, we should not hesitate to permit an action to prevent any unjust enrichment realized by the defendants from their allegedly wrongful act". 24 N.Y. 2d 494, 501, 248 N.E. 2d 910, 914 (1969).

87 See the recent case of *North & South Trust Co.* v. *Berkeley* (1971) 1 All E.R. 980. Wright "Insider Trading—Can We Learn From America" (1971) 4 N.Z.U. L. Rev. 209, 226 doubts whether a corporate action for insider trading would be sustained. The inclination in Israel is to adopt the English rules for non-interference. See A. Barak, "Minority Shareholders and Their Rights to Management" (1969) 25 *HaPraklit* 488, 509 (Hebrew). Prof. Barak criticizes this trend and argues that even in terms of the importation channels from English law (See *supra* n. 7.) rules stemming from partnership law, as it stood in England in the 19th century do not answer the needs and conditions of Israel today. According to sec. 112 of the 1957 Companies Draft Bill, actual ratification by the general meeting will defeat a minority action alleging insider trading. See *supra* n. 10.

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VI. *REPORTING AND DISCLOSURE REQUIREMENTS IN ISRAEL AND ENGLAND FOR INSIDER TRADING*

The rules imposing liability for trading on inside information will be an exercise in futility if they are not accompanied by rules facilitating the tracing of such transactions. We turn now therefore to see what rules of this character Israeli and English law furnish.

A law passed in 1929 [88] and modeled on the 1929 English Companies Act [89] is still the positive law in Israel. Forty-three years have produced three revision committees; the first Zeltner Committee,[90] the second Zeltner Committee [91] and the Yadin Committee [92] and, a Companies Draft Bill in 1957,[93] but very little modification in the law. The two Zeltner Committees and the Companies Draft Bill have achieved no results thus far. Only the recommendations of the Yadin Committe led to legislation—the 1968 Securities Law,[94] which implemented only part of the Committee's recommendations, as a separate Act. The fate of a recent bill proposing limited changes [94a] is unclear.

With this background it is understandable that there are no ade-

88 Companies Ordinance, May 15, 1929, *Drayton,* vol. 1 ch. 22.

89 19 & 20 Geo 5, c. 23.

90 Appointed in November, 1949 "to consult the Ministry of Justice in the matters of company law, to make suggestions to amend the law and to examine suggestions submitted to the committee by the Ministry of Justice and by the public". Its report was published by the Ministry of Justice in June, 1953. The Committee included experts in company law and is named after its chairman, Z. Zeltner, President of the District Court of Tel-Aviv.

91 Appointed by the Ministry of Justice in May, 1962 to update the work of the first Zeltner Committee, taking into account amendments in English and other Company Laws. The Report of the Committee was published in November, 1965.

92 Appointed by the Minister of Finance in March, 1962 "to advise me and make recommendations in connection with legislative and administrative provisions regarding the issuance of shares and other securities, the methods of their distribution and trading in such securities within and outside the stock exchange". The report of the Committee was published in June, 1963, named "Yadin Committee" after its chairman, U. Yadin, Deputy Attorney General of Israel. Citations from the Yadin Report are taken from the English translation by William B. Goldfarb (1963).

93 Prepared by the Ministry of Justice in conjunction with the Harvard-Brandeis program for the development of the law of Israel.

94 (1968) 22 L.S.I. 266.

94a See *supra* n. 8.

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quate tools under the Companies Ordinance for tracing insider's dealings in securities. Every company must keep a members' register which is open to public inspection.[95] But it reflects only registered owners, and insiders can legally hide their holdings through nominees. Sec. 29(2) even *prohibits* entry of trusts in the register. To the extent that the company issues bearer shares, moreover, insiders need not even bother to employ straw men, for the register will reflect only the fact that bearer shares are issued and there is no way to trace the shareholders.[96] A company must also keep a register of debenture holders,[97] open to inspection by the registered debenture holders and by shareholders. But again the company can issue bearer debentures.[98] If the insiders do not hold any bearer securities and do not hide behind nominees, a comparison of the shareholders register (and debenture holders register) with the directors register (another register required by statute)[99] should be able to disclose the insiders' holdings. But when insiders have holdings in several companies which constitute a "group", then the matching is a protracted process. Since the registers of any company will show only *its* directors and security holders, one must compare the directors' list of any company with the security holders' lists of *all* the affiliated companies.

Most suggestions to amend this situation have been abortive. The first Zeltner Committee recommended:

> ...to impose on directors of public companies the duty to record in a special register all their shares and rights as creditors, those who are registered in their own names and those who are registered in the names of nominees, and to record in the register all their transactions regarding these shares and rights (following the lines of sec. 195 of the new English Act).[100]

The second Zeltner Committee endorsed this recommendation[101] and added: "...the directors would be bound to notify the company not

[95] Sec. 29 of the Companies Ordinance.

[96] A public company can, if authorized by its articles, issue "bearer warrants" in respect to its paid up shares. Sec. 28. In such a case the company strikes from the members register, the shares specified in the warrant and enters the fact of the issue of the warrant and the shares included in it.

[97] Sec. 126 (1).

[98] Sec. 122 (1).

[99] Sec. 76.

[100] Para. 6 of the report.

[101] Para. 7 of the report.

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later than two weeks after the acquisition of shares held for them"[102] (by nominees). These recommendations, however, would not impose any reporting duty on controlling shareholders. If they are not directors they can employ nominees or deal, without being traced, in bearer securities. But as noted above, even this small addition was not implemented. On the contrary the 1957 Companies Draft Bill, issued between the reports of the two Zeltner Committees, would have exempted private companies from keeping registers of members, if their articles of association did not require that they do so.[103] A public company would have to keep a register, but not a subregister of directors "holdings", and the members' register would show only registered shares.[104] The setback from the first Zeltner Committee, the recommendations of which the bill purported to implement, was not explained in the draft bill.

More promising were the suggestions of the Yadin Committee. This committee concluded that the war against insider trading in public companies should be waged by stock exchange regulations, an anti-fraud provision, and extensive reporting and disclosure requirements.[105] Disclosure would begin with the issue of the securities by revealing in the prospectus the insiders' holdings and interests.[106] Then disclosure should continue in annual reports,[107] immediate reports by the company upon the occurrence of certain events particularly likely to influence one's appraisal of the company's condition and the value of its securities,[108] *and* reports by directors of their security holdings and 5% or more shareholders of their shareholdings.[109] All the reports would be filed with the Securities Authority (hereinafter S. A.), and (if the company is listed) with the stock exchange, and would be open for public inspection. The stock exchange, in turn, would also give them appropriate publicity.[110] Were all the recommendations implemented, they would make quite a comprehensive scheme. Once again, however, the legislation lagged behind the recommendations. The Securities

[102] Para. 22 (d).
[103] Secs. 166 and 167 of the draft.
[104] Sec. 170 of the draft.
[105] Para. 196 and 197 of the report.
[106] Para. 68-71 of the report.
[107] Para. 68-71 of the report.
[108] Para. 126.
[109] Para. 128.
[110] Para. 129.

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Law delegated to the Finance Minister the power (upon the proposal of the S.A. or after consulting with it, and subject to the approval of the Finance Committee of the Knesset) to provide in regulations, the details that should be included in a prospectus [111] and the reports that should be required from corporations which either are quoted on the exchange or have made public offering.[112] The Law states expressly that the rule-making power of the Finance Minister extends also to require immediate reporting of certain events.[113] He can employ his powers in a classificatory manner.[114] Furthermore,

> When regulations according to sec. 36 require a corporation to disclose in its reports securities in the corporation, held [115] by the directors or by the auditor of the corporation, the directors and the auditor must submit to the Securities Authority and to the Companies Registrar a notice of the securities of the corporation which they hold, according to details, date and form as fixed, to the extent that the corporate reports do not include these details.[116]

This created quite an awkward situation, for until the Finance Minister had promulgated regulations, no reports were required of either the directors or shareholders. Moreover the Finance Minister cannot straightforwardly require directors or shareholders to report their holdings or changes therein. He can require the *company* to report periodically and upon the occurrence of changes the holdings of its directors and auditor and he can require the directors and the auditor to report their security holdings, to the extent that the company's reports do not disclose them. The controlling shareholders cannot be required to report even in this roundabout fashion because sec. 37 refers only to directors and auditors. The regulations which the Finance Minister issued in July 1969,[117] contained no such provision and did not require the company to reveal its directors' and auditor's security holdings even in the *annual* report. True, the annual return which every company had to file with the registrar of the

[111] Sec. 16, Israel Securities Law.

[112] Sec. 36, Israel Securities Law.

[113] Sec. 36 (c), Israel Securities Law.

[114] Secs. 16 (c) and 36 (d), Israel Securities Law.

[115] The term "holding" as defined in sec. 1 of the Securities Law, and in all the regulations under that Law includes holding through nominees.

[116] Sec. 37, Israel Securities Law.

[117] Regulations of Securities (Preparation of Financial Reports), 1969; Collection of Regulations (*Kovetz HaTakanot*), No. 2417, July 13, 1969.

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companies, according to sec. 36 of the Companies Ordinance, 1929, had to contain a list of all the shareholders and the number of shares that each of them holds, and, by definition, had to include also the directors' and auditor's shares. But this fact does not authorize the Finance Minister to require the directors and auditors to disclose their bearer and nominee held shares, unrevealed in the company's return because his power is restricted only to the situation where regulations according to sec. 36 of the Securities Law require that the directors' and auditors' securities be disclosed in the company's report. Therefore, excluding the information about insiders' securities, which had to be disclosed in the prospectus according to the Regulations of Securities (details, structure and form of prospectuses), which the Finance Minister also promulgated in July 1969,[118] nothing had changed at that stage in the matter of bringing the insiders' dealings to light.

New regulations which have been issued in July 1970[119] and came into force on December 31, 1970,[120] increase the disclosure duties. These regulations require every corporation which has issued a prospectus or is listed on the Stock Exchange to detail in its periodical report,[121] to the best of its knowledge, the names, holdings and rights

[118] Collection of Regulations, No. 2417, July 13, 1969. The prospectus must disclose the share holdings of any shareholder who owns 5% (or more) of the shares, or of the voting power or the power to appoint directors (Reg. 28) and also the share holdings of a group of people defined as interested in the issuer (Reg. 52), which includes (a) any person who holds at least 10% of the issued shares, voting power or power to appoint directors of the corporation; (b) a promoter; (c) any person entitled to appoint the managing director; (d) any director; (e) any corporation, in which one of the following (1) a director; (2) a holder of 10% or more of the shares, voting power or power to appoint directors; (3) a person entitled to appoint the general director—holds more than 25% of its shares, voting power or the power to appoint directors. The holdings of all the interested persons to be disclosed include holdings in the issuer, in a subsidiary or any affiliated company, both on the date of the prospectus and one year earlier. The information is to be filed "to the best of the knowledge of the issuer and its directors" (Regs. 28 and 55) and is, thus, designed to cover bearer and nominee held shares.

[119] Securities Regulations (Periodical and Immediate Reports), 1970; Collection of Regulations, No. 2591 July 30, 1970. See also Securities Regulations (Periodical and Immediate Reports of Investment Trusts), 1970; *Id.*

[120] Reg. 38 of the regulations.

[121] The periodical report must be published within six months of the financial

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or obligations to purchase further shares of every shareholder who holds at least 5% of either issued stock, voting power or power to appoint directors.[122] Furthermore, the corporation must also reveal in the periodical report the shareholdings, not only in itself but also in its subsidiaries and affiliated corporations, of a category of persons defined[123] as "interested parties" (insiders).[124] The disclosure in both cases must relate to the date of the report[125] or to as close a date as possible.[126] Since the definition of an "interested party" includes a director, the ground has been laid for requiring a director to report his holdings under sec. 37 of the Securities Law. Although an auditor is not an interested party, it is our opinion that auditors who hold at least 5% of the shares in the corporation will also come under the umbrella of sec. 37. Our view stems from the fact that sec. 37 is conditioned on a duty on the corporation under sec. 36 to disclose the shareholdings of an auditor, not necessarily as such.

Since sec. 37 is not self-operative, however, regulations fixing the "details, date and form" of the directors' and auditors' notice were required in order to impose on directors and auditors a reporting duty. In September 1970 the Finance Minister issued such regulations but applied them to directors only and not to 5% shareholder auditors. The regulations, named Securities Regulations (Directors' Notice) 1970,[127] require every director whose holding in the corporation, its subsidiaries or affiliated corporations,[128] is not disclosed in the annual report, to file a notice with the S.A. and the Companies Registrar. The notice must be filed within 30 days of the date of the annual

year and at least a week before the convention of the annual meeting to approve the financial reports. Reg. 7.

122 Reg. 21.

123 The definition of an interested party is almost identical to that under Reg. 52 of the prospectus regulations. See *supra* n. 118. The only difference is that a promoter is not included.

124 Reg. 24.

125 The date of the report is the date on which it was signed, provided it does not antedate its submission to the S. A. and to the Companies Registrar by more than 14 days. Reg. 6.

126 Regs. 21 & 24.

127 Collection of Regulations, No. 2615, September 17, 1970.

128 Note, however, that sec. 37 requires disclosure only of holdings in the corporation itself, not in a subsidiary or an affiliated corporation. The requirement to disclose holdings in subsidiaries and affiliated corporations may, therefore, be *ultra vires*.

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report and must disclose all the information which should have been contained in the annual report.[129]

The July 1970 regulations also establish a duty of immediate disclosures. *Inter alia* such a duty accrues when there is a change in the holdings of an interested party, whether the holdings are in the corporation, or in a subsidiary or in an affiliated company.[130] Also when a person becomes an interested party in the corporation, the corporation is placed under a duty to disclose his holding in the corporation and in any subsidiary or affiliated corporation.[131] In both cases the disclosure is to be made within 15 days of the occurrence or from the date the corporation had knowledge of the act[132] and is to be made to the best of the knowledge of the corporation.[133] The September 1970 Securities Regulations (Directors' Notice) impose on directors a reporting duty also when the corporation does not file such immediate reports. The director has to file a notice with the S.A. and the Companies Registrar within 30 days from the occurrence of the reportable event and to reveal all the information which should have been disclosed in the corporate report.

At present the Securities Law and the regulations thereunder provide outsiders with sufficient tools to trace directors' share dealings. We think that sec. 37 should be amended to require reports also from other insiders ("interested parties") notably 5% shareholders.

It should be noted that any officer, director or shareholder who, "with an intent to defraud" causes the failure to disclose any required item in a "corporate document" now commits a crime under sec. 9A of the Penal Law Amendment (Deceit, Blackmail and Extortion) Law, 1963, as enacted in 1970. A "corporate document" includes the members' register and corporate reports. When the failure to make the disclosure is designated to prevent outsiders from tracing insiders' dealings an "intent to defraud" is present.

The English scheme of reporting and disclosure requirements is far more complex than the Israeli. We shall only comment on its high-

[129] Regs. 2 & 5. Failure to file an appropriate notice constitutes a crime under sec. 53 (c) (6) punishable by a fine of up to IL. 5,000.

[130] Reg. 33 (a).

[131] Reg. 33 (b).

[132] Reg. 30 (b).

[133] Regs. 33 (a) & (b).

[133a] (1970) *Sefer HaHukim*, No. 582 at 22.

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lights. The Jenkins Committee recommended[134] the supplementation of the reporting provisions, which were contained in sec. 195 of the Companies Act, 1948 in order to complement provisions imposing liability for insider trading which the Committee also recommended. While the resulting 1967 Companies Act contains no express civil provisions imposing liability for insider trading, it implements, in secs. 27-34 of the Act, the recommendations of reporting and disclosure duties.[135] It will suffice here to note that the present scheme would in most cases make it possible to trace directors' dealings, but with considerably less facility, controlling shareholders' dealings. This phenomenon stems from the different policy grounds which underlie registration of director's shares as opposed to registration by a controlling stockholder. Only the former is concerned with curbing insider trading by bringing it into light. The latter, as made manifest by Paragraph 192 of the Jenkins Report, is designed to supply the company (*i.e.*, the board) with information about controlling shareholders, so that it cannot be surprised by unexpected takeover bids. Therefore disclosure is required only from holders of 10% of those shares entitled to unrestricted voting rights in listed companies. It would seem that a holder of 10% of a class of shares would be included in the disclosing group,[136] but Gower thinks that the statute leaves this unclear.[137] Controlling shareholders do not have to disclose the price of their dealings, and this along with the other deficiencies mentioned above provide serious shortcomings in the anti-abuse network.

[134] Report of the Jenkins Committee Paras. 99 (d) & 99 (e).

[135] See discussion in Magnus & Estrin, *op. cit., supra* n. 66, at 551-74. Loss at 1131.

[136] See the definition of "relevant share capital" in sec. 30 (10).

[137] Gower at 390 n. 23.

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VII. *IMPLICATION OF CIVIL LIABILITY IN SECURITIES LAW IN THE UNITED STATES*

Implied Liability for Insider Trading under American Federal Securities Laws—Comparison of the Framework Thereof with that in England and Israel

The only express civil remedy against insider trading contained in the Securities Exchange Act of 1934 is the "shortswing accounting section" 16 (b) which is a corporate remedy.[138] The courts, however, have implied a tort from the violation of Rule 10b-5 under sec. 10(b) of the Act. Although the precise extent and nature of this tort remains as yet unknown, it at least covers the case of insider trading. The Supreme Court, until recently, had not expressed [139] any opinion [140] and there was some fear that if the courts of appeal continued to broaden the extent of Rule 10b-5 the Supreme Court might act to restrict the reach of that provision altogether. Yet grasping an opportunity, in *S.E.C.* v. *National Securities, Inc.*,[141] the majority of the court, per Justice Marshall, decided that the rule covers proxies which are out of the reach of sec. 14(a), the express proxy section. Although *National Securities* did not deal with the question of implying civil liability (the case was an injunction action by the S.E.C.), letting Rule 10b-5 supersede the restriction of secs. 14(a) and 12(g)[142] indicated which way the wind was blowing. In a rigorous dissent, Mr. Justice Harlan (joined by Mr. Justice Stewart) highlighted this point and stressed the far-reaching ramifications of the decision. Finally in *Superintendent of Insurance of the State of New York* v. *Bankers*

[138] 15 U.S.C. sec. 78 p (b) (1964).

[139] Although several expressions in *Surowitz* v. *Hilton Hotels Corp.* 383 U.S. 363 (1966) can be read to imply a recognition of a private action under Rule 10b-5, *Id.* at 364, 373-374.

[140] It should be noted that when the Supreme Court found civil liability under sec. 14 (a) (the proxy section) of the 1934 Act, in *J. I. Case* v. *Borak*, 377 U.S. 426 (1964), it did not in so many words apply the "torts derived from crimes" doctrine. The most significant consideration in the court's decision was the insufficiency of existing remedies. This, however, is also one of the crucial factors in the inquiry whether or not a tort implies a crime, Street, *infra* n. 179 at 275. As to the query: Does implication of civil liability from sec. 14 (a) logically compel implication of liability from sec. 10 (b) and Rule 10b-5 thereunder? See the eloquent discussion in Loss at 1763-1764.

[141] 393 U.S. 453 (1969).

[142] 15 U.S.C. sec. 78 n (a) (1964); 15 U.S.C. sec. 78 1 (g) (1964).

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Life and Casualty Co.[143] the Supreme Court per Justice Douglas unanimously upheld a private cause of action under Rule 10b-5. Not only did the court take rather for granted that a private action lies under Rule 10b-5, but it applied it to misappropriation by a corporate officer of the proceeds of a sale of corporate securities. The court, that is, ruled that when a corporation suffers injury as a result of deceptive practices touching its sale of securities, Rule 10b-5 applies even to internal corporate mismanagement. In short the Supreme Court gave its imprint to a broad private application of Rule 10b-5.

The implications of a tort from criminal behaviour, however, is not the sole basis for allowing a civil remedy under Rule 10b-5. Two additional branches of liability were suggested. Sec. 29(b) [144] of the Act, first of all, renders void contracts made in violation of the Act or of regulations thereunder. The courts have reasoned that such voiding will work not only as a shield against action by the defrauder, but also as the sword for an action by his victim.[145] This basis for civil liability, however, is available only where some kind of contract exists. It could not be used where an "abortive seller" was deprived of a contract to sell [146] or in other cases where a 10b-5 remedy was allowed in the absence of contractual privity between the plaintiff and the defendant.[147] Secondly, and a third argument for the provision of a civil remedy under Rule 10b-5 is that Congress itself regarded sec. 15 [148] of the Act as providing civil remedies. This argument stems from a provision added to sec. 29 (b) of the Act in 1938,[149] which reads as follows:

> No contract shall be deemed to be void by reason of this subsection *in any action maintained in reliance upon* this subsection, by any person to or for whom any broker or dealer purchases a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of sec. 15 of this title, unless such action is brought within one year after the

143 404 U.S. 6 (1971).

144 15 U.S.C. sec. 78 cc (b) (1964).

145 *Kardon* v. *National Gypsum Co.* 69 F Supp. 512. 514 (E.D. Pa. 1946).

146 *Cf. Ferraioli* v. *Cantor* 281 F. Supp. 354 (S.D.N.Y. 1967); *Stockwell* v. *Reynolds and Co.* 252 F. Supp 215 (S.D.N.Y. 1965); *McManus* v. *Jessup and Moore Paper Co.* 5 S.E.C. Jud. Dec. 810 (E.D. Pa. 1948).

147 E.g., *Heit* v. *Weitzen*, 402 F. 2d 909 (2d Cir. 1968), where a purchaser in the market recovered from a company which issued a false press release.

148 15 U.S.C. sec. 78 q (1964).

149 852 Stat. 1070 (1938).

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discovery that such sale or purchase involves such violation and within three years after such violation (emphasis added).

Sec. 15(c) (1) [150] and 10(b) prescribe similar fraudulent acts. If Congress indicated its intent and belief that sec. 15(c) (2) implies civil liability, the third argument goes, the same must hold true with regard to sec. 10(b).[151]

The second branch of liability is express rather than implied. The third would also appeal to the English who have based civil liability on a sec. 38 prospectus [152] on similar grounds.[153] The existence of these two additional grounds to the crime-tort theory should not lead us to regard the American development as necessarily modest in scope, for tying a remedy under Rule 10b-5 to the entire pattern of civil liabilities under the 1933 and 1934 Acts was a necessarily intricate process.

Under the 1933 Act, a defrauded buyer has an express remedy, even if he does not buy in the course of a primary or secondary distribution. Sec. 12(2) [154] affords him a right to rescission and to damages for conduct ranging from outright lies to half-truths short of total failure to disclose a relevant fact. A defrauded seller in such circumstances had no federal cause of action and was left solely to his common law remedies. Unless he used the mails, moreover, the defrauding buyer would not even have committed a federal crime. The creation of a civil action under Rule 10b-5 provided the seller with a federal action and gave him access to the federal courts, a significant advantage in the American system. [155] There immediately

150 15 U.S.C. sec. 78 q (c) (1) (1964).

151 This argument has an additional support in the language of the jurisdiction section of the 1934 Act (sec. 27) which is said to imply civil actions for violation of the 1934 Act and regulations thereunder. *Kardon* v. *National Gypsum Co.* 60 F. Supp. 512, 513 (E.D. Pa. 1946). *J. I. Case* v. *Borak* 377 U.S. 426, 430-431 (1964).

152 I.e., a prospectus under sec. 38 of the 1948 Companies Act.

153 See *infra* p. 85.

154 15 U.S.C. Sec. 77 1 (2) (1964).

155 Under the 1934 Act there is nationwide service of process. The federal disclosure procedures, unprecedented in most states, can help establish a case, especially in the area of fraud and non-disclosure. There are, presumably, states which still adhere to the so-called "majority rule", at least in the sense, that they have not yet overruled it. In case of mere concealment of facts a seller would have a hard time establishing his cause of action in those states.

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arose, however, a question of the buyer's rights. The express right under sec. 12(2) is wrapped with express restrictions—a short limitation period,[156] a provision that the buyer can only sue his seller, etc. The question thus arises whether the implied right under sec. 10(b) of the 1934 Act overrrides the express right under sec. 12(2) of the 1933 Act. A similar question exists with regard to the buyer's right under sec.11 [157] (relating to mis-statements in prospectuses). Faced with this problem, the complications of which defy a completely satisfactory solution [158]—the courts seem to have come up with a symmetric application of sec. 10(b) in the case both of buyers and sellers: [159] an application which eliminates the express limitations on buyer's express action.

The courts were even ready to imply a buyer's action from sec. 17(a) [160] of the 1933 Act, a criminal anti-fraud provision for the protection of buyers that was substantially copied in Rule 10b-5, which made it applicable to both sales and purchases. This, of course, took the matter a step further, for even though the 1933 and 1934 Acts are two pieces of complementary legislation, it is easier, theoretically, to imply an overriding remedy from a separate statute than

156 Sec. 13 of the 1933 Act fixes a limitation period of one year. 15 U.S.C. sec. 77 m (1964).

157 15 U.S.C. sec. 77 k (1964).

158 If you decide that sec. 10 (b) overrides sec. 12 (2) the buyer receives more by implication than Congress gave him expressly. If you decide that sec. 12 (2) governs the buyer's action, then you reach an absurd situation that the seller, who received no express remedies, is better off than the buyer—the favourite son. It takes more than traditional judicial law-making to read into a seller's action under 10 (b) the express limitations on a buyer's action under the 1933 Act. See *Geismar* v. *Bond and Goodwin, Inc.* 40 F. Supp. 876, 878 (S.D.N.Y. 1941) and *Kardon* at 514.

159 There are three views. A minority view that no 10b-5 action can be brought. A compromise view that a 10b-5 action can be brought only if fraud is alleged, maintaining that fraud is not necessary in a sec. 11 suit. A growing view allowing a 10b-5 action even if no fraud is alleged. See Loss at 1783-1785 and cases cited therein.

160 15 U.S.C. Sec. 77q (a) (1964). The cases originated from a *dictum* in a footnote in *Fischman* v. *Raytheon Mfg. Co.* 188 F. 2d 783, 787 n. 2 (2d Cir. 1951) per Judge Frank. See Loss at 1784-1791. It was lately decided that sec. 17 (a) cannot be made a basis for punitive damages, not disposing of the issue of compensatory damages. *Globus* v. *Law Research Service, Inc.* 418 F. 2d 1276 (2d Cir. 1969). The issue is academic only because a sec. 17 (a) civil action does not go further than a Rule 10b-5 civil action.

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to find that Congress intended impliedly to grant in sec. 17 what it expressly restricted in sec. 13.

Another characteristic of securities regulation in the United States is that, in addition to criminal sanction, there exist certain administrative and civil sanctions which the S.E.C. has power to invoke, *i.e.*, the revocation of brokers' licenses [161] and the injunction against a securities act of fraud.[162] This is in marked contrast to the regulations in Israel where there is no licensing of brokers, and the S.A. has no power to appear in court to seek an injunction against securities frauds. This difference is of some importance, for if American courts thought that a tort was implied from the crime, and that express criminal, administrative, and civil actions do not exhaust the ambit of remedies, Israeli courts should more easily come to the same conclusion.

England and Israel will not face the symmetry problems of buyers and sellers on the market, for in neither of these countries do defrauded buyers in a non-public offering have any inherent statutory advantages over defrauded sellers. The only problem is to be found in the provisions which restrict the remedies of buyers in the distribution process. In England, for example, sec. 43 of the 1948 Companies Act allows buyers a damage action only against those who sign the prospectus and the experts who give opinions contained therein. Buyers have no action against the company itself. A question arises as to whether or not the implication of a private action will require that there be established a damage action against the company—a proposition which would run foul of a basic doctrine of English law, *i.e.*, that the proceeds of an offering are corporate funds.[163] But this problem is not acute since the buyer can, arguably, base a damage action against the company on other grounds.[164]

161 Sec. 15 (b) (5) of the 1934 Act. 15 U.S.C. sec. 78q (b) (5).

162 Sec. 20 (b) of the 1933 Act, 15 U.S.C. sec. 77t (a) and sec. 21 (e) of the 1934 Act, 15 U.S.C. sec. 78u (e) (1964).

163 An idea expressed in *Houldsworth* v. *Glasgow Bank* (1880) 5 App. Cas. 317, H.L. followed in *Re Addlestone Linoleum Co. Ltd.* (1887) 37 Ch. D. 191, C.A. Sec. 31 of the Israel Securities Law permits a damage action against the issuer. Yet one writer expressed doubt whether the action can be maintained by a purchaser who still holds the security. Gross, "Civil Liability under the Securities Law" (1969) 9 Quarterly Banking Review 56, 67, 69-70 (Hebrew). The present writer thinks this doubt to be unwarranted. Sec. 31 does not contain such limitation. There is no lacuna in our system and the *Houldsworth* ruling cannot be read into sec. 31.

164 Sec. 2 of the Misrepresentation Act, 1967 presumably enables an action

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Another difficulty involves a rescission action by a buyer in a distribution. Can the limitation period of 2 years, fixed by sec. 35 of the Israel Securities Law, be overcome by suit under sec. 54? A further possibility might be an action by one, who, although induced by the prospectus to buy, bought, not from the selling group, but rather from an individual who had himself bought from the selling group. Sec. 31 (damages action) and sec. 35 (rescission action) of the Israel Securities Law provide remedies only to one who actually bought from the offeror, and hence provide no express remedies to the buyer in this case. Can the buyer bring an implied action? [105]

Various other examples are readily imaginable wherein an implied action could override restrictions cast on the express remedies. It is submitted, however, that the most tidy and defensible solution to the problems presented is to imply private actions only in the areas the legislature left as a *tabula rasa.* In the areas that the legislature covered, providing a remedy only against certain persons or conditioning a remedy on certain prerequisites, it can be said that the legislature revealed a negative intent in regard to the "no remedy" strip, rather than left a lacuna. The absence of a provision like sec. 12(2) in Israel and England permits equal treatment of buyers and sellers in market transactions, without superseding express restrictions in distribution transactions. We may therefore conclude that the Israeli and English frameworks are more adequate to the development of implied civil liabilities in securities dealings than the American framework.

Theories of Liability in the Blue-Sky (Securities) Laws

The blue-sky laws of two states in the United States — New York and Rhode Island — have no express provisions for civil liability. In these states, therefore, such a remedy can be established only by implication. In addition to these two, moreover, there are 13 states in which express liability does not always coincide with a violation of the statute and the statute does not expressly exclude the implication of private actions. At one time, the implication of liability

against the company, although it does not contain a provision which reverses expressly the rule in *Houldsworth*. Sec. 2 (1) of the Misrepresentation Act furnishes a damages action against the other party to the contract—in our case the company—and sec. 2(2) states that damages can be rewarded in lieu of rescission. See Gower at 319.

[105] See the legislative history of these sections, *infra* n. 270.

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had some role in several additional states.[166] It is thus interesting to examine what civil consequences the courts in these states have given to the violation[167] of the statutes.

It can be safely said that the courts are generally inclined not only to deny the seller any action to enforce the contract, but also to allow the buyer to rescind it. The courts have based their decisions on a variety of different theories. Insofar as the crime committed in this context is simply the failure to register under the blue-sky laws rather than fraudulent behaviour the implication of a tort presents some difficulties. Nevertheless one court did suggest that the buyer could rescind the contract because of the tort of fraud which lay in the constructive representation by the seller that the stock was registered as required by state law.[168] Other courts have based recovery on grounds of trover[169] or conversion.[170] It has been correctly noted[171] that this is the result of rather circuitous reasoning, for there can be a conversion only if the plaintiff has a right to the money, *i.e.*, only if the plaintiff may rescind the transaction. Thus the writer does not suggest that much weight be given to this line of cases.

Other cases, however, have allowed recovery on the grounds of *quasi* contract.[172] The New Hampshire case of *Karamanou* might prove to be an important one for our thesis because the court purported there to follow the English case of *Browning* v. *Morris*.[173] The defendant in *Karamanou* was a dealer who had sold shares after his license

[166] Loss at 1661-1667.

[167] The violations are commonly one of the following: (a) failure to register the security; (b) failure of somebody in the distribution group (issuer, broker, or salesman) to register; (c) failure to file required notices or reports; (d) failure to use proper sales techniques. See Gable, *The New Common Law of Blue-sky Remedies: Civil Liabilities for Criminal Violations* (1964) Seminar paper in the Harv. L.S. Library.

[168] *Shepard* v. *City Co. of N.Y. Inc.* 24 F. Supp. 682 (1938), appeal dismissed, 106 F. 2d 994 (1939).

[169] *Dress* v. *Minnesota Petroleum Co.* 189 Minn. 608, 250 N.W. 563 (1933).

[170] *Heaphy* v. *Kerr* 190 App. Div. 810, 180 N.Y.S. 542 (1920), aff'd 232 N.Y. 526, 134 N.E. 557 (1921).

[171] Gable, *supra* n. 167 at 9. Gable's theme is that civil liability cannot be based on any of the traditional common law theories of liability and that the courts should admit that they are creating new common law.

[172] *Karamonou* v. *H. W. Greene Co. Inc.* 8 N.H. 420, 124 A. 373 (1922); *Napier* v. *Decar Chemical Products Co.* (Pa. C.P. 1951) in 100 Pitts. L.J. 245, 246.

[173] [1773] 98 Eng. Rep. 1364.

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had been revoked by the commissioner. The plaintiff successfuly brought a rescission action. An earlier New Hampshire case[174] had applied *Browning* to an action against a sheriff who had overcharged for his services, and the *Karamanou* court followed this path.

In most of the cases that allowed recovery it was considered elementary law that the purchaser must surrender the security to get the purchase price back.[175]

[174] *Edgerly* v. *Hale*, 71 N.H. 138, 147, 51 A, 679, 684 (1901).

[175] See Loss at 1672 n. 202. The cases which did not condition the recovery held so on the reasoning that because the sale contract is void the security is worthless and tender would be futile. *Stern* v. *National City Co.* 25 F. Supp. 948, 952 (D. Minn. 1938), aff'd without discussion of the question *sub nom.* 110 F. 2d 601 (8th Cir. 1940), rev'd on other grounds 312 U.S. 666 (1941). This reasoning cannot apply to rescissionary actions against insiders. As we shall see there is authority in English law for the proposition that once the innocent party is allowed an action to defeat an executed contract, he can recover without giving up his benefits of the contract.

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VIII. *IMPLICATION OF CIVIL LIABILITY FROM CRIMINAL PROVISIONS REGARDING SECURITY TRANSACTIONS IN ENGLAND AND ISRAEL*

Introduction

The principal matter with which this section is concerned is whether or not an implied tort of fraud can be derived from the offences stated in sec. 13 of the Prevention of Fraud (Investments) Act in England [176] and sec. 54 of the Securities Law in Israel.[177] We shall try to trace the guidelines which the English and Israeli courts follow in this judicial legislation to see whether a development, comparable to the judicial gloss on Rule 10b-5 in the U.S.A. is possible in these two countries. We shall also deal briefly with other possible implications of liability regarding security transactions.

Implying a Tort Regarding Insider Trading in England

1. *General Tests for Implication*

The doctrine of implying torts from crimes began in England at an early stage in the development of the common law. At first, actions would be brought in trespass, but *Ashby* v. *White* [178] is regarded [179] as establishing the principle that such actions should be brought on the case. In early cases, culminating in *Couch* v. *Steel*[180] the tort would be implied as a matter of course.[181] Later cases in the nineteenth century, beginning with *Atkinson* v. *Newcastle Waterworks Co.*[182] would infer tortious consequences from a criminal violation only if, according to some test formulated by the court, the legislature could be presumed to have intended such a result. The twentieth century

[176] 6 and 7 Eliz. 2, C. 45 (1958).
[177] (1968) 22 L.S.I., 266. The law came into force on July 1, 1969.
[178] (1703) 2 Ld. Raym. 938.
[179] Street, *The Law of Torts* (4th ed., 1968) 269.
[180] (1854) 3E & B 402.
[181] Article 823 of the German Civil Code is typical of the approach of civil law countries to the "crime-tort" doctrine which resembles the approach of the early English common law: "Liability also attaches to a person who contravenes a statute designed for the protection of another. If the statute may, according to its terms, be contravened even in the absence of fault, liability in damages attaches only where fault is present".
[182] (1877), 2 Ex. D. 441, C.A.

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has witnessed much confusion and uncertainty in this area.[183] English courts willingly imply torts in the sphere of welfare industrial legislation even to the extent of interpreting criminal statutes to create strict civil liability. Strict liability is used here not only in the sense that the violator is held liable although he could not have foreseen the results and hence would not be liable at common law, but also in the sense that a violator will be found liable even in those cases where the *violation* (the noncompliance with the statute) itself was not even negligent.[184] But English courts are reluctant to infer liability in other branches of the law.[185]

Two tests of implication struggle to dominate the English judiciary. They can be loosely called the "protection test" and the "general construction test".[186] According to the first, liability is inferred if the statute is designed to protect the plaintiff or a certain sector of the public, of which the plaintiff is a member.[187]

According to the second, "the only rule which in all circumstances

[183] This confusion in turn raised complaints against the legislature for failing to state whether the crime had civil consequences. *Cf.* per Lord Du Parq in *Cutler* v. *Wandsworth Stadium Ltd.* [1949] A.C. 398, at 410 and per Wallace in *Jacob* v. *Construction and Engineering Pty, Ltd.* (1966) 83 W.N. (N.S.W.) pt. 2, 331 at 332.

[184] A recommendation of the Monckton Committee on Alternative Remedies to restrict recovery to cases in which the breach was at least negligent (Cmd. 6860, para. 82) was not implemented by Parliament.

[185] T. Weir, *Tort* (1967) 104 concludes: "The cases where the courts tend to give this remedy are where the damage is of a kind that interests them, where the relationship of the parties involves a common law duty, and where the defendant will be liable only for something approaching fault".

[186] See the somewhat different presentation of the tests in the report of the Law Commission on the Interpretation of Statutes (Her Majesty's Stationery Office, 1969) para. 38 at p. 23 and especially note 92. The commission recommended that in respect to *future* legislation the court should rely on a presumption that non-compliance with a statute is actionable, unless a contrary intention is expressly stated in the legislation.

[187] The refusal of the English courts to find that the "protection test" is met in the case of traffic regulations is explained by them in saying that those regulations are intended to secure the orderly movement of traffic and the safety of those engaged therein and not to impose duties on one class of persons to secure the safety of another class. The reciprocal nature of the duties imposed on *all* who are engaged in traffic, they reason, precludes the implication of private actions. A recent Australian case makes this point very clear. *Abela* v. *Giew* (1965) 65 S.R. (N.S.W.) 485. This case went even further than the English in refusing to imply a private action. See *infra* p. 71.

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is valid is that the answer must depend on a consideration of the whole Act and the circumstances, including the pre-existing law, in which it was enacted".[188] This second approach purports to apply certain guidelines to arrive at an undisclosed legislative intention. However, the courts purport to apply somewhat contradictory rules of construction.[189]

An attempt to bring order to this area was made by Professor Glanville Williams in his article "The Effect of Penal Legislation in the Law of Tort".[190] Professor Williams proposes a "concretization test", the essence of which is to recognize statutory duties only in areas in which there are common law duties; the statutes would then be concrete declarations of the duty of care. Professor Williams' test is the English version of the so-called "standard of negligence rule" in the United States.

Professor Williams would agree to statutory extensions of common law duties, but he opposes and criticizes the Americans for establishing new heads of duties, unknown to the common law.[191] Professor Williams in his writing made reference only to statutory negligence, probably because it is in that area that the doctrine of tort derived from a crime is most often applicable. Yet the doctrine is not limited to the tort of negligence. It embraces other torts as well and there is sufficient authority in the decisional law to show that as a matter of principle the English judiciary recognizes that a breach of statutory duty can give rise to private actions outside the four corners of negligence.

In *Champan* v. *Honig*[192] an action was brought to recover damages suffered by the plaintiff because of contempt of court by the defend-

188 Per Lord Simonds in *Cutler* v. *Wandsworth Stadium Ltd.* [1949] A.C. 398 at 407. See the formulation of this test by Lord Atkin, *infra* n. 226.

189 Report of the Commission on Interpretation, *supra* n. 186.

190 (1960) 23 Mod.L.R. 233. For additional articles, see Fricke, "The Judicial Nature of the Action upon the Statute" (1960) 76 L.Q.R. 240; Alexander, "Legislation and Standard of Care in Negligence" 42 Can. B.R. 243. For American articles see Thayer, "Public Wrong and Private Action" (1914) 27 Harv.L.R. 317; Morris, "The Relation of Criminal Statutes to Tort Liability" (1933) 46 Harv.L.R. 453, and "Role of Criminal Statutes in Negligence Actions" (1949) 49 Colum.L.R. 21; Lowndes, "Civil Liability created by Criminal Legislation" (1931) 16 Minn. L.R. 361. There are abundant articles about liability under Rule 10b-5, gathered in Loss, 1763-1764 n. 261.

191 (1960) 23 Mod.L.R. 233, 258 n. 79.

192 [1963] 2 Q.B. 502, C.A.

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ant. The court held for the defendant, reasoning that the plaintiff failed to meet the test of implying a tort from a crime. The court treated the common law crime of contempt of court as if it were a statutory crime and said that the applicable test was the "general construction test" used in statutory negligence cases.[193] The Court of Appeal applied similar reasoning in the *Throne*[194] case, where the tort sought to be inferred was also an intentional tort.

The closest we come to a holding inferring an intentional tort from a crime is in *Cunard Steamship Co. Ltd.* v. *Stacey*.[195] There the Court of Appeal upheld the grant of an injunction against union activists to prevent them from persuading seamen employed by the plaintiff to join an unofficial strike. Evershed M.R., who delivered the main opinion, assumed that no action lay for procuring a breach of contract or for civil conspiracy because of statutory exemption for these actions in trade disputes. Instead, he based his decision on two grounds, one being that a provision in another statute overrode the exemption with regard to civil conspiracy, and the second that plaintiff had, in addition to the two rights that he could not invoke because of the exemption, an inferred private action for breach of a statute. This private action was inferred from sec. 236 (1) of the Merchant Shipping Act, 1894,[196] which reads:

> If a person by any means whatever persuades or attempts to persuade a seaman or apprentice to neglect or refuse to join or proceed to sea in or to desert from his ship, or otherwise to absent himself from his duty, he shall for each offence in respect to each seaman or apprentice be liable to a fine not exceeding ten pounds.

[193] Davies L. J. expressed the opinion that "perhaps the nearest one gets to a statement of principle is in the words of Atkin L.J. in *Phillips* v. *Britania* [for which see *infra* n. 224] ... and the principle can, in my judgment, be applied in the present case." *Id.* 523-524, Pearson L. J. said: "The answer depends on the construction of the particular enactment, i.e., on the intention which it manifests. Here there is no enactment which is directly relevant and I can only consider, perhaps in a rather metaphorical way, what intention is to be inferred from the nature and exercise of the jurisdiction".

[194] *Thorne* v. *British Broadcasting Corporation* [1967] 1 W.L.R. 1104, C.A. This was an injunction to restrain alleged violations under sec. 6 of the Race Relations Act, 1965. See *infra,* p. 118.

[195] [1955] 2 Lloyd's Reports 247, C.A. See discussion of the case in Clerk and Lindsell, *Torts* (13th ed., 1969) 416 n. 83.

[196] 57 & 58 Vict. C. 60.

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Finding that this section was enacted for the protection of shipowners, Evershed M. R. observed that special consideration should be given to the fact that the defendant owed the plaintiff duties at common law (for civil conspiracy and procuration of breach of contract) which cannot be made the basis of a cause of action against him because of statutory exemptions only. In such a case, he thought, the court should more easily infer private actions from criminal statutes than in cases where, but for the statute, there is no legal relationship between plaintiff and defendant. On balance he was inclined to imply a private action but rested his opinion on the cumulative effect of the two tentative grounds.[197] Despite the opinion's tentativeness, *Cunard* v. *Stacey* is important authority because the tort implied was an intentional tort in the nature of implied conspiracy or procuration of breach of contract.

On the ground of this anaysis one should be able to imply a tort of statutory deceit (or fraud) from the criminal provision of sec. 13, if the applicable test of inference is met. It was indeed suggested by Professor Gower[198] that civil liabilities in connection with the issuance of prospectuses can be implied from secs. 13 and 14 of the Protection of Fraud (Investments) Act, 1958, to cover holes in the net of express civil remedies in the Companies Act. Professor Loss seems to give these suggestions of Professor Gower an even wider connotation.[199] We shall strive to show in this paper that a private action against insiders, for concealment of inside information, in favour of the defrauded party can be implied from sec. 13.

We shall turn now to analyze the section to see whether the test for implication is met and whether the section proscribes concealment of material information by insiders in securities transactions.

197 Jenkins L.J. in a concurring opinion, stated: "Without in any way prejudging the result I content myself by saying that I think both points are points of substance". [1955] 2 Lloyd's Reports 247, 260. Parker L.J. concurred with his two colleagues.

198 Gower, 338-39. See also *infra* p. 91.

199 Loss, "The Protection of Investors, The Role of The Courts" (1963) 80 South African L.J. 372 at 383. It is, indeed, the theme of this paper that there is sufficient authority for these suggestions to become law in regard to the problem of insider trading.

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2. *Analysis of Section 13*

a. *Is the Test for Implication Met?*

Section 13[200] is a general anti-fraud provision designed to fulfil the same function as the two general anti-fraud provisions in the United States.[201] The purpose of the section is revealed not only by the short title of the Act, but even more so by the long title of the original 1939 Act,[202] "...an act to make general provision for preventing fraud in connection with dealings in investments", and by the cross-heading immediately preceding the section "General Provisions for the Prevention of Fraud". Presumably some headway can be made from these titles and heading in arguing that the legislature intended to protect the investing sector.[203] But in terms of the "protection test" the question is not that simple. Can investors[204] be re-

[200] The section is set out *supra* n. 21.

[201] Sec. 17(a), 1933 Act; sec. 10(b) and Rule 10b-5 (see *infra* n. 438) under it, 1934 Act.

[202] 2 & 3 Geo. 6 C. 16.

[203] It was the consensus of Donovan J. in *R* v. *Bates* (*infra* n. 209) and Salmon J. in *R* v. *Mackinnon* (*infra* n. 211) that the long title and the crossheading are legitimate aids for the construction of this section, while the side title ("penalty for fraudently inducing persons to invest money") is not admissible, because it was not debated in Parliament. However, resort to these aids can be made only when the statute is ambiguous. Thus Donovan J., who thought the section ambiguous used these interpretive aids, while Salmon J. who thought the section unambiguous rejected them. In construing the section for the purpose of implying a private action, there is, of course, no ambiguity in the section, since by definition the section does not deal with its civil consequences. But, by the same token, the resort to the interpretive aids cannot contradict the language of the legislature, but only shed light on it. Resort to the side-title would have no negative effect on our proposition. Again, we start from a penal section. To point out the penal attributions does not mean that they *exhaust* the consequences of the section.

[204] Sec. 13 applies not only to investments in securities, but also to arrangements in respect to property other than securities. But, it is submitted, that the apparently wider scope of the English anti-fraud provision compared with the American and Israeli, should not be an obstacle in the way of establishing the investing sector for the purposes of the "protection test" or "general construction test". This apparent wider scope is illusory. "Security" as defined in sec. 26(1) of the Protection of Fraud (Investments) Act does not include investment contracts. Secs. 13(b) and 13(c) are designed to afford protection against fraud to investors also in investment contracts. (And see the further crime of sec. 1

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garded as a class? Is there a distinct sector of investors in the sense of an identifiable group? Does the public nature of the capital market, the fact that an outsider (investor) in one company can be an insider in another and the interchangeable nature of the market (the efficiency of which is really judged by the liquidity and transferability of securities) rule out a finding of a "protected class" and a "protected from ('oppressive') class"?[205] It is submitted that these reflections, as forceful as they are, go not to the application of the "protection test" to security transactions, but rather to the validity of the test itself. Even in the employee cases, where implied remedies are constantly granted, the ambit of protection can not always be ascertained *a priori*. Questions have arisen as to whether independent contractors are protected and whether employees of a certain business engaged in an activity, different in nature from its usual one, come under the umbrella of a statute governing the different activity.[206] Moreover, one can argue that at any given moment the security holders of a certain company are as identifiable as the employees of a certain factory. Although it is true that prospective security holders (purchasers) are protected as well as present security holders (sellers), it is so only because we are dealing with a transaction, not with a static situation.

The true concern of a court should be whether the legislature intended to protect a plaintiff before it, from having the wrong inflicted upon him.[207] This, in our context, is a rather rhetorical question, and the English courts should have no more difficulty than their American peers[208] in finding that the "protection test" is met.

of the Protection of Depositors Act, 1963). Investment contracts are included in the definition of security in the 1933 Act (sec. 2(1)) and the 1934 Act (sec. 3(10)) and presumably also in the meaning of security for the purposes of sec. 54 of the Israeli Securities Act, which embraces even securities not included in the definition of security in sec. 1 of that Act. For the judicial gloss on what is an "investment contract" in the United States, see Loss at 483-511.

205 See *supra* n. 187 for the discussion of the two classes in traffic regulation cases.

206 See G. Fridman, *The Modern Law of Employment* (1963) 519-20.

207 The damage suffered by the plaintiff, in order that he should be able to bring an implied private action, must be the very damage contemplated by the legislature in penalizing defendant's behaviour: *Gorris* v. *Scott* (1874) L.R. 9 Exch. 125. This condition is met in securities fraud cases.

208 According to the *Restatement of Torts* (1934) a condition for the implied

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When we focus our inquiries on the plaintiff at bar, the "protection test" and the "general construction" test merge together, and analysis in terms of "general construction" would only be repetitious.

b. Actus Reus *and* Mens Rea *of Section 13*

But what are the criminal *actus reus* and *mens rea* of sec. 13 and their civil counterparts? As much as our research revealed, no cases today centre on the question of what is "dishonest concealment of material facts". Rather the cases deal with what constitutes "reckless making of any statement, promise or forecast". Inasmuch as those cases cast some light on *our* problem we shall discuss them now.

In *R* v. *Bates,*[209] Donovan J. rejected an argument that "reckless" connotes dishonesty. In the process of delivering his opinion, he observed that "it is not a difficult matter to decide in any given case whether a false statement of fact is false to the knowledge of him who makes it, nor whether a concealment of fact is dishonest".[210] Donovan J. thought that "dishonest" connotes a moral stigma—a state of mind which would sustain a civil action for fraud. In a case involving a statement, indifference to its truth or falsity would be sufficient. But the opinion does not reveal why he thought that it is not difficult to ascertain such a subjective state of mind, nor how this test would be applied in a case of total non-disclosure without any statement being made. Would "dishonest" in this context mean that the person who kept silent had cause to believe that the fact he concealed might exist and was indifferent about whether or not it really existed?

Then in *R* v. *Mackinnon,*[211] Salmon J. accepted the argument dismissed in *R* v. *Bates* and ruled that recklessness imputes dishonesty. It

remedy was that "the intent of the enactment is exclusively or in part to protect an interest of the other as an individual . . ." and not ". . . to secure to individuals the enjoyment of rights or privileges to which they are entitled only as members of the public". Secs. 286(a), 288(b). The second *Restatement* weakened the implied remedies using the discretionary language that the court "may adopt" a statutory standard. *Restatement (Second) of Torts* (1965) sec. 286. Note the striking similarity between sec. 286 of the first and second *Restatements* and sec. 63 of the Civil Wrongs Ordinance (New Version) in Israel. See *infra* p. 69.

209 [1952] 2 All E.R. 842. In a *dictum* the Court of Criminal Appeals endorsed this interpretation in *R* v. *Russell* [1953] 1 W.L.R. 77.

210 [1952] 2 All E.R. 842, 845.

211 [1959] 1 Q.B. 150.

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is, perhaps, unfortunate that he went out of his way to express himself in *dictum* to the effect that "dishonest concealment of material facts" covers only cases involving half truths:

> It would appear that category two [i.e., dishonest concealment of material facts] is included only *ex abundanti cautela* to cover the sort of fact that existed in *R* v. *Kylsant*.[212] If any fact that is omitted from a statement, promise or forecast is material, it can only be material in that its omission makes what has been said misleading, false or deceptive. If the omission is dishonest, it can only be dishonest because the person who makes it knows that what he has said is misleading, false or deceptive by reason of that omission. I am inclined to think that category two is already covered by category one [i.e., statement, promise or forecast known to be misleading, false or deceptive].[213]

This *obiter* is, of course, fatal to our thesis because it maintains that in a case of concealment of facts *per se* the *actus reus* of the crime does not exist and, therefore, there is no crime from which a tort can be derived. But with all respect due to Salmon J. there is no handle in the statutory language to which his *obiter* can cling. Dishonest concealment of material facts which induces another person to sell or buy is very clearly an offence even if no statement, promise or forecast were made. The word "or" can mean only "or" and it cannot be read as saying "or, if any statement, promise or forecast were made".[214]

We have now exhausted what we could use from the cases for our needs, but to bring the story to its end we shall mention two other stages in the sequence of events. In *R.* v. *Grunwald*,[215] Paul J. reached the conclusion that recklessness does not amount to dishonesty; "heedless rashness" would suffice: "The statement or promise must be a rash statement or promise and must be made regardless of whether the person making it has any real facts on which to base the statement

[212] [1932] 1 K.B. 442.

[213] [1959] 1 Q.B. 150 at 154.

[214] But see, R. Pennington, *The Investor and the Law* (1968) 204-205. Pennington regards the *Mackinnon* interpretation as more satisfactory than the grammatical reading of the section. His point is that if concealment of material facts be regarded as an independent offence the law would impose a general duty of disclosure in prospectuses, something which he seems to oppose on balance.

[215] [1963] 1 Q.B. 935.

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or the promise".[216] Then in 1963,[217] Parliament added the words "dishonestly or otherwise", thus resolving the dispute against Salmon J.'s interpretation. It is not yet settled, however, whether Donovan J.'s or Paul J.'s interpretation, for what little difference there is between them, will prevail.

c. *Is there an Insider Concept in Section 13?*

Concluding that dishonest concealment of material facts *per se* is a crime and that the crime-tort doctrine furnishes the victim with a private action against the offender, we should also examine who comes within the ambit of the criminal provision and the tortious implications therefrom. Sec. 13 prohibits "any person" from dishonestly concealing material facts. Does the section reach outsiders? Is a concealment of material outside information dishonest? Does a person, without resort to inside information, who finds that the real property of the company is going to increase tremendously in value,[218] and who searches for a shareholder and buys his shares without any misrepresentation, commit a crime? It is our opinion that the scope of sec. 13 can be limited to insiders, because we maintain that concealment of facts by an outsider is not dishonest. A similar "legal valve" [219] to this which the language "deceptive device" furnishes the Americans in developing an insider concept in sec. 10(b) and Rule 10b-5 is contained in the term "dishonest". Thus, without going all the way to impose on outsiders an affirmative duty to disclose, the second category of sec. 13 can play a very meaningful role in protecting investors in securities transactions.

Introducing the Tort to Israel

1. *The Test for Implication in Israel and Its Application to Section 54*

Section 54 of the Israeli Securities Law [220] reads as follows:

(a) Any person who does one of the following shall be liable

[216] *Id.*, at 939.
[217] In sec. 21 of the Protection of Depositors Act, 1963.
[218] E.g., because of a change in the zoning classification in the area, or because oil was discovered on adjacent land.
[219] See *infra*, p. 120.
[220] (1968) 22 L.S.I. 280.

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to imprisonment for a term of three years or to a fine of IL20,000:

(1) induces or attempts to induce a person to acquire or sell any securities, doing so by a statement, promise, or forecast—in writing, orally, or otherwise—which he knows or ought to know is false or misleading, or by concealment of material facts;

(2) fraudulently influences the fluctuations of the value of securities.

(b) In this section "securities" include securities not included in the definition of section 1.

Can one imply tortious liability from the above criminal provision?

In Israel, unlike in England or the United States, the breach of a statutory duty is a statutory tort, not one arising from common law. Sec. 63 of the Civil Wrongs Ordinance (New Version)[221] provides:

(a) Breach of a statutory duty consists of the failure by any person to perform a duty imposed upon him by any law other than this Ordinance, being a law which, on a proper construction thereof, was intended to be for the benefit or protection of any other person, whereby such other person suffers damage of a kind or nature contemplated by such law:

Provided that such other person shall not be entitled by reason of such failure to any remedy specified in this Ordinance if, on a proper construction of such law, the intention thereof was to exclude such remedy.

(b) For the purposes of this section, a law shall be deemed to be for the benefit or protection of any person, if it is a law which, on a proper construction thereof, is intended for the benefit or protection of that person or persons generally, or of any class or description of persons to which that person belongs.

At first glance it would seem that the Israeli legal system should be more amenable than its English counterpart to infer torts from criminal behaviour under the statutory guidelines. There seems to be a presumption in sec. 63 that every crime which meets the easy statutory protection test will provide the basis for a cause of action in tort, and that the defendant can escape liability only by showing that the statute, when properly construed, is not intended to afford the *remedy* sought by the plaintiff. In the case of *Sarag Adin,*[222] Landau J. did indeed

[221] Civil Wrongs Ordinance (New Version) 1968. In the Civil Wrongs Ordinance 1944 Palestine Gazette Supp. I 1680 p. 93 as amended in 1947, Palestine Gazette Supp. I 1563 p. 32, the section was numbered 55A.

[222] *Sarag Adin Ltd.* v. *The Mayor of Tel-Aviv* (1957) 11 *P.D.* 1110, 1116.

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express such a view, by way of *obiter* in that case. Several Israeli courts, however, have tried to read the English "general construction test" into sec. 63. In *Parizker* v. *Friedman*,[223] the Supreme Court did so in an alternative ruling. In that case, the Court, following the English decision in *Phillips* v. *Britania Hygienic Laundry Co.*,[224] held that no action could be based on the Traffic Regulations. In his opinion, Silberg J. emphasized that regardless of whether the Court chose to adopt the "protection test" expressed by McCardi J. in the Court of Appeal in *Phillips*[225] or the "general construction" test expressed by Lord Atkin,[226] the same result would ensue: the plaintiff would not succeed in establishing the tort of a breach of statutory duty.

Israeli courts have been more committed than their English counterparts to a rejection of the negligence *per se rule* in the area of traffic regulations. In the English case of *Mark* v. *Warby*.[227] the defendant had violated a statute by allowing a friend to operate his vehicle despite defendant's lack of insurance against third party risks. Because of that violation, the defendant was held liable to the victim of his friend's negligent driving. An early Israeli decision assumed by way of *obiter*

In this case an action against the Municipal Corporation for the breach of a statutory duty was denied on the ground that special rules apply in actions against public authorities. Followed in *Posner* v. *Noiman* (1961) (I) 15 *P.D.* 502. In *Shachada* v. *Atman* (1966) (IV) 20 *P.D.* 619., (additional hearing) an action against the Registration of Vehicles Authority for the failure of one of its clerks to ascertain that the owner had insured himself against third party risks, relief was denied to the victim of a vehicle accident. In *Mentel* v. *The Municipal Corporation of Petah Tikva* (1965) (I) 19 *P.D.* 540, 545, the Supreme Court held that the failure of the forfeiting authority to comply with its duty to publicize a notice of the forfeiting was a ground for the tort of breach of statutory duty. *Cf. Degani* v. *Development Authority* (1967) (I) 21 *P.D.* 365.

[223] (1953) 7 *P.D.* 674. See also *Kasem* v. *Municipal Corporation of Nazeret* (1955) 9 *P.D.* 243 at 249 per Olshan J. where, again, the "general construction" test was applied in the alternative with the "protection test".

[224] [1923] 2 K.B. 832, H.L.

[225] [1923] 1 Q.B. 539.

[226] "That [i.e., the implication of a tort] depends on the construction of the Act and the circumstances in which it was made and to which it relates" *Id.* at 841. "The question is whether these regulations, viewed in the circumstances in which they were made and to which they relate, were intended to impose a duty which is a public duty only or whether they were intended in addition to the public duty to impose a duty enforceable by an individual aggrieved". [1923] 2 K.B. 832 at 843.

[227] [1935] 1 K.B. 75.

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that the same result would be applicable in Israel.[228] A later Israeli decision, again by way of *obiter*, decided that the *Parizker* decision is precedent for *all* violations of traffic regulations.[229] The English rule is less sweeping: a *per se* rule was applied in *London Passenger Transport Board* v. *Upson*.[230] In that case a pedestrian was allowed by the House of Lords to recover from a driver who struck him inside a pedestrian crossing, solely by virtue of the defendant's having violated a regulation, which required that he proceed with caution while approaching the crosswalk. In *Kelley*[231] Ashworth J. decided that a violation of a no-parking regulation was a sufficient basis for allowing private recovery, finding that the regulation was designed to prevent accidents. But in *Coote* v. *Stone*[232] the Court of Appeal held that the primary purpose of a similar regulation (prohibiting stopping on clearways) was the facilitating of the passage of traffic and disapproved of Kelley. What exceptions the *Parizker* rule in the area of traffic regulations will be allowed by Israeli courts in the future remains to be seen. There is some authority for the proposition that the statute would be given an evidentiary role or even a "concretization of negligence" role.[233] In the field of employee protection, the courts of Israel have

228 *Zeibert* v. *Bishko* (1959) 12 *P.D.* 40, 48 (per Goitein J.). Followed by the District Court in Haifa, *Gabay* v. *Nagmi* (1964) 40 *P.M.* 61, 76.

229 *Schachada* v. *Atman* 1966) (I) 20 *P.D.* 163, 166-67 (per Cohn J.).

230 [1949] A.C. 155, H.L.

231 *Kelley* v. *W.R.N. Contracting Ltd. & Another* [1968] 1 W.L.R. 921.

232 [1971] 1 W.L.R. 279, C.A.

233 See, e.g., *Vishen* v. *Clapor* (1962) 30 *P.M.* 121, 130, where the District Court, bowing because of *stare decisis* to the *Parizker* precendent said: "Nevertheless, as far as we are concerned with the standard of care required from the defendants, the duty imposed by the regulation 69A is at least a helpful guide, if not more", citing Witkon J. in *Schvilly* v. *A.G.* (1952) 6 *P.D.* 470, 477. The latter was a criminal prosecution for negligent manslaughter and the court stated by way of *obiter*, "we may comment that these elements [required for the establishment of the crime] resemble to a certain extent the elements required for civil liability in an action based on negligent manslaughter in English law". Per Cheshin J. at 475. Witkon J. in a concurring opinion went as far as to say "...the mere fact that the legislature fixed a means of precaution results in anybody violating his duty to be convicted of negligence". *Id.*, at 477. In other words, a negligence *per se* rule. *Cf. Schachada* v. *Atman* (1966) (IV) 20 *P.D.* 617, 621. (additional hearing).

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been as liberal as those in England.[234] At times, in fact, they have perhaps been a step ahead of the English.[235]

The most ingenious contribution of the Israeli judiciary, however—and one which is encouraging to those who seek to imply a civil liability from sec. 54 of the Securities Law—is the development by the Supreme Court of Israel of what might be called the tort of "nuisance by implication". As a general rule, the tort of nuisance requires material interference with the reasonable use and enjoyment of plaintiff's immovable property.[236] In the case of *Gideon* v. *Saliman*,[237] however, the Supreme Court held that a plaintiff unable to satisfy this test might still obtain redress by showing that the defendant violated the Town Planning Ordinance[238] and regulations thereunder. Even assuming the test of sec. 63 to be the "protection test", the Court said, plaintiff is entitled to his remedy because the legislation was designed to protect both the public generally and neighbouring property holders.[239] In a later case,

234 *Cf. Cohen* v. *Alei Tabak Ltd.* (1969) (I) 23 *P.D.* 709; *Elbar Mfg. Ltd.* v. *Goldman* (1965) (I) 19 *P.D.* 371.

235 *Davies* v. *Thomas Owen & Co., Ltd.* [1919] 2 K.B. 39 decided that if a machine cannot be fenced safely in a way that the use of it will still be profitable, the employer may either lose on the production or forego its use. Lord Simon, cast doubt about this proposition in *Lewis* v. *Denye* [1940] A.C. 921, H.L., presumably in light of the wartime efforts of the industry. The Israel Supreme Court stayed firmly behind the *Davies* principle in *Atiya* v. *Rosenbaum* (1954) 8 *P.D.* 1135 even before the House of Lords restated the proposition in *Summers & Sons Ltd.* v. *Frost* [1955] A.C. 740.

236 Sec. 44 of the Civil Wrongs Ordinance (New Version), provides: "(a) A private nuisance consists of any person so using any immovable property of which he is the occupier as materially to interfere with the reasonable use and enjoyment, having regard to the situation and nature thereof, of the immovable property of any other person:
Provided that no plaintiff shall recover compensation in respect of any private nuisance uness he shall have suffered damage thereby".

237 (1959) 13 *P.D.* 916. Earlier cases, *Igra Rama* v. *The Board of the Municipal Corporation of Tel-Aviv* (1951) 5 *P.D.* 229 and *Adama Int'l Co. in Israel Ltd.* v. *Levy & Singlia* (1955) 9 *P.D.* 1666, 1672, indicated that a private action lies but did not articulate its regimen.

238 Town Planning Ordinance, 1936 Palestine Gazette Supp. I 589 p. 157. Replaced now by the Law of Planning and Building, (1965) 19 L.S.I. 330.

239 A minority view in Israel bases the actions in favour of persons injured by violations of the building law not on sec. 63 but on an independent crime tort theory. This doctrine was shaped by Berinson J. in *Levy* v. *Adama* (1955) 9 *P.D.* 1666, 1672. See Cheshin in Tedeschi *et al*, *General Law of Torts* (1969) (Hebrew), 105-111. Excluding Berinson J. who

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Leibovitz v. *Katz*,[240] the Supreme Court decided that neighbouring businessmen are protected as well as neighbouring residents. The Court also rejected the argument that damage to the business is not within the general scope of harm which the statute was designed to prevent.[241] The readiness of the court to divide the public into various units and to find that the test is met when the plaintiff is that unit of the public which was directly affected—what might be called the Israeli version of the particular damage rule[242]—is significant for our purposes, for it can be said with equal force that the Securities Law is designed to protect the public generally as well as those who happen to have dealt with the insider. If there can be an implied nuisance, even absent the requisite elements for an express nuisance, why can there not likewise be implied fraud, even absent all of the requisites of express fraud?[243]

has not committed himself, the general concensus among legal scholars is that the legal source for the action is sec. 63. The three elements of the *Adama* rule were (a) an illegal act, (b) damage, (c) causation. This seems to be an incomplete list of a sec. 63 action elements. The *Adama* rule eliminates the inquiries, the "protection test" and the "general construction test" are designed to answer. As a matter of positive law the writer thinks the *Adama* rule is indefensible.

240 (1964) (I) 18 *P.D.* 384.

241 The Land Bill, 1964, sought, in sec. 66(b), to sanction a civil action complaining of violation of building laws. The Land Law, 1969, deleted this section but in sec. 20 preserved the existing remedies. See (1970) 5 Is.L.R. 292.

242 Here not as an element of the tort of public nuisance like in *Boyd* v. *Great Northern Ry. Co.* (1895) 2 I.R. 555, but as a consideration for qualifying as a "protected person".

243 See also *Frou Frou Biscuit (Kfar Saba) Ltd.* v. *Froumine & Sons, Ltd.* (1969) (1) 23 *P.D.* 43, where the court held that an owner of a registered trade mark may bring a civil suit although sec. 38 of the Trade Marks Act spoke only about a penal action against the violator. But in *Frou Frou* the court emphasized that the Trade Marks Ordinance itself assumed elsewhere the availability of a private action (e.g., by stating in sec. 34 that if the trade mark is not registered, a private action cannot be brought). *Frou Frou* is, therefore, not as strong an authority for implied actions as are *Gideon* v. *Saliman* and *Leibovitz* v. *Katz*. The express tort of fraud requires a representation and a showing of pecuniary damage. Sec. 56 of the Civil Wrongs Ordinance (New Version): "Fraud consists of a false representation of fact, made with the knowledge that it is false or without belief in its truth or recklessly, careless whether it be true or false, with intent that it shall be acted upon by the person deceived: Provided that no action shall be brought in respect of any such representation unless... (a) it was intended to and did deceive the plaintiff and he

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The Supreme Court of Israel has recently re-analyzed the elements of sec. 63 in the case of *Schachada* v. *Atman*.[244] Landau J. there commented:

> Sec. 55A confers a very grave duty of construction on the court. It opens the door to the creation of indefinite torts, correlating the duties imposed on anybody by statute, subject to the limiting conditions contained in sec. 55A itself, which are themselves formulated in very general terms. I have already indicated [in *Sarag Adin*] that the last paragraph of sub-section (1) of sec. 55A apparently shifts the burden of persuasion onto him who alleges that regarding a certain duty the legislature intended to deny the civil remedy. It is thus obvious that there is here considerable room for 'judicial legislation' in the imperative of the legislature.[245]

After observing the unsettled situation in English law, Landau J. commented that sec. 63 says just what it says—*viz*, that a duty to the public generally can be a basis of establishing civil liability. The true distinction is between a duty owed only to the public *qua* public and a duty owed also to the individual plaintiff who, *ex hypothesis*, is a member of the public. That should be, in his opinion, the judicial yardstick. "The solution would not be found by a mechanical restriction of the protection of sec. 55A to a portion of the public, but first of all by examining the nature of the duty itself, imposed by the relevant law".[246]

The inclination is, therefore, in the direction of a "general construction test" instead of a *permissive* "protection test", as one would deduce from a literal reading of sec. 63. There is some presumptive element in sec. 63, not an absolute presumption as suggested by the English Commission on Interpretation, the effect of which is cloudy. All the same, it seems fair to say that either in terms of a "protection test" or a "general construction" test there are reasonable chances that the Israeli court, having proved its willingness to find a tort when it thinks as a matter of policy that the plaintiff is entitled to

has acted upon it and has thereby suffered pecuniary damage". Pecuniary damage, although not an element of a private action derived from sec. 54 of the Securities Law, will of course, exist when the insider conceals successfully material information. The only element which does not exist is that of "false representation", which must include, at least, a half truth.

[244] (1966) (IV) 20 *P.D.* 619 (additional hearing).

[245] *Id.*, at 620.

[246] *Id.*

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redress—as in the cases where it inferred a nuisance from a crime—will supplement the legal framework laid down in the Securities Law for the Israeli financial market, and the criminal anti-fraud provision, by an implied fraud, very likely limiting it to concealments by insiders.

2. *The Legislative History of Section 54 and the Reporting Provisions, and Their Interpretive Value*

It can be expected that the legislative history of the question of insider trading in Israeli will be read to militate against the proposed introduction of insider's liability by way of tortious conduct implied from a penal statute. We shall try to emphasize here that such an assertion is devoid of support both in the legislative history itself and in those rules of law governing the utilization of legislative history in the interpretation of statutes. But, we shall begin with the preliminary argument that no resort whatsoever should be made to legislative history, even if it is generally looked upon as an aid in interpreting statutes, for the purpose of an inquiry into inferring tortious liability from criminal activity.

Sec. 63 of the Civil Wrongs Ordinance (New Version) contains the applicable set of rules for this inquiry. Assuming that all the tests of this section are met, but that there is a statement in the legislative history indicating, or even saying in so many words, that the Knesset did not want civil consequences to attach to a certain penal section, are we going to resort to such a statement at all? Will it be "admissible" in court? The answer should be an unqualified "no". But have we assumed a conclusion? Or in other words, *is* legislative history one of the tests of sec. 63? This section draws a substantive test. If according to its true construction a statute is protective, the presumption of sec. 63 is that a private action lies. In applying this test, it would seem the inquiry should be directed to the language and purpose of the statute leaving no room for extraneous statements. If the nature of the duty imposed and the general scheme of the statute are directed to protect and benefit a group of people,[247] this fact is conclusive. The protected people will have civil remedies notwithstanding the clearest indications to the contrary in the legislative his-

[247] On a literal reading of sec. 63, even if the duty was imposed in order to protect "people generally".

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tory. Taking the analysis up to a broader level, it can be argued that even aside from the exclusivity of sec. 63, the reference to legislative history is futile. The statute is silent on the question of civil liability. The question is not what are the consequences of the silence, but, rather, what are the consequences of the fact that the legislature penalized the activity. The answer to this question is to be found in legal rules and not in legislative history. Even assuming that legislative history is a legitimate aid in a normal case of statutory interpretation we are not merely interpreting the statute here.[248] The inquiry is not "what does the statute say?" but "what are the implications of what it says"?[249]

Before presenting the rules of utilization of legislative history in cases of interpretation proper, the legislative history of the provisions affecting insider trading in the Securities Law will be set out. The narration begins with the recommendations of the Yadin Committee which declared a full scale war on insider trading.[250] In addition to

[248] Judge Kirkpatrick put it very ably: "The question is only partly such [i.e., of statutory interpretation]. It is whether an intention can be implied to deny a remedy and to wipe out a liability which normally, by virtue of basic principles of tort law, accompanies the doing of the prohibited act". *Kardon* v. *National Gypsum Co.* 69 F. Supp. 512, 514 (E.D.Pa. 1946).

[249] See Thayer, "Public Wrong and Private Action" (1914) 27 Harv. L. R. 317, 320. Thayer points out the futility of searching for a supposed legislative intent when the statute is *ex hypothesis* silent about the intent of implication.

[250] The Committee described insiders as "persons who have a larger measure of relevant information than that available to the general investing and trading public". It thought that for the purposes of insider trading, "insiders should be deemed to include the directors of the company whose securities are being traded, shareholders who own more than a stipulated percentage of the capital of the company, and members of the Exchange who are represented on the Board of Directors of the company" (Yadin Report, para. 194). The securities market in Israel is practically controlled by the banks; they are underwriters, exchange members, investment advisers and also they themselves deal in securities. Through subsidiary investment companies banks own shares in, and are represented on, the boards of many operative companies. (Yadin Report, para. 217). Thus the banks have access to diverse sources of inside information. The Yadin Committee found that this concentration of functions had not given rise to improper acts (para. 218). In principle it favoured division of the functions and specialization of different institutions in each of them (to avoid conflict of interest, increase investors' confidence and achieve economics of specialization), but "did not see a need for making

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placing comprehensive reporting requirements on the company and on the insiders and urging the stock exchange to combat the problem in its rules, the Committee recommended that the general anti-fraud provisions to be introduced would cover this practice too.[251] The Committee recommended:

> We believe that the new law should clearly provide that the disclosure and reporting requirements are designed for the protection of the investor, and that any party damaged by reason of a violation, should have the right to demand compensation in accordance with sec. 55(a) of the Civil Wrongs Ordinance.[252]

This proposal would afford a private action against insiders who failed to report their dealings and against a company which failed to report immediately the happening of a specified important event. But the Committee did not stop there and went on to say: "In addition we recommend that every violation of the general provision against deceptive practices also give rise to civil liability for the

specific recommendations in this regard at this stage of the development of the Israel economy" and preferred to leave the matter "to the natural processes of development and to the wisdom of the banks themselves". (para. 220).

[251] (Yadin Report, para. 196-197). The Yadin Committee was of the opinion that the combined arsenal of comprehensive reports, disclosure requirements and anti-fraud provisions, plus the stock exchange rules, would be sufficient to eliminate the problem of insider trading. The Committee noted that the Tel Aviv Stock Exchange had already taken a first step in the desired direction, in sec. 3 & 4, Chapter XI of its by-laws of August 10, 1962. These by-laws forbid a member to use certain information which he has acquired and is yet unknown to the other members. The managing director of the exchange is authorized to suspend for one day trading of the securities in question, if there is reason to suspect that the information has not yet become public. In the new June, 1969 by-laws of the Tel Aviv Stock Exchange, the above rules are contained in Part I, Chapter D(4) and in Part II, Chapter J 1(a) respectively. See also the requirement of listed companies to make immediate reports to the Stock Exchange (Part II, Chapter J). At the present stage of securities trading in Israel, the Yadin Committee did not recommend the adoption of special provisions for insider trading, but recommended that developments in this area be closely followed. The greatest loophole in the scheme proposed by the Committee was that in the absence of a duty to report prices of the insider's dealings, actions against insiders would be less likely. A minority of the Committee wanted to include such a duty (Yadin Report, para. 198).

[252] Para. 214.

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payment of damages to the extent that such violation causes monetary damages".[253] Moreover the Committee would make such civil liability more severe by "reducing the plaintiff's burden of proof in a damage action, and shifting this burden to some extent, to the respondent".[254] It closed this chapter of the recommendations by saying: "This general civil liability... will be applicable both to acts and omissions. It will serve to complement the special provisions for civil liability with regard to the issuance of prospectuses".[255]

Those who oppose an implication of tortious liability from the penal provisions of the Securities Law will argue that the failure to inject any of the above recommendations into the final law is a clear indication that the legislature refused to attach civil liabilities to violations of the reporting and anti-fraud provisions. But in so arguing, they overlook one step in the legislative history, which, when placed against the background of the final statute and the Yadin Report supports their allegation that the legislature intended to have no civil ramifications for non-compliance with the reporting sections. Yet at the same time this combined picture destroys their allegation in regard to the general anti-fraud provision of sec. 54. This missing step is the Securities Bill introduced in the Knesset in 1964.[256]

This bill did not contain even a *criminal* anti-fraud provision, but it did provide that directors[257] and controlling security holders[258] of public companies[259] should report to the S.A. their security holdings; that directors should report also changes therein;[260] and that if

[253] *Id.*

[254] Para. 215.

[255] Para. 216.

[256] (1968) *Hatza'ot Hok* 625. The Bill was vigorously criticized by the press, Banks Association and by a public committee appointed by the Tel Aviv Stock Exchange. See J. Gross, "The Securities Law, 1968—Trends and problems" (1969) 25 *Hapraklit* 392, 393 (Hebrew).

[257] Sec. 36(a).

[258] Sec. 36(b). The Bill left it to the Finance Minister (after consulting the S.A.) to define a controlling security holder.

[259] Companies listed on the Exchange, and companies which have made a public offering.

[260] Nevertheless it appears that the power delegated to the Finance Minister was broad enough to require controlling shareholders to report changes in their holdings. The language of the proposed sec. 36(b) reads: "Persons holding securities of the issuer, directly or indirectly, of a kind and of a percentage to be fixed, must notify the S.A., in dates and form to be fixed, about the securities they hold.

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directors and shareholders failed to so report, they would be liable to security holders for the ensuing injury.[261] It also provided that if the company failed to file the company report it, and any director who could not show that he took all proper precautions to insure the fulfillment of the reporting requirement, would be liable to make good ensuing damages to security holders.[262] The Knesset deleted all these provisions and instead inserted the criminal anti-fraud provision of sec. 54. If one views the legislative history on a three-dimensional plane, the Yadin Report, the Securities Bill and final Law, it cannot be said that the inclusion of only a criminal provision in the statute as enacted precludes the implication of tortious liability from sec. 54.[263]

The debates in the Knesset shed very little light on the reasons which led the House (a) to delete the reporting requirement for controlling shareholders, (b) to delete all the provisions of civil liability for non-compliance with the reporting requirement, and (c) to insert a penal anti-fraud provision. The chairman of the Finance Committee, who brought the bill to the floor of the House for its final readings, did not elaborate on its content. About the first point he said:

> Sec. 37 complements sec. 36. Its purpose is to reveal to the public the identity of the major shareholders of the company. The bill covered directors and holders of more than a certain percentage of a company's securities. The committee, on the suggestion of the accountants association added the auditor of the company. On the other hand, the committee dismissed security holders who are not directors from the disclosure duty.[264]

[261] Sec. 38(b).

[262] Sec. 38(a). It might be commented here that all these provisions were not sufficient to achieve their desired purpose because, as they were drafted, it might have been argued that only a *present* security holder could bring an action, to wit, a security holder who sold out as a result of the failure to report would have no redress. Both secs. 38(a) and 38(b) spoke about liability "to a security holder" for the ensuing injury. If the decisive time for being a "security holder" would be the time of the law suit the seller is out. If it would be the time of the transactions the buyer would be out.

[263] To this can be added the routine argument that the legislature is supposed to know the law, including the rules of implication of sec. 63 of the Civil Wrongs Ordinance (New Version).

[264] (1968) *Divrei HaKnesset* 3371.

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There is no reference to, or explanation of why the Finance Committee conditioned the disclosure duty of directors and auditors on the placing of such a duty on the company by virtue of regulations under the Securities Law[265] and why controlling security holders were exempted from disclosure.

The reason for deleting civil liability for failure to report was explained by the chairman of the Committee as follows: "This provision seemed impractical to the committee, which was of the opinion that the criminal liability and the power of the court to order compliance[266] would suffice". It is therefore apparent that the Committee was of the opinion that no civil liability would be implied from those sections penalizing one for non-compliance with the reporting sections. The inclusion of the criminal anti-fraud provision was also only stated as a fact, unexplained:

> I shall finish with two comments. The first relates to the penal provisions. The committee gathered in sec. 53 provisions which were scattered throughout the bill in different sections (34, 39, 54) and added a new provision (sec. 54) which generally imposes imprisonment and a fine for fraudulent practices in connection with the dissemination of securities and the organized trade thereof, even if these acts do not violate the specific provisions of the Law.[267]

That was it. The Law was abruptly passed to the surprise of many who did not expect that it would be voted on at all in the Sixth Knesset.[268]

It is indeed astonishing that throughout the debate in the Knesset, during the first reading of the Law,[269] not one member complained about the lack of an anti-fraud provision in the Bill. It is also significant that the members of the Knesset failed to question an omission in the final draft submitted by the Finance Committee of a duty to disclose by controlling security holders and of civil remedies

[265] See *supra* p. 46.

[266] Sec. 38 of the Law empowers the S.A. to ask the court to order compliance with the provision on corporate reports. The S.A. cannot, however, obtain an order against directors for non-compliance with their reporting duty.

[267] (1968) *Divrei HaKnesset* 3372.

[268] The Law was passed on the last day of the summer session without discussion. It took the public by surprise.

[269] There was no debate in the second and third hearings. See *supra* n. 268.

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for failure to report. The problem of insider trading was not mentioned at all in the Knesset; instead it appeared as if the House focused on only one issue, and that was the extent of control the Finance Minister would have over the S.A. From what little legislative material one can gather from the Knesset discussions, two conclusions emerge. First of all, the Finance Committee, and probably the majority of the Knesset, was of the opinion that failure to report would not result in civil liability. Secondly, the Knesset, which added a "new" penal anti-fraud provision did not consider whether a violation of the provision would subject the violator to civil liability.[270]

Assuming that there are no special rules about the utilization of legislative history as regards an implication of torts from crimes, what weight should be given to inferences arising from the legislative history? In other words, does the legislative history preclude an implication of civil liability for nonreporting?[271]

The legitimacy of *travoux préparatoires* in interpreting statutes is the subject of a legal debate in Israel. In what appears to be a minority opinion, Cohn J. never, even when the statute is ambiguous, resorts to explanatory statements (notes) contained in bills or to Knesset discussions for interpretation. He thinks they are an irrelevant and even a misleading source for answering the question of "what does

270 As to the matter of civil remedies for purchasers in the market against the issuer and its directors, see *supra* p. 56. Our conclusion that because the Law *restricts* civil remedies it excludes implied civil remedies in favour of those not explicitly afforded them by the Law, renders the examination of legislative history in this respect futile. We shall say that the bill provided that a purchaser within six months from the issue of the prospectus is presumed to have bought the security in reliance on the prospectus (sec. 31). Thus, those who purchase in the market during the first half year of the date of issue would have a rescission action against the issuer and an action for damages against it and the signers of the prospectus. This presumption was deleted from the final Law because the Finance Committee, as its chairman stated in the Knesset, "thought that such a liability would be too far-reaching". See *supra* n. 264. Thus market purchasers have no explicit remedy against the issuer and the other prospectus signers. The legislative history, of course, buttresses the conclusion that civil liability in favour of purchases in the market should not be implied from sec. 54.

271 This is the only question left because there is nothing in the legislative history to indicate that an implied remedy in sec. 54 was discussed. The fact that the Knesset thought that civil liability did not ensue from secs. 36 and 37 should have no bearing on an implication from sec. 54.

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the statute say?"[272] His colleagues on the Supreme Court are not quite as adamant about the demerits of legislative history. Perhaps the most common approach is the one expressed by Sussmann J. in *Minister of the Interior* v. *Mussa*[273] and repeated in *Svisky* v. *Finance Minister*.[274] This view would disavow explanatory statements in bills because they represent only one thing—the opinions of the draftsman of the Ministry which originated the legislation.[275] The view further holds that where the statute is unambiguous, there is no need to resort even to the clearest indication in the Knesset discussions.[276] But when the statute is unclear[277] *and* the Knesset discussions convey

[272] In *Svisky* v. *Finance Minister* (1965) (II) 19 *P.D.* 369, 375 Cohn J. said: "All these incidents of the Knesset discussions (*i.e.*, the explanatory statements in the bill, the speech of the Minister who brings the bill for its first reading in the house, the statement of the chairman of the committee who brings the bill to the house for the final readings and speeches of Knesset Members expressing reservations about the bill) are disqualified from passing the threshold of the court, when the latter deals with the question of the legislative intent of a certain piece of legislation. Not only can they not point to the intent which is relevant in court—which is reflected in the language and provisions of the Law as enacted, but they might mislead and trip the court by attempting to insert into the Law things which are not there, or to give its language a different meaning from its normal and grammatical meaning. Even when the language of the Law is ambiguous, I shall not interpret it by the Knesset material". (In free translation from Hebrew, which is bound to do injustice to the original). Cohn J. expressed the same view in *Director of Stamps Duty* v. *Levinson* (1963) 15 P.D. 2226, 2236-2237.

[273] (1962) 16 *P.D.* 2467, 2481 (additional hearing).

[274] (1965) (II) 19 *P.D.* 369, 379.

[275] *Id.*

[276] The best example of such a case is *Assessment Officer of Jerusalem* v. *Krongold* (1955) 9 *P.D.* 27. There the court (per Witkon J.) refused to interpret a tax statute according to a statement in the Knesset of the Finance Minister (who introduced the bill into the house), finding that the statute was unambiguous.

[277] This formula gives tremendous discretion to the court, because it decides whether the statute is ambiguous. For example in *A.G.* v. *Weigel* (1965) (II) 17 *P.D.* 712, where Cohn J. found the meaning of the statute to be crystal clear, the majority of the court (per Berinson J.) reached a different interpretation, basing it, *inter alia*, on a statement in the Knesset by the member who brought the bill to the final readings on behalf of the committee. Berinson J. explained his action by saying: "I brought this statement... not as authority for the true meaning of the statute. The statute should be interpreted according to its language and the legislative purpose. I brought it only to show that the question *sub judice*

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a clear indication of what a majority of the members intended the ambiguous passage to mean,[278] Sussmann J.'s view is to interpret the doubtful passage according to the legislative indication. If this view be extended to cover the implication of a civil remedy from a proscribed act,[279] civil liabilities would not flow from non-compliance with the report duties because the legislative history contains a clear

was not directly discussed in the Knesset, but the statement implies..." [the interpretation which he reached]. *Id.* at 718. Another example of the leeway afforded the court is to be found in the approach of the former Deputy President of the Supreme Court, Silberg J. In *Cohen & Boussik* v. *A.G.* (1954) 8 *P.D.* 4, 42-43, Silberg J. used a statement from the *explanatory statements* of a bill, not to interpret a statute in its light but because it "can shed light on the legislative background and from this point of view it may add some strength to an interpretation derived already from the body of the Law". But in a later case *Eshed* v. *A.G.* (1954) 8 *P.D.* 785, 821-822, where the majority of the court reached a result in accord with an explanatory statement, Silberg J. refused to follow suit saying: " It is my opinion that the explanatory statement does not bind the courts, since it is not a part of the positive law and moreover its content is wrong". One wonders whether this statement meets his test in the *Cohen & Boussik* case. On a third occasion, Silberg J. expressed the opinion that explanations by a speaker in the Knesset prior to the vote cannot restrict or extend the meaning of a phrase but can serve to defeat an allegation that a certain interpretation will lead to harsh results, by showing that the Knesset was aware of these results and still passed the Law. *Minister of Interior* v. *Mussa* (1962) 16 *P.D.* 2467, 2472-73 (additional hearing).

278 It is difficult to obtain such a clear indication. E.g., in *Tabal Moiz* v. *The Municipal Corporation of Haifa* (1953) 7 *P.D.* 707, the court, per Olshan J. refused to interpret a statute according to a statement made by a Member of the Knesset in explaining his reservation to a bill which caused the house to amend the bill. The court said that the reasons enunciated by this member for his reservation are not necessarily embodied in the law as passed. Sussmann J. in another case, was of the opinion that the fact that an amendment was rejected by the Knesset does not indicate that the majority preferred the results which the dissenting member disliked. The majority, he observed, might have shared the dissenting member's views about the desired results but thought that the bill did not lead to them, and *therefore* dismissed the amendment. *Minister of Interior* v. *Mussa* (1962) 16 *P.D.* 2467, 2479. (additional hearing).

279 And that is the meaning of the statement that legislative history is relevant for the question of implication, just the same as for statutory interpretation. See *supra* p. 75 *et seq.*

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indication to this effect.[280] One way or the other, it is submitted that the absolute void in the Knesset discussions regarding the civil consequences of a violation of sec. 54 leaves *this* question entirely under the umbrella of sec. 63 of the Civil Wrongs Ordinance (New Version), which has established the rules for implying tortious conduct from criminal statutes.

3. *Other Implied Remedies*

An implied action against insiders is not the only one which can be derived from the Securities Law. Other crimes in sec. 53, may also give rise to civil actions. We shall dwell here on two possible implications of liability from these criminal provisions.[281]

a. *Issue of Securities to the Public Without Registration*

The American Securities Act of 1933 in sec. 12 (1) [282] expressly furnishes a purchaser with the right of rescission if he holds on to securities issued in violation of sec. 5 [283] (i.e., not registered at all or issued without an accompanying proper prospectus). Such a purchaser is entitled to damages if he disposes of the securities. The Israeli Securities Law, which makes it a crime to issue securities to the public not according to a prospectus approved by the S.A.,[284] does not expressly contain civil remedies in favour of purchasers in such circumstances. But does this mean that there are no civil remedies? In other words, does the crime *per se* affect the legal rights of the parties? A proper situation in which to test this question would be to find an issue clear of fraud or misrepresentation.

It would seem that a contract of issuance where there is improper

[280] One might still argue that the statement of the chairman of the Finance Committee is not a clear indication of the Knesset's intent. The majority of the house might have voted in favour of the Law, because they thought that as a matter of law the chairman was wrong in assuming that violations of secs. 36 and 27 do not result in civil liability. See *supra* n. 278.

[281] Without suggesting that they exhaust all possible implication. A handy candidate for implication is, of course, sec. 54 (a) (2). The problem of manipulating prices is altogether a different one from insider trading, and we avoided dealing with it.

[282] 15 U.S.C. sec. 77 (l) (1) (1964).

[283] 15 U.S.C. sec. 77 (e) (1964).

[284] Sec. 15 (a) of the Securities Law. The punishment for violation is up to a year in prison, or a fine not exceeding IL 10,000. Sec. 53 (b) (1).

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registration would be impliedly prohibited, and that the issuer could not bring an action for payment of the purchase money. It is also submitted that the purchaser could rescind an executed purchase contract both on the theory of quasi-contract and breach of statutory duty. It is crystal clear that the registration scheme is designed to protect investors, and for this very purpose the S.A. was established.[285] The American Blue-sky cases[286] and the Canadian *Lumley*[287] case would be cited as persuasive authority for a rescission action. There are no English cases directly in point.

In England two crimes are relevant in this situation. Sec. 41 (4) of the Companies Act, 1948, renders it a crime to issue unregistered securities to the public and sec. 38 (3) (b) penalizes the issuance of an application form for securities without an accompanying complying prospectus. There are a few *dicta* regarding the civil consequences of the violation of the previous version of sec. 38 (3) (b). In *re Wimbledon Olympia Ltd.*,[288] Neville J. commented that a violation *per se* (i.e. omission of required information in a prospectus) would not render the issue rescindable. In *re South of England Natural Gas & Petroleum Co. Ltd.*,[289] Swinfen Eady J. remarked that a *damages* action would lie because sec. 38 (4) which exempts directors from liability in certain instances *contemplates* liability. In a later decision,[290] the House of Lords left *both* questions, rescission and damages, open, and today they are not yet settled. Interestingly enough, a South African case,[291] applying Rhodesian company law as the proper law of the contract before it, arrived at a conclusion that the Rhodesian[292] equivalent section to the English sec. 38 implies the remedy of rescission.

The availability of an action for damages by a purchaser who made a bad buy and has already disposed of his securities is another matter. It can be forcefully argued that on a proper reading of the statute

285 Sec. 2 of the Securities Law reads: "A securities Authority is herein established (hereinafter the Authority) the duty of which is protection of the interests of the investing sector in securities as provided in this law".
286 See *supra* pp. 57, 58.
287 [1935] Q.R. 278. See *infra* p. 82.
288 [1910] 1 Ch. 630.
289 [1911] 1 Ch. 573.
290 *Nash* v. *Lynde* [1929] A.C. 158, H.L.
291 *Pretorius* v. *Natal South Sea Investment Trust* 1965 (3), S.A. 410 (N).
292 Sec. 289 of the 1951 Rhodesian Company Law (Act 47) relating to foreign companies.

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such a remedy was not intended, and hence sec. 63 of the Civil Wrongs Ordinance (New Version) excludes the action.[293]

b. *Action against the Stock Exchange*

The Tel-Aviv Stock Exchange[294] might also run foul of implied civil liability under the Securities Act. A stock exchange must obtain a license from the Finance Minister, who first consults the S.A.[295] A condition precedent to obtaining such a license, is *inter alia,* for the stock exchange to promulgate by-laws. The by-laws must be approved by the Finance Minister (after consulting with the S.A.) and by the Finance Committee of the Knesset and must ensure fair and proper administration of the affairs of the Exchange and regulate, among other things, disciplinary proceedings against the members of the exchange and their supervision by the exchange.[296] Strictly speaking no provision in the Securities Law imposes a duty on the Exchange to supervise the business of the members to prevent injury to their clients. An American court,[297] however, has ruled that sec. 6 (b)[298] of the Securities Exchange Act worded very much the same as sec. 46[299] of the Israeli Securities Law, establishes such a duty: "There can be no doubt that sec. 6 (b) places a duty upon the stock exchange to enforce the rules and regulations prescribed by the section. Any other construction would render the provision meaningless".[300] Once finding the existence of a duty, the court had no problem in implying a civil liability for violation of this supervisory duty. Otherwise, the court observed, the designed purpose of

[293] The proviso of sec. 63 (a) excludes implied remedies which are not reconcilable with the true construction of the statute.

[294] The only stock exchange in Israel at present and in the foreseeable future.

[295] Sec. 45 (a) of the Securities Law.

[296] Sec. 45 (b) (3) and sec. 46 (b).

[297] *Baird* v. *Franklin* 141 F. 2d, 238 (2d Cir. 1944), cert. denied, 323 U.S. 737. Plaintiff did not succeed, however, because the majority of the court found that he did not trace any damages to the exchange's breach.

[298] 15 U.S.C. sec. 78 (b) (1964).

[299] "No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade".

[300] *Baird* v. *Franklin* 141 F. 2d. 238, 244 (2d. Cir. 1944), cert. denied, 323 U.S. 737.

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the statute to provide protection to investors would become "a snare and a delusion".[301]

It follows that if the Exchange *knows* that a member has violated its rules, for example those of separate recording, and the client can show that he suffered damages *as a result* of the Exchange's failure to take action, a suit can be brought by the client against the Exchange. It is not settled yet what amount of *scienter* would suffice, short of knowledge. The *Baird* case, where actual knowledge was proved, used the language "duty to take disciplinary action... for violations... which it either knew of or at least had reasonable cause to suspect".[302] In *Pettit*[303] the District Court of New York ruled that a showing of negligence would suffice.[304] At any rate, the management of the exchange will be well advised to keep in mind the possibility of civil liability.

301 *Id.* at 245.
302 *Id.* at 244.
303 *Pettit* v. *American Stock Exchange* 217 F. Supp. 21 (S.D.N.Y. 1963).
304 See further, Loss at 937-938 and 1177–1178 and cases cited therein. Also, Note, "Private Actions as a Remedy for Violations of the Stock Exchange Rules" (1970) 83 Harv.L.R. 825, 826, 829. This note deals with regimens of liability against the *violators* of the rules. It is highly unlikely that Israeli courts will go that far, but it should be noted that an Israeli plaintiff would have a much better case than his American counterpart. He can argue that the Exchange by-laws are tantamount to administrative regulations because to come into force they need the approval of the Finance Minister (after consulting with the S.A.) and the Finance Committee of the Knesset, and *every* rule can be changed by the Finance Minister (after consulting with the S.A. and obtaining the approval of the Finance Committee). Sec. 48 (b) of the Securities Law.

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IX. *QUASI-CONTRACT REMEDIES—RESCISSION OF THE CONTRACT*

Availability of a Quasi-Contract Action

It is submitted that even if the hapless outsider cannot bring an action for damages because of the existing state of the law regarding fiduciary duties and breach of statutory duties, he still has an equitable remedy of rescission of the contract based on quasi-contractual principles. The crime of fraud, under secs. 13 and 54, respectively, would be made the basis of setting the contract (of sale or purchase) aside. To support this proposition we shall explore the quasi-contractual principles which enable one contracting party, the victim of a crime committed by the other party in entering the contract, to defeat this contract.

In *Browning* v. *Morris,* in an oft-quoted statement by Lord Mansfield, the following principle was declared:

> But, where contracts or transactions are prohibited by positive statutes, for protecting one set of men from another set of men; the one, from their situation and condition, being liable to be oppressed or imposed upon by the other; there, the parties are not *in pari delicto;* and in furtherance of these statutes, the person injured, after the transaction is finished and completed, may bring an action and defeat the contract.[305]

[305] (1778) 2 Comp. 790, 792, 93 E.R. 1364. See also Lord Mansfield's statement in *Smith* v. *Bromley*: "If the act is in itself immoral, or a violation of the general laws of public policy, there the party paying shall not have this action; for where both parties are equally criminal against such laws... the rule is, *potior est conditio defendentis.* But there are other laws, which are calculated for the protection of the subject against oppression, extortion, deceit, etc. If such laws are violated, and the defendant takes advantage of the plaintiff's condition or situation, there the plaintiff shall recover". (1781) 2 Doug. 696N., 697. This case was decided in 1760, but reported only in 1781. The holding in *Browning* v. *Morris* was endorsed by Silberg J. in an *obiter* in the milestone case of *Geikobs* v. *Kartuz* (1955) 9 *P.D.* 1401. Landau J. will allow the innocent party to rely on the contract even in order to uphold the transaction. *Id.* at 1418-19. But note that the contract was pleaded in defence and not as a constituent element of a cause of action. Witkon J. reserved judgment on the rights of the innocent party. Lately the court refused to entertain an action by an allegedly innocent party to enforce the illegal contract; *Sivan* v. *Reisman* (1968) (II) 22 *P.D.* 683, 687; and also refused a restitutionary action by such party to recover advance money on a frustrated contract; *Reider* v. *Morgenstern* (1969) (II) 23 *P.D.* 95. See also R. Gottschalk.

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Lord Mansfield's statement was directed at a situation where both parties were participants in an illegal act. In *Browning* v. *Morris* the issue before the court was whether the principle of *ex turpi causa* barred an action by one of the parties to recover his consideration in an executed contract, but the court made an exception to the *ex turpi causa* principle. Since the statute was designed to protect one party to the contract, *he* could recover despite the illegality. The application of this exception involves difficult problems. When is the relative illegality of the parties such as to say that one is not *in pari delicto*? Must the recovering party surrender his benefits under the contract as a condition to a recovery of his consideration? Does the exception apply only when the contract is expressly prohibited or also when it is only impliedly prohibited? Can a person bring an action in quasi-contract to defeat the contract even if the crime committed does not furnish him with a cause of action against the other party to the contract on the basis of breach of a statutory duty?

The queries presented above are not all [306] articulated in a tidy and

"Illegality in Contract" (1967) 2 Is.L.R. 589. The proposition of *Browning* v. *Morris* was endorsed in *dicta* in *Bar-on* v. *Topol* (1954) 8 *P.D.* 1065, 1072, and in *Sivan* v. *Reisman* before attaining something akin to the status of a holding in *State of Israel* v. *Lior Ltd.* (1969) (I) 23 *P.D.* 436, 442. *Cf. Shimoni* v. *Ulamei Chain Ltd.* (1971) (I) 25 *P.D.* 824, 835-40. The Contract Law (Remedies for Breach of a Contract), (1970) *Sefer HaHukim*, no. 610, in sec. 24 blocks the importation of English law in matters of breach of contracts regulated by that law. It does not, however deal with the question of the rescission of an illegal contract by the oppressed party. That is, the English rules, in this matter still apply in Israel. The Draft Contract Law (General Part) (1970) *Hatza'ot Hok*, no. 880 at 129, proposes original Israeli rules in the matter of rescission of contracts for defects in their creation. Instead of rendering illegal contracts unenforceable, sec. 31 of the draft Law declares them invalid. Under this section the defrauded outsider would be able to rescind the contract. Sec. 19(a) of the Bill provides that "a party who was induced to make a contract by the other party taking advantage of his distress, mental feebleness or inexperience may rescind the contract when the terms of the contract are more unreasonable for him than is customary". Query, however whether the outsider can ever show the required "distress" and bad terms to be able to raise sec. 19(a).

306 Of note is the discussion of when is a party not *in pari delicto* in Grodecki, "In pari delicto, potior est conditio defendentis" (1955) 71 L.Q.R. 254. It has been recently held in Israel that a party is not *in pari delicto* only when his conduct is not tainted at all. *Sivan* v. *Reisman* followed in *Reider* v. *Morgenstern*. See *supra* n. 305.

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systematic way in case law and even in legal writings. The last and most crucial query for our proposition was only lately brought to light. Before the decision in *Green* v. *Portsmouth Stadium Ltd.*[307] and *Kiriri Cotton Co., Ltd.* v. *Dewani*,[308] two streams of judicial decisions developed, and moved slowly and inexorably toward an inevitable clash. On the one hand there were cases involving a breach of statutory duty, showing a reluctance on the part of the English court to infer new torts from crimes, and on the other hand quasi-contract cases, especially "money-lender" cases furnishing the "protected person" with a right of recovery.

Green was an ideal meeting ground. A previous case[309] had held that the Betting and Lotteries Act, 1934[310] did not imply a tort in favour of an aggrieved bookmaker who was refused admission to a stadium in violation of the Act. Then along came Green, who, in order to recover an overcharge, brought an action for money had and received against a stadium, which admitted him but overcharged him in breach of the Act. Green's answer to the argument, that the Betting and Lotteries Act did not furnish him with a tort action, was that unlike the usual cases involving breach of a statutory duty, here there was an additional element, a contract, and therefore he should be able to recover the overcharge on quasi-contract principles. Parker J. in the Queens Bench[311] accepted this reasoning and decided that even if actions for a declaratory judgment, for an injunction or for damages would not lie, different considerations apply to an action for money had and received.

The Court of Appeal reversed, Lord Denning saying:

> In my judgment, those observations of Lord Mansfield (in *Browning* v. *Morris*) only apply to cases where the statute, on its true construction contemplates the possibility of civil action. He said it was "in furtherance of the statutes" that the action for money had and received could be brought. Just as in an action for damages, so also in an action for money had and received, it is a question of the true interpretation of the statute whether an action lies so as to recover the overcharge. I see nothing in this statute to authorize such an action.[312]

[307] [1953] 2 Q.B. 190, C.A.
[308] [1960] A.C. 192, P.C.
[309] *Cutler* v. *Wandsworth Stadium Ltd.* [1949] A.C. 398, H.L.
[310] 24 & 25 Geo 5, c. 48.
[311] [1953] 1 W.L.R. 487.
[312] [1953] 2 Q.B. 190 at 196, C.A.

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Hudson L. J., in a concurring opinion, stated the same principle but added that the plaintiff had not pleaded any facts tending to show that he was not *in pari delicto* with the defendant.[313]

If we were left at this juncture there would have been no need for this chapter. A simple statement to the effect that no restitutionary action will lie when a tort cannot be implied from a crime would have sufficed. We would have to disagree with Gower, who, after observing the reluctance of the English courts to imply torts from crimes, submitted that "a contract concluded in non-compliance with the statutes or regulations was illegal and unenforceable by the party in breach" and "since the other party would be one of those intended to be protected, that should be no obstacle in the way of his suing on the contract *or for restitution*" (emphasis added).[314] But in *Kiriri,* an action by a tenant to recover from his landlord, key money received in violation of a Uganda Rent Restriction Ordinance, 1949, Lord Denning retracted[315] his statement in *Green,* and held that an action for money had and received lies even if a tort cannot be implied:

> Seeing then that the parties are not *in pari delicto,* the tenant is entitled to recover the premium by the common law: and it is not necessary to find a remedy given by the ordinance, *either*

[313] *Id.* at 197.

[314] Gower at 338 and n. 40. Gower expressed this opinion, without discussion, in regard to filling the gaps in the protective wall of civil remedies to buyers in distributions. He does not elaborate on the problem of invoking a restitutionary remedy when an implication of a tort is ruled out. In the context of insider trading, Gower describes the law to be that which follows from *Percival* v. *Wright* subject to the exception of *Allen* v. *Hyatt* (Gower at 544). In another place he envies the American law for its development under Rule 10b-5: "But as yet we lag far behind the American law, which, as a result largely of a judicial gloss on rule 10b-5 made under the Securities Exchange Act 1934, has virtually placed directors in a fiduciary relationship to all those with whom they have dealings in their company's securities". *Id.* at 517. It is the thesis of the present writer that a thorough examination of the law justifies Gower's observations as regards an action for enforcement by the violator and a restitutionary action by his victim, and both should be extended to *market transactions.* Percival's action against Wright was a *restitutionary* action, and an English court today should entertain it on the basis of sec. 13.

[315] Webber, "Restitution of Illegal Payment" (1960) 23 Mod. L.R. 322, 326 observes: "Kiriri is a decision of the Privy Council and the law still awaits re-examination and restatement by the House of Lords".

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> *expressly or by implication.* The omission of a statutory remedy does not, in cases of this kind, exclude the remedy by money had and received. (emphasis added).[316]

There was still the "little" problem of the *Green* decision. Lord Denning explained the *Green* result by saying the Betting and Lottery Act was not designed to protect bookmakers, and hence an element of the action of money had and received was missing. He also adopted Hudson L. J.'s point in *Green* that the plaintiff there did not establish his not being *in pari delicto* with the defendant. In his own words:

> [Parker J.'s] decision was only reversed by the Court of Appeal because they thought the statute there was of a different kind. It was not intended to protect bookmakers from the demands of race-course owners, but was rather for the regulation of race-courses. There was nothing in that case to show that the plaintiff was not *in pari delicto* with the defendants.[317]

The Canadian *Lumley*[318] case also supports our proposition. There the court was confronted with the question of whether a purchaser of a security, not registered, in violation of the Security Act, could rescind the sale for failure to register. The trial court (per Kingstone J.) concluded that the transaction was an isolated sale, i.e., exempted from registration. He said:

> The Security Act, 1930, is in its essence a regulatory enactment intended and designed to give to the Attorney General control over salesmen of securities in Ontario, but it does not purport to give to the purchasers in an incorporated company the right to recover the money so involved when the sale is a completed one and there has been no fraud or misrepresentation on the part of the vendor of the shares.[319]

Masten J. A. in the Court of Appeal agreed with both the conclusions (i.e., that the statute is regulatory and that the sale was an isolated transaction), but he went on to consider what would be the result assuming *arguendo,* that both conclusions were wrong. On this assumption he observed:

> The statute does not, except indirectly, prohibit the purchase. It does not make the purchaser liable to a penalty. There is

[316] [1960] A.C. 192 at 205, P.C.

[317] *Id.* at 206.

[318] *Lumley* v. *Broadway Coffee Co. Ltd.* [1935] O.R. 104, aff'd [1935] O.R. 278.

[319] [1935] O.R. 104, 108.

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> nothing immoral in the purchaser's act in buying the security. The statute appears to be enacted for the protection of purchasers... It makes it [the sale] voidable at the option of the purchaser, subject to the conditions hereinafter stated [i.e., the possibility of *restitutio in integrum*].[320]

The right of recovery was based on Lord Mansfield's statement in *Browning* v. *Morris.*

Thus we can conclude that upon a showing of the elements of money had and received, a defrauded buyer or purchaser can bring an action for recovery against the insider. Can he establish the necessary elements? We have striven to show that the defrauded party meets the protection test. Not only is he not *in pari delicto,* he is not *in delicto* at all. When he is a buyer he has indeed delivered *money* to the insider and therefore falls within the legal criteria for an action of money had and received. But a defrauded seller has delivered a *security* not money and therefore cannot properly bring an action for money had and received. However, the rules of quasi-contract allow recovery not only to a victim of a crime whose consideration was money, but also to a victim whose consideration was property. The cases in point deal with property deposited as security for a loan made by the lender in violation of Moneylender Acts. But the principle enunciated in these cases applies to any property delivered by the party who is not *in pari delicto.*[321] It is submitted, therefore, that the *Kiriri* rationale covers sellers' as well as buyers' actions against the insider.

The Nature and Extent of Recovery

An action for damages against the insider cannot be brought on the traditional principles of quasi-contract. Unlike a case of premium or overcharge collected in violation of a statutory rate of payment, even in the buyer's action against the insider, the overcharge is not

320 [1935] O.R. 278, 283-284. On its facts this case is, perhaps, the closest argument in favour of a rescission action in insider trading cases. The court's conclusion that the registration scheme was regulatory in nature was directed at a system requiring the registration of *brokers* (where even the issuer had to register as a broker). It could not be applicable to Israeli law (which registers only securities, not brokers or dealers) or to the English Act.

321 Anson, *Law of Contract* (23rd ed. 1969) 359 sums up the law as follows: "Where the parties are not *in pari delicto,* the less guilty party may be able to recover money paid, or property transferred, under the contract."

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a liquidated amount. The seller's position is weaker because he can only argue a "constructive receipt" by the insider of the "undercharge". One would assume that the traditional quasi-contract remedy appropriate in insider trading cases would be rescission, i.e., a restitutionary remedy.[322] But that is not always the situation in English law. Occasionally the party who is not *in pari delicto* obtains an unconditional recovery of his consideration *keeping* the benefits he derived from the contract. The guidelines for determining when the remedy should be restitutionary and when unconditional are not quite clear.

In England the question of tender was the crux on which many cases involving moneylenders turned. The English Moneylender Act[323] and its respective counterparts in the Commonwealth, render the loan contract and the collateral for the loan either illegal or unenforceable when the lender fails to do one of the following things: to register or get a licence, to use his authorized name, to procure a contract or memorandum of the contract signed personally by the borrower, or to keep a book in which he enters a contemporary record of transactions. Lord Parker in the *Lodge*[324] case held that a borrower who seeks equity must do equity, i.e., tender his benefits and restore the *status quo ante* in order to obtain recovery. In practical terms this means a repayment of the loan with interest in order to recover the collateral security. Unfortunately later decisions made inroads into this sound principle. In *Chapman* v. *Michaelson*[325] the court decided that since plaintiff did not seek a "pure equitable relief" he need not tender repayment. *Chapman,* however, must be read in the context of its limited factual setting. A trustee in bankruptcy of the borrower was able to obtain a declaratory judgment, necessary for the discharge of his duties, that the transaction was illegal without being forced to render *restitutio in integrum.* But the courts in two other cases have expressed a broader proposition. In *Cohen* v. *Lester*[326] the court decided that since the statute declared the loan unenforceable, rather than illegal as in *Lodge,* plaintiff need not repay, because repayment

[322] For quasi-contractual recovery in cases involving unliquidated claims, see P. Winfield, *The Law of Quasi-Contracts* (1952) 131-2.
[323] 17 & 18 Geo V. C. 21.
[324] *Lodge* v. *National Union Investment Co. Ltd.* [1907] 1 Ch. 300.
[325] [1908] 2 Ch. 612; aff'd [1909] 1 Ch. 238.
[326] [1939] 1 K.B. 504.

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would be tantamount to enforcement. The Privy-Council in *Kasumu*[327] reached a similar result in regard to the Nigerian Moneylenders Ordinance which also declared the loan unenforceable. Lord Radcliffe's judgment proceeded on different grounds than did the *Cohen* court. He found it "not inherently satisfactory"[328] that a lender who committed a crime (as in *Lodge*) could recover repayment while a lender who does nothing more than enter into an unenforceable bargain is less successful. To him the true test was whether putting the plaintiff to terms could be consistent with the policy of the legislature as expressed in the enactment. Applying this test to the Nigerian Ordinance, Lord Radcliffe concluded that the statute assumed "that no loan that is not contemporaneously recorded can be established with sufficient certainty to be recognized at law"[329] and hence ordered unconditional recovery. His Lordship said that under usury acts the restitutionary remedy was appropriate.

> ... What the law penalized and made void was a particular kind of grasping contract; and it was evidently felt by equity judges at any rate that they were doing nothing that contravened the policy of the Acts if they insisted that the price of their remedies should be the return of the principal money and a reasonable rate of interest, so long as no effect was given to those elements of the loan in which the usury itself consisted.[330]

The very rationale of the *Kasumu* decision, it is submitted, buttresses a restitutionary remedy in recovery actions against insiders. In situations involving insider trading, the law prohibits (impliedly) a grasping contract, as do the usury Acts, and rescission will remove consequences of the fraudulent act rather than give effect to any of its attributions. Moreover the allegation that rescission will frustrate the legislative purpose because it achieves enforcement can be directed only at a secured loan contract in which the final performance involves a re-exchange of the original performance subject only to the "adjustment" of interest. This is not true of a sale or purchase contract.[331]

327 [1956] A.C. 539, P.C.
328 *Id.* at 547.
329 *Id.* at 552.
330 *Id.* at 551.
331 But see the analysis of the moneylender cases in Goff & Jones, *The Law of Restitution* (1966) 292-293, where the writers arrive at the quite gloomy conclusion that in most cases of rescissionary actions the recovery would be unconditional.

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The Canadian courts also experienced ample litigation regarding the extent of the recovery. Excluding the unusual case of *Steinberg* v. *Cohen*,[332] every case advocates restitutionary relief. In *Steinberg* v. *Cohen*, plaintiff gave the defendant cash and a chattel mortgage to stifle a prosecution for theft against a third party, fearing he would be involved as a receiver. Plaintiff sought a declaratory judgment that the mortgage was void and prayed for a return of the cash. A majority of the court granted the first prayer without putting plaintiff to terms, but refused the second on the grounds that the parties were *in pari delicto*. Orde J.A. concurred in the result holding that the mortgage was not a completed transaction requiring enforcement for realization. Masten J.A., writing the majority opinion, conceded the inconsistency in the treatment of the cash and the mortgage, saying "anomalous results are not unknown in our law".[333]

More appealing are the other Canadian decisions. In *Haug & Nellermore* v. *Murdoch*[334] the Court of Appeals of Saskatchewan held that the seller of a traction engine in violation of the Steam Boilers Act[335] was required to return to the purchaser his purchase money, but only on return of the engine. In *Steedman* v. *Frigidaire Corporation*[336] the Judicial Committee, on an appeal from the Ontario Court of Appeals, held that a buyer of equipment, whose agent was bribed, was entitled to the remedy of rescission. The court arrived at its holding because of the bribery, but, since the buyer was not in a position to offer *restitutio in integrum*, his action failed.

In *Lumley*,[337] Masten J.A. held that a purchaser of a security which was not registered by the issuer in violation (so the court assumed for the sake of the argument) of the Securities Act, could recover his purchase money only on a restitutionary basis. Since the sale also involved a contract of employment between purchaser and issuer, the terms of which were carried out temporarily, the court decided that *restitutio in integrum* was impossible. This conclusion was reached by the court's application of the equity maxim that "he who seeks equity must do equity". The court applied this maxim to override what it considered to be the common law principle embodied in

332 [1930] 64 O.L.R. 545.
333 *Id*. at 558.
334 [1916] 26 D.L.R. 200.
335 R.S.S. 1909, Ch. 22, Sec. 19.
336 [1933] 1 D.L.R. 161.
337 *Lumley* v. *Broadway Coffee Co. Ltd.* [1935] O.R. 278.

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Browning v. *Morris,* that a party to an executed contract who is not *in pari delicto* can recover his consideration.

More recently in the case of *Sidmay Ltd.* v. *Wehttam Investments Ltd.,*[338] the Ontario court was again faced with the problem of tender as a condition precedent. In *Sidmay,* a mortgagor sought a declaratory judgment that a mortgage was a nullity because the mortgagee violated the Loan and Trust Corporations Act by engaging in the business of a trust corporation without registration. The mortgagor had received a loan of more than $300,000 from the mortgagee company and that was the value of his prayer. The lower court agreed with the plaintiff, and held that the defendant company violated the Loan and Trust Corporations Act[339] which was designed to protect borrowers. The court decided that the mortgagor came under the exception which enables a party, not *in pari delicto,* to recover. Purporting to apply the *Kasumu*[340] test to the question of tender as a condition of recovery, the court concluded that the mortgage was void not because of its terms or form, but because of defendant's participation in a prohibited business. It maintained that the legislative intent would be frustrated if the remedy were restitutionary and therefore declared the mortgage agreement unenforceable.

On appeal, the case was reversed on all grounds. Allowing rules of common sense to override rules of grammar, the appellate court held that the purpose of the registration Act was to protect investors and depositors in the mortgage company rather than borrowers. Hence a private company lending only its own money, its charter prohibiting public offerings, was not subject to the Act. The court did not rest its holding there, however, and the opinion proceeded on the assumption that defendant company had violated the terms of the Act. If, the court continued, the purpose of the statute is to protect investors and depositors rather than borrowers, any borrower, no matter how innocent or ignorant of defendant's breach of the statute, would not be a protected person and would have no cause of action against the defendant. The court went on to say that even if the plaintiff had a cause of action, he would be entitled to a declaratory judgment only on restoring the *status quo ante,* "Repayment of the sum advanced

[338] [1967] 61 D.L.R. 2d 358 rev'g [1966] 54 D.L.R. 2d 194. For an excellent note on this case see *Lister* (1967) 25 U. of Tor. L.R. 177.

[339] R.S.Q. 1960, c. 222.

[340] [1956] A.C. 539.

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[to the mortgagor] and interest thereon according to the terms of the contract they made should be imposed as a condition of any relief".[341]

The proposition of the *Lodge* case has recently been reinstated in Israel in the case of *State of Israel* v. *"Lior" Ltd.*[342] In so holding, Justice Cohn observed that Parker J.'s ruling in *Lodge* finds support in earlier English decisions.[343]

We can conclude this exploration of the law by stating, what intuitively seems elementary, and, but for the anomalous development in the moneylender cases, would undoubtedly be the general law, that in the cases of insider trading the quasi-contract remedy should be restitutionary.

Recovery when the Contract is Only Impliedly Prohibited

In the moneylender cases previously discussed the contracts were expressly rendered illegal or unenforceable by statute. Yet an action for rescission is not limited to situations involving contracts expressly proscribed. The *Kiriri*[344] rent contract was not expressly prohibited nor was the sale contract in *Lumley.*[345] In *Sidmay,*[346] the court assumed that a contract impliedly prohibited by statute can be avoided as easily as a contract expressly prohibited. It seems therefore safe to conclude, although the cases do not deal squarely with this issue, that the fact that secs. 13 and 54 prohibit the *inducement* by insiders to enter into a contract of sale or purchase, rather than their *entering* into such contracts, will not be an obstacle on the defrauded party's action for rescission.[347] As a matter of principle, moreover, should it

341 [1967] 61 D.L.R. 2d 358 at 361 (per Kelly, J.A.).

342 (1969) (I) 23 *P.D.* 436. The later English cases coming out the other way were not cited. The Draft Contract Law (General Part) (see *supra* n. 305) states in sec. 32 that upon the rescission of a contract for its illegality each party must make restitution to the other party unless the court excuses him from so doing in order to serve justice.

343 *Mason* v. *Gardiner* (1793) E.R. 973, and *In Re Cork* and *Youghal Ry* (1869) 4 Ch. App. 748 at 762.

344 [1960] A.C. 192, P.C.

345 [1935] O.R. 278.

346 [1967] 61 D.L.R. 2d 358.

347 An opposite conclusion will allow the criminal to reap the fruits of his own crime. American courts do not hesitate to untie resulting transactions if they consider it an adequate remedy. *J.I. Case Co.* v. *Borak* 377 U.S. 426 (1964); *Mills* v. *Electric Auto-Lite Co.* 90 S. Ct. 616 (1970).

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matter whether the contract was prohibited expressly or impliedly? If the causal relationship between the prohibited act and the contract is close enough to imply prohibition of the contract, the "protected person" should enjoy all of the ensuing remedies.

Comparison of the Test of Denying Enforceability of the Contract with the Test for Rescission of it

As will be discussed later[348] a contract will not be enforced when a statute, making criminal certain activity is construed to prohibit contracts related to this activity. In construing the statute, an important consideration, but by no means a decisive one, is whether the plaintiff is a "protected person". In order to rescind a contract, the plaintiff first must show that he is a "protected person", i.e., not *in pari delicto* with the criminal. He must also show that the contract is impliedly prohibited or, in other words, that had he not yet rendered his performance, the other party, the defendant in the present litigation, could not legally force him to render it. We have tried to show that the defrauded purchaser or seller can meet *both* these tests.

When a party who does not perform his contractual obligation brings an action for a declaratory judgment that the contract is illegal and unenforceable, an interesting situation arises. A party *in pari delicto* cannot get a declaratory judgment, even though the other party is unable to enforce the contract in court. In short, neither of them is entitled to the assistance of court. This rule can raise awkward situations. A liquidator, for example, might not be able to obtain a declaratory judgment that a certain claim is unenforceable.[349] The buyer or seller, defrauded as a result of insider trading, however, will be able to obtain such a judgment because he is not *in pari delicto*. He is not *in delicto* at all and therefore is not denied access to court. He will not have to surrender the benefits of the contract (the security or money as the case may be) because he is not asking for a *recovery*. The result in his declaratory action should be identical to that reached in an action for enforcement brought by the insider.

[348] See *infra* p. 103.

[349] In *Chapman* [1908] 2 Ch. 612; aff'd [1909] 1 Ch. 238 the borrower was a "protected person". Thus this case is not an authority for a declaration in favour of a person who cannot establish himself as not *in pari delicto* or for a "legal" fiduciary (such as a trustee in bankruptcy) of his. See *Sidmay* [1967] 61 D.L.R. 2d 358 at 381. *Cf. Helmut* v. *Peretz* (1971) (II) 25 *P.D.* 35, 41 (minority opinion).

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X. *ACTION BY THE INSIDER TO ENFORCE HIS GAINS*

General Test for Implying a Statutory Prohibition of a Contract

Although denying an action of enforcement to a party who has performed his part of a contract results in a harsher penalty than allowing the other party to rescind,[350] this is the automatic consequence of a *contract* made *mala prohibita* by the legislature. The action for enforcement is denied not only against a "protected person", but also against a fellow criminal. *Ex turpi causa non oritur actio*. These harsh consequences occur not only when the legislature decrees the contract void or unenforceable, but when it penalizes a party for entering into such a contract.

> Every contract made in or about a matter which is prohibited and made unlawful by any statute is a void contract, though the statute itself doth not mention that it shall be so, but only inflicts a penalty on the offender, because a penalty implies a prohibition, though there are no prohibitory words.

said Holt C.J. in *Bartlett* v. *Vinor*.[351]

Baron Parke in *Cope* v. *Rowlands* expressed the principle in similar terms:

> It is perfectly settled, that where the contract which the plaintiff seeks to enforce, be it express or implied, is expressly or by implication forbidden by the common or statute law, no court will lend its assistance to give it effect. It is equally clear that a contract is void if prohibited by a statute, though the statute inflicts a penalty only, because such a penalty implies a prohibition.[352]

When the contract is not explicitly prohibited by statute, but the legislature prohibits an *act* of the plaintiff, performed by him in the sequence of events which led to the contract, the question then becomes whether a prohibition of the *contract* should be implied from the prohibition of the act. In situations involving licensing activities and penalties for those carrying on an activity without a licence, the courts have developed the classic distinction between a licensing

350 In the first instance the party renders his performance and receives nothing in exchange, in the second the considerations are merely re-exchanged.

351 [1963] 90 E.R. 750.

352 (1836) 2 M & W 149 at 157. See also the milestone case of *Mahmoud* v. *Ispahani* (1921) 2 K.B. 716, criticized in Williams, "The Legal Effect of Illegal Contracts" (1944) 8 Camb. L.J. 51.

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scheme aimed at the protection of the public and one whose purpose is to raise revenue. Thus in *Smith* v. *Mawhood* an unlicensed tobacconist was allowed to recover from the buyer the price of tobacco he delivered. Parke B., in his opinion, stated:

> I think the object of the legislation was not to prohibit a contract of sale by dealers who have not registered. Looking to the Act of Parliament, I think its object was not to vitiate the contract itself, but only to impose a penalty upon the party offending for the purposes of revenue.[353]

In *Kocotis* v. *D'Angelo*.[354] Schroeder J. A. of the Ontario Court of Appeals decided that a municipal by-law requiring registration of electricians was not passed to protect the members of the public in their dealings with electricians but only to provide revenue and therefore could not be interpreted as prohibiting the making of *contracts* by electricians. Another test frequently used in this context focuses on the statute to determine if it were passed to protect the licensed group against competition or to protect the public against unqualified people.[355]

The increasing scheme of statutory prohibitions, a growing tendency by government to regulate many activities of modern life, has caused the courts to be reluctant to imply a statutory prohibition of contracts from the legislature's prohibition of activities surrounding the contract.[356] Instead the courts have developed a refined test of implying statutory disapproval of a contract connected with an illegal activity.

Perhaps the best articulated and most notorious modern decision refusing to imply statutory disapproval of a contract is the *St. John*

[353] (1845) M & W 452 at 463.

[354] [1958] 13 D.L.R. 2d 69.

[355] *Cf. St. John Shipping Corp.* v. *Joseph Rank Ltd.* [1956] 3 W.L.R. 870 at 879.

[356] The statement of Kelly, J.A. in *Sidmay* is instructive: "...the unfavourable consequences which will result from the universal application of the principle [of illegality] under which the impugned mortgage was declared null and void demand that, in the public interest, this court, unless compelled to do so by authorities which are so clear and unambiguous that they defy distinction, should not arrive at a conclusion the effect of which will interfere with the rights and remedies accorded to parties by the ordinary law of contract, particularly when such interference will have such an impact upon a substantial area of the financial life of the community". [1967] 61 D.L.R. 2d 358 at 362.

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Shipping case.[357] Plaintiff shipping company was permitted to bring suit against defendant shipper for freight charges after the plaintiff violated the Merchant Shipping Act,[358] by taking on a cargo which submerged its load line. Notwithstanding the fact that it was profitable for the plaintiff to violate the Act (because the penalty imposed was less than extra profit made by the excess loading) Devlin J. held that the Act did not by implication prohibit the freight contract between plaintiff and defendant. His Lordship based this conclusion on the fact that the forbidden act was too far removed from and had no direct causal relationship to the contract.[359] Therefore Devlin J. concluded that the legislature could not be presumed to have impliedly prohibited the freight contract between plaintiff and defendant. The same observation led the court to conclude that the defendant could not invoke two other principles to thwart plaintiff's action: (1) that a criminal should not be allowed to reap the fruits of his crime,[360] and (2) that the plaintiff should not be allowed to resort to court where the illegal contract is an integral part of his cause of action.[361] The importance of Devlin J.'s statements justifies the following extensive quotation:

[357] [1956] 3 W.L.R. 870.

[358] 22 & 23 Geo. 5, c. 9.

[359] When the carriage contract between plaintiff and defendant was entered into, the loadline of the ship was not submerged. It became so only because of subsequent loadings.

[360] A personal representative of an assured person, claiming insurance benefits matured by the assured's suicide, in circumstances amounting to a crime, will not be heard in court—*Bresford* v. *Royal Ins. Co., Ltd.* [1938] A.C. 586—not to speak of the denial of a claim of, or through, a murderer to a legacy from the murdered—*In the Estate of Cunigunda (otherwise Cora) Crippen, Decd.* [1911] P. 108—or through manslaughter, *in re Hall* [1914] P. 1. The same holds true to preclusion from taking benefits on the victim's intestancy, *in re Singworth* [1934] 1 Ch. 89. See R. Goff & G. Jones, *The Law of Restitution* (1966) 439-42. Legal writers think that the rationale of the principle limits its application to crimes having an element of *mens rea*. It might also be restricted only to crimes of moral turpitude. See Goff & Jones, *id.*, at 439, and G. Cheshire & C. Fifoot, *Law of Contract* (7th ed. 1967) 315-6. Even in the crimes in which the principle prevails, it would apply only if *but for* the crime the plaintiff would have no right or title. *St. John Shipping* [1956] 3 W.L.R. 870, at 886.

[361] Devlin J. observed that this principle is indeed only another presentation of the rule for implying a prohibition of a contract. [1956] 3 W.L.R. 870, at 884.

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> If a contract has as its whole object the doing of the very act which the statute prohibits, it can be argued that you can hardly make sense of a statute which forbids an act and yet permits to be made a contract to do it; that is a clear implication. But unless you get an implication of that sort, I think that a court ought to be very slow to hold that a statute tends to interfere with the rights and remedies given by the ordinary law of contract. Caution in this respect, I think, is especially necessary in these times when so much of commercial life is governed by regulations of one sort or another, which may easily be broken without wicked intent.[362]

The question again here is whether the statute, if construed in the ordinary way, prohibits the contract under consideration. The benefit and protection afforded by the statute to the victim of the violation, the defendant, is a judicial consideration but not the only one. An important guideline for deducing legislative intent is the closeness or remoteness of the contract to the forbidden act.

Israel law contains numerous examples of cases considering the various facets of the illegal contracts problem.[363] Like the English and Canadian judiciaries, Israeli courts resent the hardships in the *ex turpi causa* doctrine.[364] They would endeavour to bring a meritorious case

[362] *Id.* at 881-882. *St. John Shipping* was followed in *Archbolds (Freightage) Ltd.* v. *Spanglett Ltd.* [1961] I Q.B. 374, the Court of Appeal deciding that the Road and Rail Traffic Act, 1933, 23 & 24, Geo. 5, c. 23, 1933, requiring a licence from any person using a vehicle for the carriage of goods, was designed to provide an orderly and comprehensive service and not "to interfere with the owner of goods or his facilities of transport" (*Id.* at 386 per Pearce L.J.) and does not implicitly forbid a carriage contract. Also in *Shaw* v. *Groom* [1970] 1 All E.R. 702 where the Court of Appeal decided that the crime of not providing a proper rent book (under sec. 4 of the Landlord and Tenant Act 1962) did not bar a landlord's action for rent.

[363] Two aspects of the problem which were thoroughly articulated are (a) the illegality of a cohabitation contract of married persons (*Peretz* v. *Helmut* (1966) (IV) 20 *P.D.* 337, and earlier cases cited therein, *cf.* *Helmut* v. *Peretz* (1971) (II) 25 *P.D.* 35, 38-40 (minority opinion)) and (b) the availability of an independent action when the contractual action is barred, whether a quasi-contractual action (*Man* v. *Aion* (1957) 11 *P.D.* 1612; *Teichner* v. *Eckhaus* (1967) (I) 21 *P.D.* 7; *Reider* v. *Morgenstern* (1969) (II) 23 P.D. 95), money had and received (*Aharonest* v. *Neiman* (1956) 10 *P.D.* 1121; *Halperin* v. *Teiger* (1966) (IV) 20 *P.D.* 372), or a proprietary action (*Libman* v. *Lifshitz* (1952) 6 *P.D.* 57; *Ben Yechezkel* v. *Engelberg* (1969) (II) 23 *P.D.* 370).

[364] See per Justice Witkon in *Reider* v. *Morgenstern* (1969) (II) 23 *P.D.* 95, 100; per Silberg J. in *Jekovs* v. *Kartoz* (1955) 9 *P.D.* 1401, 1404-5.

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within one of the exceptions to the rule, yet often will find themselves forced to let the defendant retain his windfall.[365]

A series of cases found contracts not complying with the foreign currency regulations to be unenforceable.[366] The same result was reached in other cases prohibiting transactions without obtaining a permit.[367] The courts will presume that the parties intended to obtain the permit and legalize the transaction.[368] However, when the circumstances rebut such presumption the courts will refuse to entertain the action. But it should be noted that in this line of cases the prohibition is express. Moreover some of them fall also within the category of contracts to commit a crime.[369] All the same the distinction between contracts expressly prohibited and contracts the entering into which is a crime, is devoid of substance. In neither case does the legislature spell out the civil consequences. What difference should it make if the legislature used the technique of prohibiting an act and punishing the actor or of punishing the actor only? The question in both cases should be "what did the legislature try to achieve?" Indeed the courts in the above cases refused the action on the ground that the licences were required in the public interest to guard the foreign currency reserves of the state.

The question of implied prohibition with which we are concerned was discussed by a panel of five Supreme Court Justices in *Libman* v. *Lifshitz*.[370] The taint in that case was that the parties agreed to register property owned by them jointly in the name of one of them and to change the registration only at a later date to reflect the real situation. The registration law contained a provision that nominees will disclose

[365] See per Landau J. in *Weiss* v. *Meirson* (1963) 17 *P.D.* 22, 27.

[366] *Zackay* v. *Pollack* (1955) 9 *P.D.* 864; *Verkony Moscowitz* v. *Pepo* (1956) 10 *P.D.* 480; *Teichner* v. *Eckaus* (1967) (I) 21 *P.D.* 7 and cases cited therein. Note, however, that this area is one in which an independent action for money had and received has been recognized. See *supra*, n. 363.

[367] E.g., *Weiss* v. *Meirson* (1963) 17 *P.D.* 22, regarding a regulation prohibiting the transfer of ownership of diamonds without a written permit given by the Controller. Even the fact that the Controller testified he used to waive the duty to obtain a permit, did not help the plaintiff.

[368] *Shmuel* v. *Israel* (1960) 14 *P.D.* 1642, and cases cited therein.

[369] The distinction between contracts prohibited *per se* and contracts to commit a crime is not always adhered to. For example, in the case of *Gerscht* v. *Gerscht* (1956) 11 *P.M.* 219, approved in (1958) 22 *Psakim* 164, Judge Lamm employed the instructive versus imperative dichotomy to analyze the legality of a partnership contract to commit a crime, i.e., run a certain business without a required licence.

[370] (1952) 6 *P.D.* 57.

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their principals and register the property in the name of the latter. The law went on to authorize the High Commissioner (whose powers were succeeded to by the Prime Minister) to penalize everybody concerned with registration in a nominee's name by a fine. However, the penalty was discretionary and the High Commissioner could impose it only after a court reported to him the occurrence of a violation pursuant to an inquiry by the court.

The Supreme Court unanimously held that the illegality did not bar the action. The majority of the court endorsed the English rule distinguishing betwen imperative (obligatory) and directive (instructive) registration provisions. Only the first nullify contracts in violation of them. The Supreme Court observed that only when the intent of the legislature, as inferred from the object of the provision, is to invalidate the contract, such result will follow. The *Libman* court found that refusal of the action will encourage people to serve as nominees and therefore will frustrate the legislative object. Inasmuch as the decision shows the reluctance of the Israel courts to apply the *ex turpi causa* rule two things must be kept in mind: (a) the contract did not involve a crime, the parties only became subject to a discretionary administrative penalty, (b) the plaintiff came within a recognized exception to the illegality rule, allowing an independent proprietary action in spite of the illegality of the contract. A minority of the court indeed based its decision on this ground.

In another celebrated case, *Jekovs* v. *Kartoz*,[371] the effects of a tainted contract were again the issue at bar. The court reached a unaminous decision, the Justices employing different rationales. The action was for evacuation of a tenant. The gravamen of the complaint was that the premises were rented without the rent being fixed by the appropriate tribunal. Such lease was expressly forbidden and constituted a crime by the lessor. The lessor maintained that the prohibition invalidated the lease. Silberg J. ruled that the lease was clearly illegal but the lessor could not base his action on his own illegality, even if he was doing so only in a way of replication to defeat the lessee's argument that the lease contract entitles him to occupy the premises.[372] Justices Landau

[371] (1955) 9 *P.D.* 1401.

[372] In a later case, *Kouch* v. *Duchan* (1963) 17 *P.D.* 1953, the court decided that a landlord can evacuate a tenant whose "rights" to the premises flow from an unregistered lease. The registration law declared unregistered leases to be null and void. The Supreme Court ruled that plaintiff can win the case by relying merely on his ownership. Since the contract is a

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and Witkon thought that the violation of the provision requiring the fixing of the rent by a tribunal did not invalidate the lease and that the tenant could rely on it to defend the action. Landau J. went on to say that even if the contract was illegal as far as the lessor is concerned, it was legal as far as the innocent (not *in pari delicto*) lessee was concerned. Thus, even assuming the lease to be illegal across the board, the innocent party could rely on it to enforce his contract.

Recently the question of an implied prohibition confronted the Israeli courts in the matter of false declarations about transactions made in order to defraud the tax authorities. The rule emerging from a series of cases is that when the false statement is inserted in the contract itself the contract is unenforceable.[373] When the contract however, accurately reflects the transaction and the false information is given only in a tax return or in a registration report, the crime of defrauding the tax authorities does not bar contract actions.[374] In shaping the above distinction the Israel courts relied on the English *St. John Shipping* case. The courts reasoned that when the defect is not in the contract itself and only the performance of the contract is tainted with an intent to defraud the tax authorities, the defect is incidental and not in the root of the contract.[375] When the violation is in the centre of the contract, a prohibition of the contract would be implied. When the violation is only incidental to the contract it would not taint the contract itself with illegality.

It is thus manifest that the basic propositions in English and Israeli law in the matter of implied prohibition of contracts are very much the same. It remains to be seen what the operative results are when the proposition is applied to an action by an insider to enforce his contract.

Application of the Test to the Situation of Insider Trading

The *St. John Shipping* formula would, it is submitted, prevent enforcement of a contract by a defrauding insider. Although an insider's contract is not expressly prohibited, his inducing one to enter into the

nullity the defendant will have no defence and the plaintiff will not have to resort to the contract (or its illegality) even as a replication. See also *Orenstein* v. *Heiman* (1965) (IV) 19 *P.D.* 190, *Heiman* v. *Cinema Company Ltd.* (1969) (II) 23 *P.D.* 190.

[373] *Siani* v. *Izhari* (1965) (I) 19 *P.D.* 40; *Reider* v. *Morgenstern* (1969) (II) 23 *P.D.* 95; *Havardi* v. *Klinsky* (1970) (II) 24 *P.D.* 565.

[374] *Meoded* v. *Don* (1970) (I) 24 *P.D.* 2283 (*dictum*).

[375] *Id.* at 287.

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contract by concealing material facts is a crime. Since the insider's contract is very much "in the centre of"[376] the proscribed act as a formalized expression of that act, the defence of remoteness is not available to the insider. Furthermore, the prohibited act is the proximate cause of the defendant's damage because, but for the concealment of material facts, the insider would not have title to the security, or, as the case may be, to the purchase money. By the same token the illegal act is an integral element of the plaintiff's cause of action. And, finally, the insider's fraudulent act has an element of *mens rea*.[377] It is not an activity proscribed in a regulatory or a licensing scheme but rather an activity prohibited by an anti-fraud provision of a protective act. It is therefore submitted that the courts could deny judicial assistance to an insider under the three principles enunciated above.

Enforcement of Contracts of Interested Directors

The above conclusion that an insider might not be able to enforce a securities contract may be qualified somewhat by a recent decision[378] in the related area of enforceability of contracts of interested directors. England still holds to the strict view that a contract between a company and its director or a legal entity in which the latter is interested, is voidable at the instance of the company.[379] In the United States this strict trusteeship view has been gradually watered down. Starting from the voidability principle, many states moved to deny voidability if the contract were approved by a disinterested board; more accurately, there had to be a majority of a disinterested quorum. Some states stopped there, while others introduced the fairness rule, i.e., that even if the contract were not approved by a disinterested board, it could be rescinded only on a showing of unfairness. This development occurred partly by decisional law and partly by statutory law. The question as to which party bears the burden of proof is still unsettled—the company, as plaintiff to show unfairness, or the director (or the party affected by the director's interest) to show the fairness of the transaction. In the normal case, it seems the burden would be on the director to show that the contract was fair. However there is authority for the proposition that a provision in the by-laws which allows insider contracts would shift the burden of proof. There is further authority that

376 [1956] 3 W.L.R. 870 at 883.
377 See *supra*, n. 360.
378 *Hely-Hutchinson* v. *Brayhead, Ltd.* [1968] 1 Q.B. 549.
379 Gower, at 527.

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the same result can be achieved by an approval of the general meeting (ratification) or by a permissive statute.[380]

In England, mitigation of the strict rule of voidability was achieved by provisions in the by-laws (or articles of association in English terminology) which would freely allow insider's contracts. Parliament then adopted two measures to prevent absolute permissibility in the articles of association. Sec. 205[381] limited the effect of absolving clauses and sec. 199 imposed a duty on the interested director to disclose his interest to the board of directors. Any violation of the disclosure requirement was rendered a crime punishable by a fine.[382] Therefore the crucial point of controversy in England today is over the effect of an article of association which allows the directors to contract with the company without disclosure by them. Sec. 205, which limits the effect of absolving clauses, has been given the limited interpretation of prohibiting a discharge of liability only after liability has accrued and thus does not affect a permissive article.[383] The question which then arises concerns the civil consequences, if any, of a violation of sec. 199 by the director's failure to disclose his interest to the board. Can the director enforce his contract? Can the company rescind an executed "interested contract"?

In *Hely-Hutchinson* v. *Brayhead, Ltd.*,[384] the Court of Appeal dealt with the civil consequences of sec. 199(3). In that case a director sued his company to enforce contracts of guarantee and indemnity.[385] The contracts were agreed upon by the *de facto* managing director of the company and the plaintiff director. After finding that the action of the *de facto* managing director bound the company, the court had to

380 See the excellent description of this development in Marsh, "Are Directors Trustees? Conflict of Interest and Corporate Morality" (1966) 22 Bus. Law 35-50.

381 Sec. 205 of the 1948 Companies Act, 11 & 12 Geo VI, c. 38, first introduced in the 1929 Companies Act 19 & 20 Geo V, c. 23. The equivalent Israeli provision is sec. 77 of the Companies Ordinance.

382 Sec. 199 of the 1948 Companies Act. First introduced in the 1929 Companies Act. The equivalent provision in Israel is contained in sec. 75 of the Companies Ordinance. The Government has recently proposed an amendment to sec. 75 (4) stating that the company is entitled to damages suffered as a result of the crime. Amendment of the Companies Ordinance (No. 13) (1971) *Hatza'ot Hok* no. 976. For a criticism of the proposed provision see our article in 4 *Mishpatim* 167 (1972) (Hebrew).

383 Gower at 529, n. 85, 532.

384 [1968] 1 Q.B. 549; [1967] 3 W.L.R. 1408.

385 There was no doubt that the contracts were *intra vires* the company.

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decide on the effects of the director's failure to disclose. The question of plaintiff's ability to bring this action in light of his offence was not brought before the court. Instead the issue discussed centred around the validity of the contract, which did not comply with either the article of association of the company or with sec. 199. The article of association reads:

> A director may contract with and be interested in any contract or proposed contract with the company either as vendor, purchaser, or otherwise, and shall not be liable to account for any profit made by him by reason of any such contract or proposed contract, provided that the nature of the interest of the director in such contract or proposed contract be declared at a meeting of the directors as required by and subject to the provisions of Section 199 of the Act...

In *Hely-Hutchinson,* the court held that non-compliance with an article of association makes the contract voidable at the option of the company, and, since *restitutio in integrum* was impossible, the plaintiff succeeded in his action. The reasoning of the court was that since the article of association did not allow the transaction (because it allowed it only if disclosed) the equity rule of voidability should be applicable. The defendant interpreted the article in question as nullifying *ab initio* undisclosed contracts, but the court rejected defendant's argument.

Two fundamental points emerge from the three opinions written by the court. First of all, a breach of sec. 199 will not invalidate the contract *per se.*[386] Secondly, the plaintiff was not denied the assistance of court. As for the first point it is clear that Lord Wilberforce thought that sec. 199(3) had no civil consequences. He expressed himself in the following manner:

> ...it is clear to my mind that what it does is to impose a statutory duty on directors of companies to disclose their interest in contracts under sanction of a monetary penalty and that it says nothing directly as to the effect on a contract or proposed contract of failure to do so. It does contain, however, in sub-

[386] It is submitted that Gower's conclusion at p. 529 and in note 87, that *Hely-Hutchinson* is an authority that non-compliance with sec. 199 *per se* renders the contract voidable, is indefensible. Pennington, *Company Law* (2nd ed., 1967) 498 cites *Hely-Hutchinson* for its *obiter,* that "nor does a company have a right to avoid it [the contract] merely because of the director's failure to make disclosure".

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> section (5) a statement that nothing in the section shall be taken to prejudice the operation of any rule of law restricting directors of a company from having any interest in the contracts with the company.[387]

It follows that if an article of association waiving disclosure is valid, then a director need not disclose and the company would have no defence against the director's action on the contract. Lord Pearson, who shared the same opinion, said:

> It is not contended that sec. 199 in itself affects the contract. The section merely creates a statutory duty of disclosure and imposes a fine for nondisclosure; but it has to be read in conjunction with Article 99.[388]

Lord Denning, M.R., in reaching his decision, held the contract voidable because it did not comply with either sec. 199 or with the Article of association.[389] Therefore even *his* opinion does not stand for the proposition that noncompliance with sec. 199 renders a contract voidable. However *Hely-Hutchinson* is not authority for the opposite proposition. It cannot be cited as precedent that a contract with a director, which violates sec. 199(3) is not subject to rescission by the corporation because the operative result in *Hely-Hutchinson* was that the contract was declared rescindable.

It appears from the holding in *Hely-Hutchinson* that the court assumed that an argument of breach of statutory duty could not be based on sec. 199.[390]

The question whether sec. 129 of the Companies Act, 1936,[391] a local version of sec. 199 (substantially identical) gives rise to a private

[387] [1967] 3 W.L.R. 1408 at 1421.
[388] *Id.* at 1425.
[389] *Id.* at 1417.
[390] This point would make no difference in *Hely-Hutchinson* itself. The company had the remedy of rescission anyhow, and an additional basis for the remedy would add nothing. An implication of a cause of action would not render the contract void, but in other circumstances the availability of an implied action would be the crucial point. E.g., the director sold an asset to the company which he bought for himself without breach of duty in the purchase. The company can rescind, but it cannot stick to the contract and make the director account for his profits See Gower at 556, n. 87. An implied action would, presumably, enable such accountability.
[391] The Companies Act of 1936, No. 33 (N.S.W.).

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action arose recently in New South Wales, Australia.[392] The Australian court decided in the negative, giving a variety of reasons for its decision, but it is appropriate to explain how the case arose for its holding to be put in its proper perspective.

In *Castlereagh Motels, Ltd.* v. *Davies Roe,* plaintiff company, after discovering that it had entered into an unfavourable contract, brought an action in law[393] for damages against one of its directors who had failed to disclose his interest at the board meeting. It is impossible to determine from the reported decision why plaintiff did not bring a suit in equity, praying for rescission of the contract on the grounds that defendant's failure to disclose was a breach of his fiduciary duty to the company. It might be that rescission was not available because of an exempting article of association or because laches had set in. On the other hand, it might have been more advantageous for the company to keep the contract and collect damages from the director. With that in mind, the only question presented to the court was whether the company had a common law right to damages due to defendant's violation of sec. 129.

Of the two opinions written, the one by Wallace P. asserted that torts can be implied from statutes also in situations other than those involving personal injury (where, in industrial cases, the theory flourished)[394] if the implication is in accord with the statutory purpose. But he found: "it is not the prevention of the financial loss to the company which appears to be the main or direct object of the provisions, but the insuring that companies are benefited by the proper and devoted discharge by directors of their fiduciary duties".[395] He observed that if the legislature contemplated civil consequences from a violation of the section, it would have shaped the section in a more efficient manner, As it stood, Wallace P. thought, many a time there would not be a *violation* at all because the duty of disclosure is conditioned on two prerequisites. First of all, the contract must be decided by the board and secondly, the facts revealing the director's interest in the contract must be known by the director. These two prerequisites often do not exist simultaneously. Even accepting Wal-

[392] *Castlereagh Motels Ltd.* v. *Davies Roe* 67 S.R. (N.S.W.) 279 (N.S.W. Sup. Ct. C.A.) (1966).

[393] Full fusion of law and equity has not yet been achieved in New South Wales.

[394] 67 S.R. (N.S.W.) 279, 284 (N.S.W. Sup. Ct. C.A.) (1966).

[395] *Id.*

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lace P.'s asumption that the duty of disclosure is restricted to contracts which come before the board, a point which has not yet been decided, it would appear that his reasoning is fallacious on two grounds. First of all, the second condition was added [396] to the section only after the cause of action accrued, and one cannot deduce from a repealing statute what the intent of the legislature was in the repealed statute. Secondly, what is more basic, the narrow ambit of a penal statute can have no bearing on the question of implying a tort therefrom.

Another point which impressed Wallace P. was the fact that sec. 129 contained a saving clause of the general law, which indicated to him that in saving the general law the legislature meant to exhaust the civil consequences of nondisclosure. He concluded by referring to the article of association which disqualifies an interested director from his office,[397] and to the section in the Companies Act,[398] which makes the memorandum and articles of association a contract between the members and the company and each member, to show that when they are read together, they "confirm the view that Parliament was intending to impose sanctions to insure fulfillment of fiduciary duties rather than create private rights of action".[399] It is difficult to understand the message of this comment, since the articles of association are not a contract between the company and its director, and even if they were, the optional nature of the article, which any company can decide not to include in its articles of association, precludes the conclusion that the legislature intended the disqualification to exclude other remedies of the company.

The concurring Justices (Jacobs and Asprey, J.I.A.) proceeded on different grounds. They emphasized that even before the introduction of sec. 129, the company had a right in equity to rescind the contract. Therefore the legislature's injection of a criminal statute into the picture should not be interpreted as conferring a civil liability

[396] In sec. 123(1) of the Uniform Act. Constitutional difficulties made it impossible to have a federal, all-embracing Companies Act. Uniformity was achieved by producing a uniform model, which was enacted separately in each of the states and territories of Australia. Yorston & Brown, *Company Law*, vol. III (2nd ed., 1964).

[397] Article 72(g) of Table A which contains a set of articles, that, to the extent not modified by each company, are deemed to be the company's articles of association. In England this article was deleted from Table A in 1948.

[398] Sec. 22.

[399] 67 S.R. (N.S.W.) 279, 284 (N.S.W. Sup. Ct. C.A.) (1966).

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in an area of law similar to that which existed in equity. They gave no credit to the fact that sec. 129 was enacted to curb exemption clauses which defeated this equitable right. The Justices buttressed their conclusion by the remoteness of the crime (nondisclosure) to the damage suffered (loss from an unfavourable contract), observing that "One element in determining a civil cause of action arises in the directness or indirectness of the relationship between the mischief sought to be prohibited and the damage or loss sought to be protected".[400] All of that led them to a similar conclusion:

> The purpose of a requiring disclosure of interest is not related only or mainly to the prevention of loss to the company. Rather it is directed to the prevention of undisclosed profit by a director, whether or not the contract is favorable or unfavorable to the company.[401]

Would these Justices derive an action from sec. 129 to disgorge secret profits to the company, even if the articles provide that the directors are not accountable? The lesson of this decision, if understood as a total denial of an action of breach of statutory duty based on sec. 199(3), is obvious. If no private remedy can be inferred and if an exempted clause would be found valid, the company should not be able to rescind even in equity. The statement that the company is not a "protected person" would also rule out a rescissionary action based on the concept of quasi-contract. Nevertheless we should not be discouraged by it in regard to our proposition relating to rescissionary actions based on secs. 13 and 54. In that situation, no negative effect can be drawn from existing legal remedies or from saving clauses in the statute, and the oppressive nature is, if anything, more apparent. The disclosure in sec. 199 is also required if the company is represented by a disinterested board and apparently is not at a disadvantage as regards the director, while he who trades with a director who utilizes inside information is always at a disadvantage in relation to him.

Both *Hely-Hutchinson* and *Castlereagh* should have no bearing on a director's access to court to enforce a "prohibited" contract. In *Castlereagh,* sec. 199 was used in argument as a sword rather than

[400] *Id.* at 287. Note the striking resemblance between this test and the test in *St. John Shipping* [1956] 3 W.L.R. 870 for disallowing an action to enforce a contract.

[401] 67 S.R. (N.S.W.) 279, 287 (N.S.W. Sup. Ct. C.A.) (1966).

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a shield, and in *Hely-Hutchinson,* where sec. 199 was resorted to in defence, the point of access to court was not brought up at all. The fact that the court did not raise it itself has a negative effect because courts should raise the point of lack of standing on their own initiative.[402] Yet the importance of the court's silence should not be exaggerated, and one would expect that the question of assistance of a court to enforce a contract in violation of sec. 199(3) would come up in English courts. The shift in the decisional law involving the enforcement of contracts in violation of sec. 54 of the 1948 Companies Act buttresses our view.

Enforcement of Option Contracts of Directors and Their Relatives

The question whether a statutory penal prohibition has civil consequences arises also in respect to option dealings of directors. The Jenkins Committee recommended in Paragraph 99(c) the prohibition of dealings by directors in options in the securities of their company. It is not clear from either Paragraph 99(c) or from the introductory discussion in Paragraph 90, whether the Committee meant to invalidate the dealings or to make such dealings criminal only.

The recommendation prohibiting one from dealing in options became law in secs. 25 and 30 of the 1967 Companies Act. It embraces puts and calls in securities (shares and debentures) of the company's group listed on a stock exchange in Great Britain or elsewhere. The prohibition applies to a spouse and infant child of the director,[403] but it does not extend to buying rights to subscribe to a security or buying a debenture which confirms a right to subscribe for or to convert the debenture into shares.

The civil consequences of the crime are not expressed. Sec. 30 makes it a defence for a person charged with an offence by virtue of that section "...to prove that he had no reason to believe that his spouse, or as the case may be, parent was a director of the company

[402] See *Selangor United Rubber Estates Ltd.* v. *Cradock* (No. 3) per Ungoed Thomas J.: "It is in accordance with this substantial public policy nature of the courts' refusal of aid to illegality that such illegality is not treated as a matter of pleading, or a matter merely as between the parties, but as a matter of which the court will, of its own initiative, take cognisance irrespective of pleadings or wishes of the parties". [1968] 1 W.L.R. 1555 at 1653. That is also the law in Israel, *Aharonst* v. *Neuman* (1956) 10 *P.D.* 1121, 1125-6; *Menkes* v. *Beton* (1961) 15 *P.D.* 902.

[403] Sec. 30.

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in question".[404] It cannot be argued that if the legislature contemplated civil liability for child and spouse it would furnish them with a civil as well as a criminal defence. The criminal defence eliminates the breach, and of course a civil action for breach of duty will not lie. The writer suggests that a director cannot enforce a prohibited option contract since such a contract is expressly prohibited and the director should be denied the assistance of the court in enforcing it. It would also appear that the aggrieved party would be able to rescind a consummated contract on quasi-contractual grounds.[405] As for an action for damages, it would lie only if a tort could be implied from the crime.[406]

The criminal provision of sec. 25 is absolute in the sense that it is not conditioned on the misuse of inside information.[407] The same would hold true in regard to the ensuing civil consequences. Therefore, it is inconceivable that the courts will imply a damages action.

The text writers, it seems, do not share the above view about civil consequences. The editors of Palmer's[408] state:

> It is thought that prohibited option dealings are not invalid, but that, apart from his liability to criminal penalties, a director would have to account for any profits to the company. In the case of a spouse or infant child the result would appear to be the same, if, as it is submitted, the defendant can be regarded as a trustee *de son tort* towards the company.

This analysis seems to us to be highly questionable. Recovery by the company will lie only if there be a misuse of inside information, which is not an element of the crime of sec. 25 and thus would not be an issue in the criminal proceedings. A corporate action stands or falls

[404] Sec. 30(1) (b).

[405] Unlike the situation involving an implied action based on sec. 13 of the Prevention of Fraud (Investments) Act the outsider in an option case is *in delicto* when he knows that he deals with a director, or his spouse or child. However, it is submitted that he is not *in pari delicto* with him.

[406] See *supra* p. 93 for the recovery of damages in a restitutionary action.

[407] The Committee noted that "a director who speculates in this way with special inside information is clearly acting improperly, and we do not believe that any reputable director would deal in such options in any circumstances", para. 90. If the outsider can prove abuse of inside information, he will be able to base his action both on sec. 13 of the Prevention of Fraud (Investments) Act and on sec. 25 of the Companies Act, 1967.

[408] Palmer, *Company Law* (21st ed., 1968) 569.

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on different facts. The relatives would be trustees *de leur tort* only on the theory that inside information is property. Ample authority in the context of abuse of inside information points to the opposite conclusion.[409] Moreover, one cannot speak of "invalidity" as a single entity; it has a different meaning depending on who brings suit and what recovery is sought.

Pennington,[410] who is of the same opinion, states: "An option contract, which a director is prohibited from entering into does not appear to be void, and it seems that it may be enforced by the director or by the other party".

Both Palmer and Pennington rely on the analogy to cases decided under sec. 54(1)[411] of the Companies Act, 1948. This position seems untenable today both on principle and on authority. Even the court in the *Victor-Battery*[412] case which concluded that a security (debenture) given by the company is not illegal, but valid and enforceable by the debenture holder, so held on the following two grounds: (a) sec. 54 (then 45 of the 1929 Act) assumes that the security is valid because otherwise financial assistance would not be given, (b) the company was *in pari delicto* because it did not meet the "protection test", so that even if the contract were illegal the company could not defeat the contract (set the debenture aside).

The first portion of the decision, very rigorously criticized by text writers and not followed in Australia[413] or Israel,[414] was rejected in an *obiter* in the *Selangor*[415] case and finally not followed in *Heald*

[409] See *supra* p. 38 et seq.

[410] Pennington, *Company Law* (2nd ed., 1967) 497.

[411] Which reads: "It shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security, or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company". 11 & 12 Geo. 6, c. 38.

[412] *Victor-Battery Co.* v. *Curry's Ltd.* [1946] Ch. 242.

[413] *Dressy Frocks Pty. Ltd.* v. *Bock* (1951) S.R. (N.S.W.) 390; *Sheorer Transport Co. Pty Ltd.* v. *McGrath* (1956) V.L.R. 361 and *E.H. Dey Pty. Ltd.* v. *Dey* (1966) V.R. 464.

[414] *Gibor* v. *Goshen & Hachaklaith* (1961) 15 *P.D.* 2101; *Kimche* v. *Feuchtwanger Ltd.* (1970) (I) 24 *P.D.* 527.

[415] *Selangor United Rubber Estates Ltd.* v. *Cradock* (No. 3) [1968] 1 W.L.R. 1555 at 1659. The *Selangor* court (per Ungoed Thomas J.) decided that a loan given by an acquired company to the acquiring shareholder is rendered unenforceable by sec. 54, and that the same rationale will render a security given by the company unenforceable too. Yet, in the *Selangor*

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v. *O'Connor*.[416] Moreover, even if *Victor-Battery* were good law it would not necessarily follow from that that the director can today enforce an option contract. In *Victor-Battery,* the court refused rescission rather than not allow enforcement. On the second ground of the case which assumes that the contract is illegal and that both parties are *in pari delicto,* the director cannot, of course, enforce the option contract. The bizarre reasoning which led Roxburgh J. in *Victor-Battery* to decide that sec. 54 assumes validity of the security is also limited to that special section and cannot be said *mutatis mutandis* to apply to sec. 25.

In the option prohibition, it is the director who is made punishable to prevent him from engaging in this flagrant abuse of office.[417] It cannot be said that the hapless outsider is *in pari delicto,* and it would follow, even on the *Victor-Battery* reasoning, that the option contract is rescindable by the outsider, in addition to its being unexercisable by the director.

case itself the illegality was not a ban to an action by the company, because suit was brought against the directors for breach of trust and against the shareholder (borrower) as constructive trustee, rather than on the contract. In *S. Western Mineral Water Co. Ltd.* v. *Ashmore* [1967] 1 W.L.R. 1110, an action by the seller of shares against the buyer, Cross J. decreed *restitutio in integrum* because a debenture given by the company to the seller to secure the principal part of the price was an integral part of the agreement. The decision assumes that the debenture became *unenforceable* against the company as a result of a violation of sec. 54. All the same, Cross J. thought the seller entitled to his day in court to set the agreement aside. The reliance of Palmer's on *Western Mineral Water* for his proposition is unexplainable.

416 [1971] 1 W.L.R. 497. Fisher J. reasoned that even if the debenture was invalid, the company had given financial assistance to the purchaser of its shares, since the seller had sold the shares on the strength of the company's purported security.

417 Roxburgh J. in *Victor-Battery* could not conceive that "notwithstanding that in sec. 45 the only persons singled out by name for punishment are the company and its officers the primary class of persons for whose protection the illegality of the contract was created—assuming it to be illegal—is companies." [1946] Ch. 242 at 249.

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XI. *PRIVATE ENJOINMENT OF A VIOLATION OF THE ANTI-FRAUD PROVISION*

There appears to be a rule in English law, which allows the prospective victim of a criminal act (apparently a continuous act), to enjoin the commission of that act even though no tort would be implied from the crime.[418] This rule derives from the case of *Steven* v. *Chowan*,[419] in which a statute made it a crime to trade outside of a particular market. In that case the plaintiff had leased the market in question and was successful in his suit for an injunction to prevent defendant from violating the statute. According to the court, the injunction remedy was available to him even though he could not also bring a damage action, the criminal sanction being the sole sanction intended by the legislature.

The Court of Appeal, however, has recently declined to grant an injunction against an alleged violation by the B.B.C. of the Race Relations Act. In *Thorne* v. *British Broadcasting Corp.*[420] the Court held that the plaintiff could not enjoin the criminal violation of the Act because he could establish no civil right arising from the Act. It is submitted, however, that *Thorne* does not altogether dispense with the rule of *Steven* v. *Chowan*. The plaintiff in *Thorne* did not plead that he had suffered any injury, and the Race Relations Act expressly states that no prosecution for the offence can be brought absent the consent of the Attorney General.[421] The decision, therefore, stands for the rather narrow holding that an action to enjoin the commission of an offence is deemed to be a prosecution of that offence. It therefore follows that in appropriate cases a plaintiff might be able to have a securities transaction enjoined, at least where it is one likely to be repeated, even though the court may be reluctant to imply a tort from the criminal behaviour.

American securities law has given a very broad scope to the injunction remedy. Thus, for example, even a consummated merger

[418] See Street, *The Law of Torts* (4th ed., 1968) 455-8.

[419] [1901] 1 Ch. 894.

[420] [1967] 1 W.L.R. 1104, C.A.

[421] The injunction was brought to enjoin an alleged violation of sec. 6(1) of the Race Relations Act 1965, 13 & 14 Eliz. 11 Ch. 73, making incitement to racial hatred a crime. Sec. 6(3) (b) provides "no prosecution for such an offence shall be instituted in England and Wales except by or with the consent of the Attorney General."

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may be enjoined (and unscrambled) in the United States.[422] The court can, as ancillary relief to an injunction, squeeze the profits from the insider on a theory of restitution.[423] Even were a more narrow scope given to the injunction power, however, in numerous cases the plaintiff might still find shelter therein.[424] This may be illustrated by consideration of a hypothetical tender offer to shareholders by an insider. No prospectus will be required of the insider because he is not soliciting offers *to buy* and there is no converse prospectus approach in Israel and England requiring a prospectus to accompany the solicitation of an offer *to sell*. Assuming that the offer is conditioned on its acceptance by holders of a minimum percentage of the stock and that such acceptance is irrevocable (by terms of the offer), an offeree who has accepted and tendered his stock might nevertheless seek to enjoin the tender offer altogether and thus prevent enough other shares from being tendered to consummate the transaction to his injury.

422 *J. I. Case Co.* v. *Borak* 377 U.S. 426 (1964); *Mills* v. *Electric Auto-Lite Co.* 90 S.Ct. 616 (1970). For a private 10b-5 action, refusing damages yet allowing an injunction, see *Mutual Shares Corp.* v. *Genesco* 384 F 2d 540 (2nd Cir. 1967).

423 *S.E.C.* v. *Texas Gulf Sulphur Co.* 297 CCH Fed. Sec. L. Rep. Para. 92,572 at 98,584 (S.D.N.Y. 1970). Note, however, that in this case the remedy of injunction was express, only the ancillary relief can be said to be "implied".

424 See e.g., the injunction issued in *S.E.C.* v. *Great American Industries Inc.*, 393 U.S. 453 (1969).

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XII. *THE DESIRABILITY OF DEVELOPING A BODY OF LAW FOR INSIDER TRADING BY IMPLICATION FROM THE CRIMINAL ANTI-FRAUD PROVISIONS IN ISRAEL AND IN ENGLAND*

We should pause for a minute and ask ourselves if an inference of civil liability from penal anti-fraud provisions is desirable in terms of legal policy. By way of definition the penal provisions do not elaborate the elements and scope of civil liability. Are there sufficient "legal valves" in the sections to enable a healthy development of civil rules?[425] In answering this question we are very fortunate to be able to employ previous judicial interpretation of Rule 10b-5, and to have the advantage of "hindsight".[426]

Economic Evaluation of Insider Trading: "Unsafe at any Price" or "Fundamental to the Survival of [the] Corporate System".

No one who advocates the introduction of civil liability on insiders for trading on inside information can ignore the forceful argument recently made in the United States which favoured insider trading because of its economic advantages.[427] As a matter of positive law, the short answer to this argument is that it is a deep-rooted policy

[425] We keep in mind Lord Devlin's illuminating description of the process of judge-made law: "It is not in accordance with traditional methods of judicial law-making to begin by saying how far you will go. Some cases are allowed and then others are disallowed as going too far, and the formulation of principle has to wait until that process is well advanced; and during the process the common lawyer will stop, logic or not logic, when something tells him that he has gone far enough." Devlin, *Samples of Law Making* (1962) 10. All the same it helps if there are "road indicators" for the journey which might be called "legal valves", known *a priori* at the starting point.

[426] Prof. Loss has on two occasions observed that "slavish importation" is futile. Loss, "The Protection of Investors, The Role of the Courts" (1963) 30 South African L.J. 372, 383; Loss, "The Fiduciary Concept as Applied to Trading by Corporate Insiders in the United States" (1970) 33 Mod. L.R. 34. What we are doing here is, indeed, examining whether implication of civil liability is justified in terms of Israeli and English law. A recent New Zealand article examines which American developments should be introduced in New Zealand and England. But the article does not discuss the question of implied civil remedies. Wright, "Insider Trading in Corporate Securities—Can We Learn from America? (1971) 4 N.Z.U.L.R. 209.

[427] H. Manne, *Insider Trading in the Stock Market* (1966). The second quotation in the heading is from this work.

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in English and Israeli law that insider trading is a detrimental practice. The reporting and disclosure requirements try to deter these transactions by exposing them to the limelight. Moreover, a legal system which has a tenet that a certain mode of conduct is economically favourable and even fundamental, does not penalize it, as Israel and England did. Civil liability will enhance this policy.

The economic analysis of Professor Henry Manne which leads to the conclusion that there is an economic cost for upholding this policy is in our view questionable itself.[428] Manne's thesis is that utilization of inside information is essential for the optimal allocation of financial resources. Insiders are entrepreneurs; they engage in enterprises only if the incentives offered therein are attractive to them. Straightforward compensation devices supply no incentives for innovations and breakthroughs; only trading on the information will insure favourable

[428] See Wu, "An Economist Looks at Section 16 of the Securities and Exchange Act of 1934" (1968) 68 Colum. L.R. 260. Prof. Wu thinks that "unfortunately Prof. Manne missed the real economic issues in his discussions". *Id.* at 260 n. 3. But Wu reaches a similar conclusion, *viz.* that "speculative trading by insiders may be beneficial in an 'economic' sense", and that "we must know all the costs and benefits of particular legislation, and the benefits from requiring equity between individual investors must justify any economic cost." *Id.* at 269. His analysis starts with the classic theory that knowledgeable speculators contribute both to allocational efficiency—by stabilizing prices and aiding in "fair price determination" (i.e. prices which reflect the "intrinsic value" of the stock) and to promotional efficiency (or liquidity) by their readiness to trade when the current price is slightly different from the normal (i.e. reflecting "intrinsic value") price. Prof. Wu quickly disposes of other economic theories which conclude that insider speculation is destabilizing: Keynes' theory that speculators predict mass psychology—average public opinion—and not intrinsic values; Kaldor's criticism that the inherent difficulty in appraising intrinsic values can lead to a destabilizing effect—changes in quotations will lead insiders to change their price expectation in the *same* direction; and Baumol's observation that speculators trade "with the market"—buy only *after* the trough has been passed and sell only *after* the peak has been reached and thus, while profiting themselves, *increase* price fluctuations. Even *accepting* all the empirical assumptions in favour of Prof. Wu's analysis the crucial question is the *effect* on the outsiders of the revelation that they have been "taken". If it reduces their confidence in the market, and, therefore, the long-run *demand* curve in the capital market, Wu's building, which assumes that there is not such a change in the demand curve, collapses. Moreover, the conflict of interest between the insiders and the company may cause that the very market speculations will decrease the intrinsic values of the stock. See *infra* p. 122.

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changes. Moreover, basically no one is hurt, only in and out speculators "pay" the entrepreneurs' premium. The interests of long-term investors overlap the interests of the company, which is benefited by the favourable changes. It has been answered,[429] correctly, that this analysis assumes an identity of interest between the corporation and the insiders, while in fact there might be conflict of interest. Why should one not run the company so as to promote his own interests? For example, to decide to pay dividends even while the company needs working capital, to buy on the market before the decision becomes public, sell afterwards and pocket the profit? How does this transaction promote the business of the company?

To return to basic economics, everyone will agree that the ideal is a "perfect capital market". Such a market denotes a number of perfect circumstances: perfect knowledge of the market for all potential traders, complete mobility and transferability of financial resources in the market, continuing objective valuation of the corporate assets and the securities, and no interference with its functioning. In real life this ideal does not and cannot exist.[430] Information and knowledge are distributed in different quantities among potential traders; legal rules disqualify certain people from trading[431] and also permit concealment of material facts,[432] etc. The utilization of inside information provides an example of these imperfections. To curb it, means to eliminate one vice (unequal information)[433] at the cost of another (denying access to the market from potential traders—the insiders). It is impossible to balance *a priori* and to say that in a given market the net result is a distortion of the allocation of resources.

[429] Schotland, "Unsafe At Any Price: A Reply to Manne, Insider Trading in the Stock Market" (1967) 53 Va. L.R. 1425. The Appellate Division endorsed this view in *Diamond* v. *Oreamuno* 287 N.Y.S.2d. 300, 303. Other writers, too criticized Manne's thesis in book reviews. See e.g. Jennings, (1967) 55 Cal. L.R. 1229; Marsh, (1968) 65 Mich. L.R. 1317; Poser, (1967) 53 Va. L.R. 753. See also Loss, *supra* n. 60 at pp. 35-37.

[430] The Kimber Report, *supra* n. 11 (para. 1.08-1.09).

[431] E.g., in most of the Commonwealth countries the company cannot re-purchase its own shares.

[432] E.g., the laws of patents.

[433] Which, in turn, contributes to the achievement of another perfection-investors' confidence that the market prices indeed reflect the value of their investments.

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The Elements of Sections 13 and 54

We have already expressed our opinion[434] that the element of "dishonesty" in England can be utilized to limit the ambit of sec. 13 to insiders—people who gain confidential information by virtue of easy access to corporate information. The scope of the Israeli section is obviously broader than the English one because concealment is punishable even if it is not "dishonest". The writer proposes to suggest, however, that the *actus reus* of concealment connotes affirmative action. Total non-disclosure does not amount to concealment. One conceals only when he employs devices to prevent the other party to the transaction from gaining knowledge of certain facts. For example, Repide[435] concealed from Strong the materializing negotiations by employing agents. Directors who avoid bringing up a subject in a board meeting or filing corporate reports, in order to prevent the information becoming public, conceal this information. A situation involving an outsider "concealing" information, according to this definition, is hardly conceivable. Under this definition of concealment the reach of sec. 54 is practically restricted to insiders, but even in their case a showing of something more than total non-disclosure would still be needed to establish liability. But, if the courts are willing to follow this path, they can develop some kind of "special circumstances" doctrine. The special facts upon which liability would depend will be conduct by the insider calculated to keep material information secret.

Hiding behind a market mask in utilizing inside information on a stock exchange transaction is probably concealment, but does it meet the further requirement of secs. 13 and 54 of inducement? Does the insider who trades on the market induce the sale or purchase by the outsider? Strictly speaking, the outsider formed his decision to sell or buy independently without any reliance on the insider or his behaviour. In a typical market situation, the effect of the insider's offer (ask) or bid would be marginal and it would not affect the quotations or induce the transaction. When the outsider places a *limit* order with his broker, or where the insider's orders have a substantial effect on market quotations, one might, presumably, find that the insider induced the transaction. But even then, the insider might argue that he is not liable because the sections prohibit inducement to *buy or*

434 See *supra* p. 68.
435 *Strong* v. *Repide*. 213 U.S. 419 (1909). See *supra* p. 26.

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sell and he induced only the *transaction* not the *decision to buy or sell*. Such an argument is, perhaps, too formalistic to succeed. At any rate, reliance is a necessary element of an implied action because of the requirement of inducement.[436]

Is *mens rea* a necessary requirement for finding "concealment"? Would innocent non-disclosure suffice? Must one at least prove negligence? recklessness? or actual knowledge? It is our belief, and it follows from our definition of the *actus reus* of concealment, that more than innocent or negligent non-disclosure is required. In England, of course, the *mens rea* of the crime is contained in the term "dishonest". We have already seen that negligence alone is not dishonesty.[437] The Israeli courts would very likely reach the result that the legislature did not intend to create a strict crime of innocent fraud. Some *mens rea* is required and it can easily be traced to the connotation of "concealment". But what exactly is this *mens rea* and its correlating civil *scienter?* It is submitted that actual knowledge is not necessary. Recklessness, whether the undisclosed information is true or not, would suffice. A person, who, through inside sources, hears rumours that an ore strike was discovered and rushes to the market has the requisite *mens rea* and *scienter*. A non-officer director who in a board meeting hears that the company begins drilling, refrains from following the developments and places orders with his broker for good measure in the hope that the drillings would succeed also has the required *mens rea* and *scienter*.[438]

[436] Attempt to induce to buy or sell by concealment of material information is also a crime. However, if no contract is induced and no damages are inflicted there could not be a rescissionary action and, of course, no tort action.

[437] See *supra* at p. 66.

[438] The American Rule 10b-5 reads as follows:
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility or any national securities exchange,
"(1) To employ any device, scheme, or artifice to defraud,
"(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
"(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security".
See the articulation of the *scienter* element in Rule 10b-5 in Ruder,

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Privity should not always be required. For example, a company by a false press release, can induce purchases of its stock and be liable to a purchaser on the market. All the same, it is hardly conceivable that there could be concealment and inducement without a transaction in which the concealing party participates. For example, it is unlikely that an action could succeed against a company for not publicizing a discovery or an ore strike.[439] However, the plaintiff must be a seller or a buyer. Materiality is, of course expressly required, and the *Texas Gulf Sulphur* court definition of materiality[440] would most likely be followed.

Must the outsider prove causation and damages[441] in his civil action implied from sec. 54? The penal section could be violated without the outsider suffering damages. In such a case the outsider would not be able to bring a tort action for rescission because sec. 63 (a) of

"Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases" (1968) 63 N.W.U.L.R. 423, 427; B. A. Mann, "Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and *Scienter*" (1970) 45 N.Y.U.L.R. 1206.

439 It is another question whether a private action could be inferred from the duty to file a report on the occurrence of such an event. The July 1970 Regulations (see *supra* at p. 49) require any company which made a public offering or has securities traded on the stock exchange, to disclose within 15 days "the details of any event which materially affected the company's profitability, assets or liabilities or may do so". Reg. 36(a).

440 "Material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell or hold the company's securities". *S.E.C.* v. *Texas Gulf Sulphur Co.* 401 F. 2d 833, 849 (2d Cir. 1968).

441 The quantum of damages in a Rule 10b-5 private action in the United States has not yet been settled. Professor Cary observes: "The courts have thus far developed rationales as to the proper measure of damages primarily in cases where privity of contract was present. The trend seems to be toward a rescission measure, by which a plaintiff seller would receive the difference between the price at which he sold his stock and its market value at some time later, most likely at the time of trial". W. Cary, *Corporations* (4th ed. 1969) 790. But what would be the measuring stick when the stock appreciates from the time the insider buys and the seller loses his right of rescission by laches? *Baumel* v. *Rosen* 412 F 2d 571 (4th Cir. 1969) held that the seller could recover the appreciation in price up until the time he lost the rescission remedy. At any rate, the hapless outsider is not limited to the difference between the price he paid and actual value at the time of sale.

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the Civil Wrong Ordinance (New Version) in Israel, as well as the common law rules in England,[442] require a showing of damages in an action brought for breach of a statutory duty. In a quasi-contract restitutionary action, a showing of resulting damages would presumably not be necessary.[443]

This analysis of the elements of an implied fraud action and its comparison to the traditional elements of a common law deceit action[444] can be summarized as follows: There are enough "legal valves" in the penal sections to enable a rational development of a body of law which will impose liability on insiders for their trading on corporate information and will not compel, as a cost thereof, the imposition of liability on outsiders in securities transactions.[445] But the question of the desirability of such a development cannot stop here, for we must also examine an alternative. Would the results be more acceptable if we waited for enactment of *express* civil remedies?

The Meritorious Nature of and Chances for Express Legislative Remedies

It has been noted[446] that the area of insider trading is an example *par excellence* of the basic truth that certainty and equitability in law do not go hand in hand. If one wants a precise and accurate set of rules to define an insider, the result will be the exclusion of everyone

[442] Damages will not be a prerequisite to recovery in just those cases where it is clear from the context of the statute that the legislature intended to protect plaintiff even from a violation without damages. Street, *The Law of Torts* (4th ed., 1968) 278.

[443] But the plaintiff must move to rescind within a reasonable time after discovery of the concealment. Because "Rescission is a radical move, and the law exacts the election of that course to be asserted without wait". *Baumel* v. *Rosen* 412 F. 2d 571, 574 (4th Cir. 1969). See also Friedman, "Delay as a Bar to Rescission" (1941) 26 Cornell L.Q. 426. The fluctuating nature of securities requires prompt and immediate rescission. *Baumel* v. *Rosen* 412 F. 2d 571, 574-575 (4th Cir. 1969).

[444] The elements of a common law deceit action are: (1) representation (2) *scienter* (3) materiality (4) reliance (5) causation (6) damages. In Israel the damage must be *pecuniary damage*. Civil Wrongs Ordinance (New Version) sec. 56.

[445] Sec. 13 (2) of the Prevention of Fraud (Investments) Act, 1958 punishing a conspiracy, can be used for imposing liability on "tippers" and cognizant "tippees".

[446] Loss, "Recent Developments in Securities Regulations" (Symposium at Columbia Law School) (1963) 63 Colum. L.R. 856, 861.

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else even if, as a matter of fact, someone outside of the definition trades on inside information. If there is an automatic accountability rule like sec. 16 (b) of the American 1934 Act, insiders will be surcharged even if, in fact, they *did not trade* on corporate information. The courts in turn might rebel against these mechanical results and wrap the precise definitions with enough judicial gloss [447] to promote a just and equitable result, but at the price of decreased predictability. The most considered and articulate legislation would also leave many questions unanswered. A recent report by the British Council of Justice advocated express legislation to curb insider trading. Yet the Council found itself forced to conclude that no effective civil legislation could be devised regarding insider trading through the Stock Exchange and that only penal sanctions could be provided to redress such practices. The Council stated that "in principle it would be desirable for any statute imposing restrictions on insider trading to give as much guidance as possible as to what transactions would or would not be permitted" and accordingly recommended to define insiders in the statute and to do it widely. Disclosure, it was recommended, would be required only where its effect on the value of the securities would be substantial. For practical difficulties of providing a statutory definition of what constitutes a substantial effect, however, *Justice* concluded that the problems of definitions would have to be left to the courts.[447a] It appears, therefore, that *Justice's* proposals would hardly take us further than a civil implication from Sec. 13. Moreover, chances for express legislation are now moot. We have already seen the fate of the recommendations of the Yadin Committee regarding

[447] The cases which developed the "deputization concept" are instructive. This concept will impose liability on legal entities, including partnerships, which are not insiders of a certain corporation but one of the legal entity's insiders is on the board of that Corporation. The legal entity would thus become a "director" for purposes of sec. 16 (b). *Feder* v. *Martin Marietta Corp.* 406 F. 2d 260 (2d Cir. 1969) implementing a *dictum* in *Blau* v. *Lehman* 368 U.S. 403 (1962). There begins to appear a trend away from the crude "rule-of-thumb" to "an opportunity of abuse" rule, or as Lowenfels puts it: "[the recent cases] shifted from a strict and comparatively harsh objective interpretation of the Section to a much more subjective approach, an analysis less concerned with the narrow letter of the law than with the particular facts at bar". The starting point of this development is *Ferraiolo* v. *Newman* 259 F. 2d 342 (6th Cir. 1958).

[447a] "Insider Trading" A Report by *Justice*, (International Commission of Jurists), Chairman of Committee, William Goodhart (London, 1972).

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insider trading.[448] The work of the Jenkins Committee in England,[449] to be discussed, achieved no better results. While the Jenkins' recommendations, relating to the prohibition of directors' option dealings and to insiders' reporting and disclosure duties were enacted into law, recommendations relating to liability for insider trading were ignored.

We shall first look at Paragraph 99 (a) of the Committee's report, which relates to corporate action and Paragraph 99 (b) which relates to individual action. Paragraph 99 (a) (II) reads:

> ...a director of a company should not make use of any money or other property of the company or of any information acquired by virtue of his position as a director or officer of the company to gain directly or indirectly an improper advantage for himself at the expense of the company.

Because of the requirement that the director's advantage be at the expense of the company, the effect of this recommendation is to exclude a corporate action for insider trading *per se.*[450] Paragraph 99 (b) reads:

448 For a criticism of the pending proposed Amendment of the Companies Ordinance and its insider trading provisions, see Appendix "A" to the book.

449 Report of the Company Law Committee, Cmnd. No. 1749 (1962). For revisions of the law as regards insider trading in other parts of the Commonwealth, see Report of the Attorney General's Committee on Securities Legislation in Ontario, Kimber Report (1965), which led to legislation in Ontario, Ontario Securities Act of 1966, Ont., 14 & 15 Eliz. 2, C. 142 Part XI (1967) and in other provinces of Canada, Alta, 16 Eliz. 2, C. 76, Part II (1967); B.C. 15 & 16 Eliz. 2, C. 45, Part XI (1967); Man., 17 Eliz. 2. C. 57, Part XI; Sask., 16 Eliz. 2, C. 81, Part XII (1967). Federal legislation followed suit. Stat. Can. 1969-70, c. 70, ss. 98 to 98 F. See also, Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana, secs. 205 (a), 210, 214, 215 (1961), the comments to these sections, and the same numbered sections in the New Companies Code of Ghana, New Act 179 (1963); secs. 124 & 126 of the Uniform Companies Act in the Australian States and Territories.

450 Para 99 (a) (iii), which provides that "a director who commits a breach of these provisions should be liable to the company for any profit made by him and for any damage suffered by the company as a result of the breach", does not furnish the company with a cause of action because the director did not breach any provision by trading on inside information, which is not at the company's expense. In the *Diamond case, supra* p. 42 both the trial and the appellate courts observed that insider trading might cause damage to the company by decreasing its goodwill and re-

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> ...a director of a company who, in any transaction relating to the securities of his company or of any other company in the same group, makes improper use of a particular piece of confidential information which might be expected to materially affect the value of those securities, should be liable to compensate a person who suffers from his action in so doing unless that information was known to that person.

The Jenkins Committee was aware of the difficulty of tracing a transaction by a director to the defrauded party when the transaction occurs on the stock exchange, but was of the opinion that the director should also be made liable in these circumstances.[451] The Committee in its recommendations also dealt with sec. 13 of the Prevention of Fraud (Investments) Act. It would remove the doubt as to the meaning of "reckless" in this section, amending it to provide that conduct can be reckless even if not dishonest.[452] It went on in Paragraph 254 (made into a recommendation in Paragraph 264) to clarify another aspect of sec. 13.

> But we would resolve a doubt by giving persons, who suffer damage as a result of an untrue statement, promise or forecast in a circular to which Section 13 applies, a civil remedy against those responsible unless the latter can prove that they had reasonable cause to believe and did believe that the statement was true or the promise or forecast justified (*cf.* Section 43 of the Companies Act).

The essence of this recommendation is to state expressly that a violation of sec. 13 provides a civil remedy even if the violator is simply negligent. The aggrieved party has only to prove a violation, and the violator, to absolve himself must prove that he was not negligent. The doubt referred to by the Committee presumably concerns the civil consequences of a violation of sec. 13. It is notable that the Committee would attach civil consequences only to an "untrue

putation. A showing of such damages is practically impossible and, at any rate, there is no relation between the extent of this damage and the directors' profits from trading on inside information.

451 "We realize that it might well be very difficult for the other party to establish that he was transacting with a director, this problem is particularly difficult in the case of transactions through the London Stock Exchange because of the method of settlement. It may also often be difficult for the other party to establish a case. Nevertheless we think a remedy should be provided and we recommend accordingly below". Para. 89.

452 Para. 254.

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statement, promise or forecast in a circular", but that is explicable since the Committee recommends elsewhere civil liability for insider trading within the limited reach of the recommendations contained in Paragraphs 99 (a) and 99 (b).

A 1963 Act[453] implemented the recommendation regarding the meaning of "reckless" leaving untouched the recommendation regarding civil consequences. The Misrepresentation Act of 1967,[454] presumably, codified part of this last recommendation. Sec. 2 (1) of this Act provides that in any case of misrepresentation the aggrieved party can recover damages unless the party misrepresenting a fact proves that he was not negligent. Yet this is applicable only when there is an actionable misrepresentation at common law, i.e., in cases involving misrepresentation of fact as distinguished from cases involving a promise or a forecast. Another development which has taken place since the work of the Jenkins Committee might also have a bearing on this issue. The House of Lords' decision in *Hedley Byrne & Company Ltd.* v. *Heller & Partners Ltd.*[455] and its offsprings[456] can be used to make available actions for negligent forecasts and promises contained in circulars inviting one to trade in securities.[457]

453 Protection of Depositors Act 1963 (c. 81), sec. 21 (1) (a).

454 15 & 16 Eliz. 2, c. 7.

455 [1964] A.C. 465, H.L. This case was described as the most striking tort decision since *Donoghue* v. *Stevenson* [1932] A.C. 562, Salmond, *Torts* (15th ed. 1969) 269.

456 Gower, at 317 n. 32. See also *Ministry of Housing* v. *Sharp* [1970] 2 W.L.R. 807 and *Mutual Life and Citizens' Assurance Co. Ltd.* v. *Evatt* [1971] 2 W.L.R. 23. In *Evatt*, the Privy Council set a limitation to the *Hedley* rule, requiring that the defendant possess special skill and competence. Apparently this requirement is met in cases involving corporate circulars inviting one to trade in securities.

457 It is interesting to note that the Israel Supreme Court espoused a rule similar to the *Hedley* one, a decade earlier. *Weinstein* v. *Kadima* (1954) 8 *P.D.* 1317.

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CONCLUSION

Since our writing was highly purposive, our conclusion can be presented in a nutshell. The nature of insider trading does not lend itself to a bright-line legal test. Hence legislative attempts to curb this practice may tend either to reach too far or to fall short of their goals. Instead of awaiting civil legislation, which does not seem to be forthcoming,[458] we should exhaust the legal rules that already exist. *Percival* v. *Wright* does not appear to be as all-encompassing as it is assumed to be. There is ample potentiality in the equity rules surrounding fiduciary duties to establish duties of directors toward individual shareholders, and the seeds of such a development have already been planted in Israel. Yet the concept of fiduciary duties has built-in limitations that prevent certain cases of trading on inside information from being reached. On this background, the development of implied remedies from general criminal anti-fraud provisions, whatever the principle of law employed for this purpose, is the most desirable solution to the problem. It is hoped that such a development will indeed take place in England and Israel.

458 It has been announced recently that the British Ministry of Trade and Industry is presently studying the question of insider trading. There is still, however, a long way to specific civil legislation.

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APPENDIX "A"

THE COMPANIES BILL ON DIRECTORS' DUTIES— A PATCH TOO SMALL FOR THE HOLE

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THE COMPANIES BILL ON DIRECTORS' DUTIES— A PATCH TOO SMALL FOR THE HOLE

The Proposed Legislation

The Government has recently tabled a Bill before the Knesset to amend the Companies Ordinance.[1] This is not yet the basic and comprehensive legislation which has been long awaited. Considerable effort has been expended on company law reform in Israel over a period in excess of twenty years, so far without result except for the Securities Law of 1968. Indeed, the Bill's draftsmen note that "the Ministry of Justice is diligently working on the preparation of a new Companies Law. However, a considerable number of problems require urgent amendments which are proposed herein." [2] One of the problems with which the Bill deals is that of directors' duties. Yet, only one section of the Bill deals with the civil liability of company directors. That section [3] provides that a director who does not disclose his interest in a contract with the company will be liable to the company for the full extent of the injury caused to the company by such non-disclosure. The stated aim of the Bill is "to broaden the types of offences and sanctions applying to company directors or other fiduciaries who abuse their positions to correspond to the duties imposed upon such fiduciaries by banking law." [4] The Bill's sponsors hope to accomplish this by adding a number of directors' offences to the Penal Law Amendment (Deceit, Blackmail and Extortion) Law, 1963, in the form of sections 9B-9D of that Law.

The Bill sets out five new directors' offences. The ones which concern us are the fourth and fifth offences, the fourth being the use of information for the personal benefit of the person using it or for

1 Companies Ordinance Amendment (No. 13) Law, 1971 *Hatza'ot Hok* 976, p. 127, of December 15, 1971. The bill passed its first reading in the Knesset in May, 1972, but as of December, 1972 was not reported back from the Constitution, Legislation and Juridicial Committee to the House for its second reading.

2 Introduction to the Bill, *Hatza'ot Hok* 1971, p. 128.

3 Section 16 of the Bill, which amends section 75(4) of the Companies Ordinance.

4 Introduction to the Bill, *Hatza'ot Hok* 1971, p. 128. The Minister of Justice announced in the Knesset that the general Bill would not be introduced until the enactment of the General Contracts Law upon which the new Companies Law would be based. *Divrei HaKnesset* 1972, pamphlet 11, third session of the seventh Knesset of January 4th, 1972, p. 875.

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the benefit of any person other than the company, for which the proposed penalty is a year's imprisonment or a fine of IL 20,000.[5] The fifth offence is that of carrying out a transaction not for the benefit of the company, in securities of the company in which the director has, either directly or indirectly, a personal interest. The penalty is a treble fine, that is, a fine three times the value of the subject matter of the offence.[6]

In our opinion the proposed broadening of directors' liability is defective in a number of essential areas, the patch not covering the tear it is intended to mend. This is being written in the hope that these defects will be corrected and that the Law adopted by the Knesset will properly regulate the question of directors' duties in Israel.

Criminal Liability Only

Except for the amendment of section 75(4) of the Companies Ordinance, the Bill increases directors' duties only by imposing additional criminal liability. The Bill does not expressly make the directors liable in a civil suit for the acts which are made to constitute criminal offences. This seems quite awkward, particularly as criminal liability would be imposed for some acts which do not, under existing company law, entitle the persons injured by them to a civil remedy by way of damages or otherwise.

The imposition of a criminal sanction only gives rise to two difficult questions. Is the criminal sanction sufficient to deter directors from carrying out such acts—thereby preventing them—or does there remain a need to provide civil protection for the injured parties—the company, the shareholders or the creditors—so that they may obtain damages and satisfaction in those cases in which such acts nevertheless do occur? Do the new offences create civil liability, notwithstanding that this is not specifically provided in the Bill, by creating a statutory duty, breach of which constitutes a tort under section 63 of the Civil Wrongs (New Version) Ordinance? These two questions are interrelated, for it is possible that civil liability will in any case derive from the criminal offences. In the writer's view, the question of civil liability in such a basic area of company law should not be left in doubt. The legislator should specifically state his intentions as to the civil liability in each of the situations with which he deals.

5 Section 9C.
6 Section 9D.

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Corporate Opportunity

The proposed section 9C deals with the question of the appropriation of a corporate opportunity by directors. The section provides that a director or general manager exploiting, for his personal benefit or the benefit of any person other than the company, information which he possesses, commits an offence punishable by a year's imprisonment or a fine of IL 20,000. This section suffers from two major defects. First, the offence takes place even if the director did not obtain the information by virtue of his position.[7] Second, the section does not clarify whether the information concerned must be that which the company is able or has the capacity to exploit.

The basis of the offence is that the information be exploited for the benefit of the director or of some person other than the company. This may be interpreted narrowly as requiring that damage be caused to the company as a result of not revealing the information to it. On the other hand, it may be widely interpreted as including any case in which the use of the information was for the benefit of persons other than the company, whether the company was injured thereby or not. The law in England and in Israel[8] is, apparently, that damage to the company is not an essential element of a civil suit by the company against the director. It is sufficient that the director himself make a profit by using the information which he received by virtue of his position as director. It has, therefore, been

7 This point was also raised by Z. Shuval, M.K. during the debate on the first reading of the Bill. *Divrei HaKnesset* 1972, 11, third session, January 4th, 1972, p. 878.
The question of whether a company managing director is liable when a third party comes to him *personally* on a matter of the type with which the company deals has recently come up in England. The court decided that a director has only one capacity with regard to matters within the area of the company's business and that is his capacity as director of the company. His fiduciary duty to the company obliges him to disclose the information to the company and, in the absence of such disclosure, the director must pass on his profits from the contract to the company. This applies even where the third party was prepared to enter into the contract only with the manager personally and not with the company. *Industrial Development Consultants Ltd.* v. *Cooley,* [1972] 1 W.L.R. 443. See our note on the *Cooley* case in (1972) 4 *Mishpatim* 421 (Hebrew).

8 See the decision in *Aviam* v. *State of Israel* 25 *P.D.* (I) 665 and our note "Limiting Fringe Benefits" in (1972) 28 *Hapraklit* 15 (Hebrew), which examines the ramifications of the case with respect to the liability of a company director.

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held that the director is placed under a constructive trust for the company with regard to property which he acquires for himself through the use of corporate information, even if the company is unable, for financial reasons, to acquire the property for itself.[9] It is an open question, however, whether the company can sue the director for profits he makes by appropriating information which the company itself does not have the capacity to exploit. For example, it is not clear whether the company may bring suit against the director for profits which he made by acquiring shares in the company through the utilization of inside knowledge.[10] The reason for doubt is that in England and Israel the company is not allowed to acquire its own shares.[11]

The third difficulty to which that section gives rise concerns directors of more than one company. It is a common phenomenon in Israel for the same persons to be members of more than one Board of Directors, or to be directors in one company and general managers of others. The proposed section would bring disastrous results for such directors. Whenever they exploit information for the benefit of one company, they will commit the offence of not having exploited it for the benefit of the other. This is despite the fact that a satisfactory rule dealing with the *civil* liability of directors of more than one company, for exploitation of inside information, has not yet developed. The emerging civil rule in the U.S.A. is that where it is clear that directors received certain information within the scope of their position with one of the companies, they must divulge it to that company. If it cannot be determined that the information was obtained through one particular company, it must be divulged to that company which carries on the business most closely related thereto. If that test also

9 *Regal (Hastings) Ltd.* v. *Gulliver* [1967] 2 A.C. 134 n; [1942] All E.R. 378. The recommendation of the Jenkins Committee in England was to prohibit a director or officer of a company from using information he obtained as a result of his position in order to directly or indirectly profit improperly *at the expense of the company*. Cmnd. 1749, para. 99(a)(II) (1962). A director in breach of this duty is liable to the company for all profits which he makes and for any damage suffered by the company as a result of the breach. Para. 99 (a) (III).

10 We expressed our opinion that such a suit would be permitted. See main text, pp. 15, 16, 39. Doubts on this question have recently been expressed by Wright, "Insider Trading—Can We Learn From America", (1971) 4 *N.Z.U.L. Rev.* 209, 226.

11 *Trevor* v. *Whitworth* (1887), 12 App. Cas. 409.

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fails, the director must disclose the information to both companies, unless the actual ownership of both companies is in the hands of the same shareholders. In this latter case, disclosure to both companies would result in competition between them which would raise the acquisition price of the property to which the information relates, at the expense of identical shareholders. In such a case only, therefore, the director is given discretion to choose to which of the two companies he will reveal the information.[12] English and Israeli decisions on the question of directors in more than one company are almost non-existent. In any case, such a sweeping offence should not be created while ignoring its far-reaching results in real life.

Another difficult question which the proposed section ignores altogether is what would occur were the company in general meeting to ratify the use of the information by the director or by a person other than the company. The court in the *Regal* case expressed the opinion, by way of *obiter dictum,* that ratification would permit the use of such information by the director or by a person to whom the director conveyed the information without the director being considered as having breached his fiduciary duty to the company.[13] This *dictum* may be criticised on the grounds that the information is the property of the company and a majority of the shareholders are not entitled to give away the company's property. A unanimous decision of the general meeting should, therefore, be required.[14] In our opinion the law should provide that approval by the general meeting would suffice to permit the exploitation of the information by persons other than the company, but only when the directors do not vote their shares for the adoption of the approving resolution.[15]

12 Note, Corporate Opportunity, (1961) 74 *Harv. L. Rev.* 765.

13 [1942] I All E.R. 378, 389, 394.

14 See the discussion in Wedderburn, "Shareholders Rights and the Rule in *Foss* v. *Harbottle*", 1957 *Camb. L. J.* 194; 1958 Camb. L. J. 93. See also *Parker* v. *Daily News* [1962] Ch. 927 and main text pp. 40-42.

15 This suggestion follows the Ghanian company law. Section 205(a) of the Ghana law imposes liability on a director who uses company money, property, secret information or special knowledge which he obtained through his position in the company for his own benefit. Injury to the company is not necessary. Section 206 validates the director's act if the general meeting permits it after full disclosure of all material facts, provided that the director or other shareholders in whose shares the director has a direct or indirect interest do not participate in the vote. The Israeli Draft Companies Law, 1957, provided, in section 111, that a director must turn over to the company any profit which he makes as a

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Our suggestion for an amended section 9C which would eliminate the defects in the current proposed section, is:

9C(1) A director, general manager, or officer of a company must use information which he receives by virtue of his position in the company only for the benefit of the company. The director may not exploit such information for the benefit of any person other than the company, even if such exploitation causes no injury to the company.

(2) The liability and prohibition under this section shall not apply where the general meeting of the company has approved the exploitation of the information by a person other than the company at a general meeting before which all the relevant material facts were brought and at which the director or officer did not vote.

(3) A director, managing director or officer of the company, who is in breach of this section shall be liable to a year's imprisonment or a IL 20,000 fine.

Insider Trading

The question with which the fifth criminal provision was intended to deal, trading by directors in securities of their company, has long required specific treatment in Israeli law. One opportunity to deal with the problem was lost when, at the time of the enactment of the Securities Law, the recommendations on that point made by the Yadin Committee were not given effect.[16] The English court decided at the beginning of the century in the *Percival* v. *Wright* case[17] that a director may acquire shares from existing shareholders without revealing inside information which would influence the price of those shares. It is generally thought that the decision in *Percival* v. *Wright*, which has been most severely criticised, still represents the law today in that area. We elsewhere expressed the opinion that the law no longer gives a director a free hand in exploiting his position for his own personal profit at the expense of other shareholders.[18] A director

result of the improper use of his knowledge as a director of the company. Section 112 of the Draft provides that the approval of the general meeting releases the director from his liability under section 111.

16 For the legislative history of the provisions on insider trading under the Securities Law, 1968, see main text pp. 75-84.

17 [1902] 2 Ch. 421.

18 See main text p. 27.

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trading in securities of the company by exploiting inside information, which he acquired because of his position with the company, will be obliged, in our opinion, to pass on his profits to the company, for in so trading he breached his fiduciary duty to the company. He will, likewise, be liable in tort to the shareholders from whom he acquired or to whom he sold the shares. This is because trading in shares by a director who is withholding material facts known to him, constitutes, in our opinion, an offence under section 54(a)(1) of the Securities Law, which offence gives the injured person a cause of action in tort on the grounds of breach of a statutory duty under section 63 of the Civil Wrongs Ordinance (New Version).

The thesis which led us to the above conclusions need not be restated here. In any case the debate as to section 9D of the Bill should be carried on with the intention of clarifying these basic questions: does insider trading constitute an offence under the law as it exists today? Does it constitute a tort or a breach of a fiduciary duty under existing law? It is the writer's opinion, however, that since under existing law there is doubt both as to the criminal and civil liabilities, specific legislation is to be welcomed. The specific legislation must provide not only for criminal liability but also for civil liability and must deal with the basic problems involved in insider trading.

The proposed legislation does not, in the present view, achieve that goal. First, it imposes criminal liability on all directors or general managers "who have, directly or indirectly, a personal interest in the securities of the company and made a transaction therein not for the benefit of the company". It is not an element of the offence that the transaction was carried out on the basis of information which the director obtained as a result of his position. Every transaction in securities of the company is forbidden. Such a prohibition will not stand up. Directors cannot be prevented from holding securities in the company nor from carrying out transactions in them; only transactions based upon inside information not known to the second party should be forbidden. We know of no legal system which forbids directors altogether from trading in securities of their company. The opposite is true. The general trend is to encourage directors to be shareholders, in order to reduce the possibility of a conflict of interest between the directors and the shareholders. In short, we do not want to throw out the good with the bad; the improper use of information is to be prevented, but not trading in securities altogether.

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This writer fails to understand the requirement that the transaction be "not for the benefit of the company". If that means that only transactions which adversely affect the company are forbidden, the prohibition is most limited and ineffective. To begin with, the *company* has no interest in the question of who its shareholders may be. The fact that one shareholder (the director) makes a profit at the expense of another shareholder does not injure the company. Only upon rare occasions will injury be caused to the company. This may occur if the fact that insiders have misused their position becomes known, with the result that investors avoid the company's shares and the company becomes unable to raise money on the securities' market.[19] Such cases, however, are a rarity, for as a rule the company as such is uninterested in the price of its shares. If, on the other hand, the meaning of the requirement that the transaction must be "not for the benefit of the company" is that only transactions benefiting the company are permissible, and that every transaction from which the company does not gain a benefit is forbidden, the meaning of the requirement would be to prohibit transactions altogether. Again, since the company has no interest in the question of who its shareholders are, the directors will not be able to point out how the transaction could be for the benefit of the company, and will consequently be forbidden from carrying it out.

The proposed penalty, a fine three times the value of the subject matter of the offence, is a most severe one. It should be noted that the fine is not three times the director's profits, but three times the value of the securities which were the subject of the transaction. The securities, and not the profits, are the "matter in respect of which the offence was committed". For example, were a director to acquire shares at the price of IL 100,000, the actual value of which, after the information that was known to the director but not to the vendor of the shares became known, was IL 120,000, he would be required to pay a fine not of IL 60,000 but of IL 360,000. The extent of deterrence provided by the proposal is, therefore, immense. In the present view, however, effective deterrence could be achieved by way of a more modest and conservative provision. We would suggest employing the means used by section 54(a)(1) of the Securities Law, which provides a penalty of three years' imprisonment or a fine of

19 See the judgment of the American court in *Diamond* v. *Oreamuno*, 24 N.Y.2d 494; 248 N.E.2d 910 (Ct. App.N.Y. 1969).

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IL 20,000, *inter alia,* for inducing a person to purchase or sell securities by concealment of material facts. Since the situation under discussion concerns not any person but a company director, we would increase the penalty to four years' imprisonment or a fine of IL 100,000, as is provided in section 9B of the Bill, for conducting the company's business in a way which impairs its ability to meet its obligations. If a treble fine is preferred, the fine should be three times the amount of the director's profits.

The proposed section adopts the definition of "securities" set out in section 1 of the Securities Law 1968. For the purpose of section 54 of the Securities Law, however, securities are defined as including also securities which are not included within the definition in section 1. In our opinion, a similar definition should be applied with regard to the proposed section.

It is also insufficient to impose liability on a director or general manager. Responsibility should also be provided for any person carrying out a transaction in securities of the company based upon information which he received by virtue of his position or connections with the company, that was not available to the other party to the transaction. In this way, the accountant of the company, its officers, or any person to whom the director conveyed secret information, for example, would also be liable.

The law should specifically provide a civil remedy for a person injured in a transaction with an insider. We are not oblivious to the serious difficulties involved in enforcing civil liability in respect of the great bulk of transactions in securities carried out through the stock exchanges. The difficulty is in determining the identity of the shareholder with whom the director traded, for the stock exchange mechanism does not match a specific vendor with a specific purchaser, but only the whole of the sellers with the whole of the buyers. More important, even were such matching possible, the fact that the insider traded with a particular shareholder is entirely circumstantial. This being so, why should one shareholder be compensated, while others, who traded at the same time and at the same price, are not? That problem, however, did not prevent a civil remedy from being provided in other parts of the world. Moreover, the courts of the United States are now trying to find a solution to that problem, and it may be hoped that they will be able to find a way of taking the profits from the director and channelling them to the proper addressees.

A provision should also be included by which the company is

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enabled to demand that the director transfer to it his profits from insider trading. The director, however, should not be obliged to pay out his profits twice, once to the injured party and once to the company. The profit should remain in the company only if the director is not obliged to pay damages to the injured shareholder.[20]

In view of the above, we would suggest to the legislator that, instead of the proposed section 9B, the provision include the following elements:

(1) Every person carrying out a transaction in securities of the company without revealing information received by him as a result of his position with the company, which information was not general knowledge nor known to the other party to the transaction and which could substantially influence the value of the securities, shall be liable to four years' imprisonment or a fine of IL100,000.

(2) The other party to the transaction shall be entitled to rescind the transaction or to recover the difference between the value of the securities after the release of the information which was withheld and the price fixed for the transaction.

(3) The company shall be entitled to recover the profits of the director from the transaction if the injured party has not yet commenced a suit under this section and succeeded therein. Should an injured party succeed in his suit subsequent to the transfer of the profits to the company, the company shall forward the monies to the injured party in fulfillment of the judgment given in his favour.

(4) In this section "securities" shall have the meaning given it in section 54(b) of the Securities Law, 1968. "Company" includes a subsidiary, a holding company or a subsidiary of a holding company.

The securities market at long last came back to life in recent months. Suitable "rules of the game" should be assured by law in order that investors do not lose confidence. This is also an appropriate opportunity for increasing the duties of disclosure imposed upon insiders under the Securities Law.[21]

20 See the discussion on this point in our article, "Limiting Fringe Benefits", (1972) 28 *Hapraklit* 15 (Hebrew).

21 See our proposal on this point in main text, p. 49.

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APPENDIX "B"

THE TEXT OF THE ANTI-FRAUD PROVISIONS IN THE UNITED STATES OF AMERICA, ENGLAND AND ISRAEL

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THE TEXT OF THE ANTI-FRAUD PROVISIONS IN THE UNITED STATES OF AMERICA, ENGLAND AN ISRAEL

1. U.S.A.

Sec. 10(b) of the Securities Exchange Act, 1934

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under Sec. 10(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(1) To employ any device, scheme, or artifice to defraud,

"(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

2. England

Sec. 13(a) of the Prevention of Fraud (Investments) Act, 1958.

(1) Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person —

(a) To enter into or offer to enter into —

(i) any agreement for, or with a view to, acquiring, disposing of, subscribing for underwriting securities or lending or depositing money to or with any industrial and provident society or building society, or

(ii) any agreement the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities, shall be guilty of an offence, and liable to imprisonment for a term not exceeding seven years.

3. Israel

Sec. 54 of the Securities Law, 1968.

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(a) Any person who does one of the following shall be liable to imprisonment for a term of three years or to a fine of IL 20,000:

(1) Induces or attempts to induce a person to acquire or sell any securities, doing so by a statement, promise, or forecast — in writing, orally, or otherwise — which he knows or ought to know is false or misleading, or by concealment of material facts;

(2) Fraudulently influences the fluctuations of the value of securities.

(b) In this section "securities" include securities not included in the definition of section 1.

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APPENDIX "C"

GLOSSARY

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GLOSSARY

Divrei HaKnesset	— Records of Knesset proceedings
HaPraklit	— Law Journal published by the Jewish Bar Association (1943-48), now the Israel Bar, and, since 1964, in cooperation with the Faculty of Law of the Hebrew University, Jerusalem
Hatza'ot Hok	— Legislative Bills
'Iton Rishmi	— The Official Gazette during the tenure of the Provisional Council of State
Kitvei Amana	— Israel Treaty Documents
Knesset	— Israel Legislative Assembly
Kovetz HaTakanot	— Subsidiary Legislation
Mishpatim	— Students Law Review, Faculty of Law, Hebrew University of Jerusalem
Piskei Din (Judgments)	— Law reports of the Supreme Court, published by the Ministry of Justice (1948-)
Psakim (Decisions)	— Law reports of the Supreme Court and District Courts, published privately (1948)
Psakim 'Elyon (Supreme [Court] Decisions)	— Law reports of the Supreme Court, published by the Israel Bar Association (1948-1961)
Psakim Mehoziim (District [Courts] Decisions)	— Law reports of the District Courts, published by the Israel Bar (1949-)
Reshumot	— Official Gazette
Sefer HaHukim	— Principal Legislation
Yalkut HaPirsumim	— Government Notices

ABBREVIATIONS

A.L.R.	— Annotated Law Reports (1943-47)
Ct.L.R.	— Current Law Reports
F.H.	— Further Hearings
K.A.	— *Kitvei Amana* (in Hebrew)
K.T.	— *Kovetz HaTakanot* (in Hebrew)
L.S.I.	— Laws of the State of Israel
P.D.	— *Piskei Din* (in Hebrew)
P.E.	— *Psakim 'Elyon* (in Hebrew)
P.L.R.	— Palestine Law Reports, 1920-47
P.M.	— *Psakim Mehoziim* (in Hebrew)
P.M.S.	— *Psakim Mehoziim* Summary (in Hebrew)
P.G.	— Palestine Gazette
Rot.	— Rotenberg's Law Reports (1919-36)
S.C.J.	— Annotated Supreme Court Judgments (1937-42)
S.D.C.	— Selected Cases of the District Court (1943-47)
S.J.	— Selected Judgments of the Supreme Court of Israel (1948-58)

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