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## The Fiduciary Rights of Shareholders

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# THE FIDUCIARY RIGHTS OF SHAREHOLDERS

JOHN C. CARTER\*

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## I. INTRODUCTION

Corporation law provides to shareholders a degree of fiduciary protection. Under proper circumstances, the shareholder is protected from the acts of his fellow shareholders and the corporate directors. This Article defines the circumstances in which fiduciary duties to corporate shareholders arise, to the extent that this is possible within the state of the law today, and determines the direction of the law concerning fiduciary relationships within the corporate family.

The examination of this subject is timely. Four well-known decisions within the last few years have considered the subject and have thrown some light on it. *Smith v. Van Gorkom*,<sup>1</sup> *Moran v.*

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1. 488 A.2d 858 (Del. 1985).

*Household International, Inc.*,<sup>2</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings*,<sup>3</sup> and *ConAgra v. Cargill*<sup>4</sup> considered some of the circumstances in which directors owe a direct fiduciary duty to shareholders, a subject that has previously been treated somewhat enigmatically by the courts. Although courts commonly speak of a fiduciary duty of directors to the corporation and its shareholders, one is hard pressed to find a case in which directors are held directly liable to shareholders, absent circumstances that create a special relationship.

The scope of this Article, however, includes a consideration of all instances of fiduciary duty to shareholders, not simply those running from director to shareholder. The Article, therefore, determines the corporate capacities in which individuals incur fiduciary responsibilities and to whom such responsibilities run.

The term fiduciary duty is generally considered to mean a duty, implied in law, of "the finest loyalty"<sup>5</sup> to another party in certain relationships. A great deal has been written on the nature of fiduciary duties in a corporate setting, but surprisingly little has been said about to whom the duties run. Justice Frankfurter once stated:

We completely agree with the Commission that officers and directors who manage a holding company in process of reorganization under the Public Utility Holding Company Act of 1935 occupy positions of trust. . . . But to say that a man is a fiduci-

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2. 500 A.2d 1346 (Del. 1985).

3. 506 A.2d 173 (Del. 1986).

4. 222 Neb. 136, 382 N.W.2d 576 (1986).

5. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928). Although this definition arose in a joint venture rather than a corporate setting, it has been cited to describe the fiduciary relationships between parties to trusts, partnerships, and corporations. Implicitly, therefore, courts have recognized that the nature of fiduciary duty is the same no matter where it is found. Differences arise, however, with respect to the identity of the specific duties and to whom they are owed. Even the court in *Meinhard* recognized that different fiduciary responsibilities derive from different business relationships. The dissent by Justice Andrews drew a distinction between the fiduciary duties of partners and those of joint venturers. *Id.* at 476-77, 164 N.E. at 553 (Andrews, J., dissenting). Chief Justice Cardozo, who wrote the majority opinion, distinguished between the duties of the managing coadventurer and those of the other coadventurers when in speaking of Mr. Salmon he said, "He was much more than a coadventurer. He was a managing coadventurer. . . . For him and for those like him, the rule of undivided loyalty is relentless and supreme . . ." *Id.* at 468, 164 N.E. at 548 (citations omitted).

ary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?<sup>6</sup>

As perceived by Justice Frankfurter, judicial analysis of fiduciary relationships is often incomplete. But even Justice Frankfurter's opinion failed to recognize an important factor in a comprehensive analysis of the duties owed by a fiduciary. For although few would argue with Frankfurter's conclusion that officers and directors occupy a position of trust, or the contention of the Securities and Exchange Commission reported in the same opinion that corporate management owes a fiduciary duty to the corporation's shareholders,<sup>7</sup> no attempt has been made to specify the exact function from which this duty arose, and before one can answer any of Justice Frankfurter's questions, one must first determine whether the fiduciary responsibilities of director, officer, and shareholder differ in any respect. If they do, one must then determine from which of these capacities the fiduciary duties in a particular case are said to arise.<sup>8</sup>

The law's reluctance to recognize the distinction between the fiduciary responsibilities of officers, directors, and shareholders is perhaps not surprising. Until recent years the practice was to choose most directors from among the officers, and at an earlier time—even today in close corporations—individuals with large shareholdings were actually in control. As a consequence, perhaps saying that management occupied a fiduciary position was sufficient. Today, however, that concept may be too simplistic.

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6. *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943).

7. *Id.* at 87.

8. In another United States Supreme Court case, *Pepper v. Litton*, 308 U.S. 295 (1939), often cited in articles on this subject, Justice Douglas wrote that "a director is a fiduciary . . . . So is a dominant or controlling stockholder or group of stockholders. . . . Their powers are powers in trust." *Id.* at 306 (citations omitted). This case concerned a creditor's action to overcome the machinations of a controlling shareholder attempting to avoid payment of a corporate obligation by creating a prior claim against the assets of a bankrupt corporation. In this case the shareholder was found liable to the corporation for having exercised control in his own interests and contrary to the interests of the corporation.

## II. THE SCOPE OF FIDUCIARY DUTY IN THE CORPORATE SETTING

It is beyond dispute that fiduciary duty arises only where power exists, and one thesis of this Article is that in the formula used to determine an individual's fiduciary duty, the concept of fiduciary responsibility is the constant, whereas the existence of power is the variable. The extent of fiduciary duty must be commensurate with the power to act. The great majority of decided cases can be understood by analysis on this basis.<sup>9</sup>

The fiduciary duty of corporate directors has long been recognized.<sup>10</sup> It consists, in general, of the duty of the director to give attention to the interests of the corporation, and to give them priority, even against his personal interests, in his functioning as a director. This is the same duty an agent owes his principal and a partner owes his copartner in their respective functions.

To the extent that a difference exists between corporate officer, agent, and partner on the one hand, and the director on the other, this difference does not relate to the concept of fiduciary responsibility. It results, instead, from the difference in the functions of the positions. The officer, agent, and partner are actors with either specific or general authority within the scope of the business of the enterprise. The director is not. His function is deliberative. For example, generally a director may compete with the company on whose board he sits.<sup>11</sup> Such competition might diminish his desire to discharge his deliberative function, but it will not reduce his

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9. "[D]isregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web . . ." *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971) (citation omitted).

10. *E.g.*, CAL. CORP. CODE § 309 (West Supp. 1987); DEL. CODE ANN. tit. 8, § 141(e) (1983); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1988); TENN. CODE ANN. § 48-18-301 (Supp. 1987). These statutes and others similar to them are actually a codification of the common law on the fiduciary duty of corporate directors to their corporation.

11. This grant is not absolute. Certain limitations have been set, and certain criteria must be met. For a general overview of these criteria, see Note, *Recent Decisions, Corporations—Officers and Directors—"Corporate Opportunities" Doctrine*, 50 MICH. L. REV. 471 (1952); Note, *Duty of a Director Not to Compete*, 26 ST. JOHN'S L. REV. 116, 120-23 (1951). For case law that illustrates the limitations, see *Tovrea Land and Cattle Co. v. Linsenmeyer*, 100 Ariz. 107, 121, 412 P.2d 47, 57 (1966); *Red Top Cab Co. v. Hanchett*, 48 F.2d 236 (N.D. Cal. 1931); *Lincoln Stores v. Grant*, 309 Mass. 417, 34 N.E.2d 704 (1941); *Golden Rod Mining Co. v. Bukvich*, 108 Mont. 569, 92 P.2d 316 (1939); *New York Auto. Co. v. Franklin*, 49 Misc. 8, 97 N.Y.S. 781 (N.Y. Sup. Ct. 1905); *Barr v. Pittsburgh Plate Glass Co.*, 51 F. 33 (C.C.W.D. Pa. 1892), *aff'd*, 57 F. 86 (3d Cir. 1893).

ability to do so. In contrast, an agent generally may not compete with his principal within the scope of the agency.<sup>12</sup> Acting in competition with the principal would certainly be inconsistent with the obligation to act in the principal's interest within the scope of his business.

The strictness of the fiduciary obligation of loyalty of corporate directors has been ameliorated to some extent by statute and by the courts. Undoubtedly, at one time any contract between a corporation and one of its directors or an organization in which he had an interest that was not insubstantial was voidable by the corporation, as would be the case in a contract between principal and agent. Although this may still be true between principal and agent, it is not true with respect to directors.<sup>13</sup> Today the subject is generally treated by state statutes, which usually deny the corporation the right to void a fair agreement,<sup>14</sup> although most of them place the burden of establishing fairness on the director who is ostensibly in conflict with the corporation.

Such contracts exist in many familiar forms. An often recurring example is found among the large public-issue corporations, whose boards of directors include executives of other large corporations. In such circumstances transactions between the corporation of which the director is an employee and the corporation of which he is a director occur from time to time, and, except in egregious circumstances, do not constitute violations of any reasonable conception of fiduciary duty.

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12. RESTATEMENT (SECOND) OF AGENCY § 393 (1958).

13. Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966). This article gives an historical perspective on the conflict of interest problem. At one time a contract between a corporation and its directors was voidable by the shareholders. Now their validation is not required because the courts themselves will look at the contract and decide its fairness without shareholders' approval. This article traces the history of this change in corporate law.

14. *E.g.*, CAL. CORP. CODE § 310(a) (West 1977); DEL. CODE ANN. tit. 8, § 144(a) (1983); ILL. ANN. STAT. ch. 32, para. 8:60 (Smith-Hurd 1985); N.Y. BUS. CORP. LAW § 713 (McKinney 1986); TENN. CODE ANN. § 48-18-302 (Supp. 1987). The Delaware statute puts no burden of proving fairness on the interested directors; it provides only that the transaction be a fair one. DEL. CODE ANN. tit. 8, § 144 (a)(3) (1983). Delaware case law, however, provides that once the shareholders have established that the procedures of the statutes were not followed, the directors have the burden of proving the fairness of the transaction. *See Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976); *Gottlieb v. Heyden Chemical Corp.*, 33 Del. Ch. 177, 91 A.2d 57 (1952).

Under long-established law, directors may not divert to themselves corporate opportunities,<sup>15</sup> just as the agent or partner may not divert to himself opportunities of his principal or copartner.<sup>16</sup> Corporate opportunities have been variously defined. In many older cases, they were defined as "property wherein the corporation has an interest already existing, or in which it has an expectancy growing out of an existing right, or. . . [where denial of the opportunity to the corporation] will in some degree balk the corporation in effecting the purposes of its creation."<sup>17</sup> Another court has defined the phrase to mean opportunities in the corporation's line of business,<sup>18</sup> but by far the most common understanding of

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15. H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* § 237 (3d ed. 1983).

16. *RESTATEMENT (SECOND) OF AGENCY* §§ 389, 393.

17. *Lagarde v. Anniston Lime & Stone Co.*, 126 Ala. 496, 502, 28 So. 199, 201 (1900). In this case the corporation, which was in the business of quarrying limestone and manufacturing lime, had a lease and interests in valuable quarry land. Two directors, who were also stockholders, procured a third party to purchase the interests in the land from its owners in the name of the directors. The directors had full knowledge of their corporation's interest in the property. The court ordered the directors to hold the land in trust for the corporation. *Id.* at 499, 28 So. at 200-01. In another early case, *McCourt v. Singers-Bigger*, 145 F. 103 (8th Cir. 1906), the corporation ran two theaters held under leases. One of the directors formed a new corporation and obtained the renewal of both leases in trust, and the court ordered the new corporation to transfer the leases to the old company. Somewhat later, in *News-Journal Corp. v. Gore*, 147 Fla. 217, 2 So. 2d 741 (1941), two tracts of land essential to the corporation were bought by an officer of the business purely for his own interest. The court held that the officer could not retain the benefit but instead had to hold the land in trust for the corporation. These cases illustrate the importance the courts place on the corporation's existing and expectancy interests in the property and need for the property in the furtherance of the purpose of the company. The courts linked these interests directly to corporate opportunity and ruled that the directors should not avail themselves of these opportunities.

18. *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939). This case discusses the fact that not all corporate opportunities in the "line of business" will subject directors to a fiduciary duty to the corporation. In some situations the director may not owe this duty; for example, if the director is approached in an individual capacity, if the nature of the opportunity is not essential to the company, or if the corporation has no interest or expectancy in the opportunity. *See also* *Maclary v. Pleasant Hills*, 35 Del. Ch. 39, 49-50, 109 A.2d 830, 837 (1954), a stockholder derivative action challenging a transaction. The defendant corporation, a family-owned business, transferred real estate to its president at a price significantly below its fair market value. The land was owned by the corporation, which was in the business of renting and selling real estate. The president made improvements on the lots, and the court ruled that the president should pay to the corporation the difference in value for the land rather than reconvey because the president controlled the corporation. The president had availed himself of a corporate opportunity and the corporation was entitled to the benefit received by the president.

the doctrine today is the subjective idea that directors may not unfairly divert to themselves opportunities when the interest of the corporation calls for protection.<sup>19</sup> One commentator has argued, however, that these alternative articulations of the corporate opportunity doctrine are simply exercises in semantics, and that a constructive trust for the benefit of the corporation generally will be imposed only when property acquired by the director was necessary to an existing corporate objective or when the director abused his position by the manner in which he accomplished the transaction.<sup>20</sup>

In view of the fact that a partner functions as a general agent in the conduct of a partnership business, whereas a corporate director has no authority whatsoever to conduct the business of the corporation, it is not surprising that the doctrine of partnership opportunity is considerably more onerous than the doctrine of corporate opportunity. This difference results from the application of the same fiduciary standard as is applied in the case of the corporate director, but to a much broader range of responsibilities. It is logical, therefore, that the partnership may have the benefit of any

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19. H. BALLENTINE, *BALLENTINE ON CORPORATIONS* § 79 (1946). The test calls for application of fairness on a case-by-case basis. On facts similar to *Guth*, 23 Del. Ch. 255, 5 A.2d 503, the Supreme Court of Massachusetts applied the Ballentine fairness test, rejecting the existing corporate interest or expectancy test. *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 199, 80 N.E.2d 522, 529 (1948). A director and officer of Durfee & Canning set up a dummy corporation, Pacific Gas Corp., procured gas shipments for Pacific through a third corporation, and sold the shipments to Durfee & Canning at a substantial profit. The shipments could have been bought directly from the third corporation by Durfee & Canning. The court ruled that the defendant director had to return all profits he made to Durfee & Canning.

Later cases have used a combined test that incorporates both the "line of business" test and the fairness test. The Supreme Court of Delaware used this combination test and stated that the fairness aspect should be applied in consideration of the surrounding facts and circumstances. *Equity Corp. v. Milton*, 43 Del. Ch. 160, 164-65, 221 A.2d 494, 497 (1966). When a director purchased stock of his corporation, an investment company, the court ruled that no opportunities were available to the corporation because the director had dealt with his own property. See also *Miller v. Miller*, 301 Minn. 207, 222 N.W.2d 71 (1974), in which directors of family-owned corporations took advantage of related market needs and set up different corporations over a span of time to meet and provide these needs. The court ruled that the directors had not breached any fiduciary duty to the family corporation.

20. Note, *Corporate Opportunity in the Close Corporation—A Different Result?* 56 *Geo. L.J.* 381, 382-83 (1967).



transaction by a partner within the scope of the partnership business.<sup>21</sup>

As is true of partners, the participants in a close corporation are often general agents and have the authority to bind the corporation in the ordinary course of its business. In such case the participants should be subject to the more demanding duty of a partner, rather than the duty of a mere director.<sup>22</sup> The individual's fiduciary duty should be commensurate with his authority, and the participant in a close corporation has greater authority than the ordinary director.

Allegations of breach of the duty of loyalty frequently occur in transactions related to corporate control when corporate managers or controlling shareholders are perceived to have obtained an advantage at the expense of the minority or the outside owners. Examples of such transactions include defensive purchases of shares held by a corporate raider (also known as "greenmail"),<sup>23</sup> the issu-

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21. See *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928). This case was decided in a joint venture setting. The degree of fiduciary duty the court found here has been applied to all types of business settings, including the corporate setting. Here the plaintiff was helping to finance defendants' venture, which was to reconstruct and manage property that the defendant had leased for 20 years. The plaintiff was to receive a percentage of net profits and bear half the losses. With less than a year to go on the initial lease, the owner of the buildings approached the defendant with a lucrative business deal to lease the property and others adjoining it. Defendant did so without telling the plaintiff. Plaintiff brought suit and was awarded half the value of the new lease. The court ruled that this new lease was incident to the joint venture, and therefore defendant had a duty to tell the plaintiff about it. *Id.* at 464-65, 164 N.E. at 547. The plaintiff thus received the benefit of the transaction because it was within the scope of the joint venture.

22. See *Burg v. Horn*, 380 F.2d 897 (2d Cir. 1967). Here the defendant directors and shareholders were involved in the purchase and sale of low-rent housing before, during, and after the plaintiff corporation, Darand, was formed to purchase and operate low-rent housing. No discussion or agreement was made concerning Darand having the first opportunity to buy low-rent housing that defendants found. The other shareholder brought suit because after Darand was formed, the defendants bought low-rent housing without giving Darand the opportunity to buy first. The court held that the directors did not breach any duty of corporate opportunity, without more evidence of an agreement, because defendants spent most of their time in unrelated businesses and already owned other corporations that were holding similar property. *Id.* at 900. The dissent was based on the idea that a fiduciary duty was imposed by law and prevented the defendants from selecting the best properties for themselves. *Id.* at 903 (Hays, J., dissenting).

23. *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964). This is one of the early cases approving the defensive tactic of buying out the corporate raider. The court held that this was permitted if, in the business judgment of the directors, it was advisable as a means to meet a challenge to corporate policy. The court stated, however, that the buy-out would be

ance of shares into friendly hands for the same purpose,<sup>24</sup> the sale of controlling shares,<sup>25</sup> and the granting of "poison pill" stock options to shareholders.<sup>26</sup>

### III. FIDUCIARY DUTY AMONG SHAREHOLDERS

#### A. *In Publicly Held Corporations*

Little question exists that under appropriate circumstances majority shareholders have a direct fiduciary liability to the minority. This was established long ago by the United States Supreme Court in *Southern Pacific Co. v. Bogert*.<sup>27</sup> In Delaware it was first determined in 1923 in *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*,<sup>28</sup> a case involving a proposed sale of all the assets of a corporation, and it has been followed many times since then. Probably the three best known cases today discussing the existence of such a duty among shareholders of publicly held corporations, however, are *Zahn v. Transamerica*,<sup>29</sup> *Perlman v. Feldmann*,<sup>30</sup> and *Jones v. H.F. Ahmanson & Co.*<sup>31</sup>

In *Zahn*, the United States Court of Appeals for the Third Circuit held that Transamerica Corporation, a Delaware corporation and the majority shareholder in control of the board of the Axton-Fisher Corporation, a Kentucky corporation, was liable directly to

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an improper expenditure of corporate funds if done for the purpose of perpetuating control. *Id.* at 508, 199 A.2d at 556.

24. *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972) (funding of an "Employees Stock Trust Plan" with corporate stock in order to get the company into friendly hands).

25. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955) (control premium held to be a corporate asset).

26. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). The "poison pill" in this case consisted of rights granted to each common share to purchase for \$10,000 per share participating preferred stock entitled to dividends and liquidating preferences of 100 times the dividends and amounts receivable on liquidation of the common stock. The rights could be exercised or sold only if certain defined takeover events occurred. If a merger ensued thereafter, the holder of the rights could purchase common stock of the acquiring company at a price reflecting a market value of twice the exercise price of the rights.

27. 250 U.S. 483 (1919).

28. 14 Del. Ch. 1, 120 A. 486 (1923). *Accord* *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977); *Epstein v. Celotex Corp.*, 43 Del. Ch. 504, 238 A.2d 843 (1968).

29. 162 F.2d 36 (3d Cir. 1947).

30. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

31. 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969).

minority shareholders. The directors had decided to redeem the Class A stock prior to the liquidation of the company, a move that was within the power of the board but quite favorable to the Class B stock, owned by Transamerica, and detrimental to the Class A shareholders, of which Zahn was one.

The court observed:

The act of the board of directors in calling the Class A stock, an act which could have been legally consummated by a disinterested board of directors, was here effected at the direction of the principal Class B stockholder in order to profit it. Such a call is voidable in equity at the instance of a stockholder injured thereby.<sup>32</sup>

The court thus held that the directors had violated their fiduciary duty by acting intentionally to prefer the majority at the expense of the minority.

The court did not specifically state the basis for holding the majority shareholder liable; however, it found that the directors had breached their fiduciary duties, and it at least implied that the controlling shareholder was liable for having solicited that breach.<sup>33</sup> The court recognized the control relationship that existed between Transamerica and the Axton-Fisher directors. "[I]t will be observed that agents or representatives of Transamerica constituted Axton-Fisher's board of directors at the times of the happening of the events complained of, and that Transamerica was Axton-Fisher's principal and controlling stockholder at such times."<sup>34</sup> Elsewhere in the opinion the court referred to Transamerica as "the board of directors of Axton-Fisher, . . . its officership or . . . its controlling stockholder."<sup>35</sup> On the basis of the agency relationship, one might conclude that the court found Transamerica vicariously liable for the action of the captive directors. One finds this difficult to believe, however.

Any vicarious liability imposed on Transamerica for having solicited a breach of duty of directors would run to the corporation, Axton-Fisher, and not to the Axton-Fisher shareholders; how-

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32. *Zahn*, 162 F.2d at 46.

33. *Id.* at 42.

34. *Id.* at 40.

35. *Id.*

ever, directors acting in their proper capacity invariably have been found to have no direct fiduciary duty to shareholders.<sup>36</sup> To hold majority shareholders liable to shareholders for inducing directors to breach their duty to the corporation would thus be illogical. In such a case the injured party would be the corporation rather than the shareholders. Solicitation of a breach of a director's duty to the corporation was not a proper basis for finding liability. There is another basis, however.

In *Zahn* the question of director liability did not arise. The directors were not even named as defendants. That suit was a class action against the majority shareholder, Transamerica, and the majority shareholder was found to have breached a duty it owed to the minority. The breach by directors, however, was not the basis of the action; rather, the basis was the breach by the majority shareholder of its duty to the minority. Without doubt, the directors also would have been liable to the shareholders, not because of their responsibilities as directors but because of their actions as agents of the controlling shareholder.

In *Perlman v. Feldmann*<sup>37</sup> an individual who was an officer, a director, and the majority shareholder sold his interest in an Indiana corporation to a group that this individual knew intended to harm the corporation. The United States Court of Appeals for the Second Circuit held this transfer to be a breach of the individual's fiduciary duty to the minority shareholders.<sup>38</sup> The majority apparently found that this duty arose due to the majority shareholder's control over the directors. Noting that the applicable Indiana law on corporate fiduciary duties was "particularly relevant to Feldmann as a director," the court maintained that "the same rule should apply to his fiduciary duties as majority stockholder, for in that capacity he chooses and controls the directors, and thus is held to have assumed their liability."<sup>39</sup>

The difficulty with this statement is that the directors apparently did not breach their fiduciary duty. In fact, the shareholder breaching his duty to fellow shareholders could have, and in all

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36. *Id.* at 42.

37. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

38. *Id.* at 176.

39. *Id.*

likelihood did, accomplish the act complained of without the need for any cooperation on the part of the directors. *Perlman* involved a transfer of stock by a shareholder, a transaction to which the directors and the corporation were mere bystanders. The basis for the majority shareholder's liability, therefore, could not have been the liability of the principal (the majority shareholder) for the acts of his agent (the director). Here the majority shareholder acted directly, and thus the breach of duty must have arisen because the controlling shareholder had a direct duty to the minority or to the corporation with respect to his sale of stock. The opinion did not discuss the basis for finding liability, as the dissent was quick to point out.<sup>40</sup> Judge Swan argued that as a selling shareholder, Feldmann was acting on his own behalf and not as a representative of the corporation. As a result, no duty arose out of the corporate relationship. He did observe, however, that if the selling shareholder

knows or has reason to believe that the purchaser intends to exercise to the detriment of the corporation the power of management acquired by the purchase, such knowledge or reasonable suspicion will terminate the dominant shareholder's privilege to sell and will create a duty not to transfer the power of management to such purchaser.<sup>41</sup>

Judge Swan characterized this duty as "the obligation which everyone is under not to assist another to commit a tort rather than the obligation of a fiduciary."<sup>42</sup>

*Perlman* has come to be known as one of the few cases in which a controlling shareholder who sold was held liable for the "control premium" received.<sup>43</sup> Although not clearly articulated, inherent in the decision is the idea that Feldmann, as controlling shareholder, had a fiduciary duty to the minority shareholders and breached this duty by selling for personal gain a corporate asset—corporate control.

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40. "My brothers' opinion does not specify precisely what fiduciary duty Feldmann is held to have violated or whether it was a duty imposed upon him as the dominant stockholder or as a director of Newport." *Id.* at 178 (Swan, J., dissenting).

41. *Id.* at 179.

42. *Id.*

43. See Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956).

In *Jones v. H.F. Ahmanson & Co.*,<sup>44</sup> the action taken by the majority shareholders clearly involved no exercise of control in the sense that the corporation was compelled to do anything. The majority shareholders had organized a holding company and transferred their shares to it, and then took the holding company public, thus creating a market for their own holdings while inhibiting the development of a market for the minority shares. Minority shareholders were successful in a class action against the majority shareholders.<sup>45</sup> Although the shares were not widely held, the court did not seem to distinguish between close corporations and others in reaching its decision.

As in *Perlman*, the corporation was made neither to do nor to refrain from doing anything. The directors never exercised their power to control. The inevitable conclusion, therefore, is that the breach was caused by the defendants as majority shareholders rather than as directors. The court stated:

[D]irectors and officers have an obligation to shareholders individually not to profit from their official position at the shareholders' expense. . . . The rule applies alike to officers, directors, and controlling shareholders in the exercise of powers that are theirs by virtue of their position and to transactions wherein controlling shareholders seek to gain an advantage in the sale or transfer or use of their controlling block of shares.<sup>46</sup>

This statement, of course, is much broader than the facts of the case will support. *H.F. Ahmanson & Co.* did not involve any exercise by directors or officers of "powers that are theirs by virtue of their position," unless the directors' failure to take the corporation public was an abuse of power. As previously noted, the proposition that directors have a direct responsibility to shareholders "by virtue of their position" has little support in the cases to date. In both *Perlman* and *H.F. Ahmanson & Co.*, however, controlling shareholders were held liable for breach of their duty to the minority. This duty evidently arose not because of an actual exercise of their control over the corporation, but rather because they had the

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44. 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969).

45. *Id.* at 101-05, 81 Cal. Rptr. at 594-97, 460 P.2d at 466-69.

46. *Id.* at 110, 81 Cal. Rptr. at 600-01, 460 P.2d at 472-73.

power to control. Thus, in both *Perlman* and *H.F. Ahmanson & Co.* liability resulted because of the defendant's status.

### *B. In Close Corporations*

With the possible exception of *H.F. Ahmanson & Co.*, the ownership of the corporations discussed in the prior section was too widely dispersed for them to be considered close corporations. Still, in those cases the majority shareholders were held to owe a fiduciary responsibility that seemed to transcend the exercise of control and be equivalent to the fiduciary duty of a partner. Many courts have unequivocally stated that such a duty exists between shareholders in close corporations.

In 1975 the Supreme Judicial Court of Massachusetts in *Dona-hue v. Rodd Electrottype Co.*<sup>47</sup> drew a distinction between the fiduciary liability of a shareholder in a close corporation and that of controlling shareholder in a more widely held corporation. The court stated:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.<sup>48</sup>

The court then contrasted this "strict good faith standard with the somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere in the discharge of their corporate responsibilities."<sup>49</sup>

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47. 367 Mass. 578, 328 N.E.2d 505 (1975).

48. *Id.* at 592-93, 328 N.E.2d at 515 (footnotes omitted). The characteristics of a close corporation in Massachusetts are a small number of stockholders, no ready market for the corporate stock, and substantial majority stockholder participation in the management, direction, and operations of the corporation. *Id.* at 586, 328 N.E.2d at 511.

49. *Id.* at 593-94, 328 N.E.2d at 515-16 (footnote omitted). The court also observed that corporate directors are held to a good faith and inherent fairness standard of conduct and are not permitted to serve two masters whose interests are antagonistic. Their paramount duty is to the corporation, and their personal pecuniary interests are subordinate to that duty. *Id.* at 594, 328 N.E.2d at 516.

The court emphasized that its reason for imposing a greater fiduciary duty on shareholders in a close corporation was the illiquidity of the shareholder's investment—one of the principal justifications for the existence of such a duty among partners. The court stated:

At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. . . . Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation.<sup>50</sup>

It should be emphasized that the court in this case, knowing full well the significance of its decision, extended the concept of a fiduciary duty among shareholders inter se somewhat beyond previous bounds. The court could have limited its decision by emphasizing that the shareholder who was alleged to have breached his fiduciary duty was a member of a family group that controlled the corporation; instead, it declared that all shareholders in close corporations were, in effect, partners, and had the duty of partners to one another. The court stated, "We do not limit our holding to majority stockholders. In the close corporation, the minority may do equal damage through unscrupulous and improper 'sharp dealings' with an unsuspecting majority."<sup>51</sup> Whether the shareholder to be charged with a fiduciary duty to his fellow shareholder controls the corporation apparently is not relevant. The court concluded that all shareholders had such responsibility, even though it spoke only of a need to protect the disadvantaged minority.<sup>52</sup>

In the Indiana case of *Cressy v. Shannon Continental Corp.*,<sup>53</sup> two principal shareholders of a close corporation challenged the validity of certain stock transactions that would have altered the control of the corporation. The court examined the corporation

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50. *Id.* at 591-92, 328 N.E.2d at 514-15.

51. *Id.* at 593 n.17, 328 N.E.2d at 515 n.17. This case was restricted specifically to close corporations and held that the corporation was required to make proportionally identical offers to all shareholders. *Id.* at 598, 328 N.E.2d at 518. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), in which a stockholder in a public issue corporation was excluded from an offer by the corporation to purchase its stock, the Supreme Court of Delaware held that no fiduciary duty had been violated and that the action of the directors was protected by the business judgment rule. *Id.* at 958-59.

52. *Donohue*, 367 Mass. at 591-92, 328 N.E.2d at 514-15.

53. 177 Ind. App. 224, 378 N.E.2d 941 (1978).



and the two principal shareholders, found that the corporation was, in fact, an "incorporated partnership,"<sup>54</sup> and held that the shareholders of such a corporation owed a fiduciary duty to each other.<sup>55</sup> The court held that the standard of conduct shareholders owed one another in an "incorporated partnership" was the same as that owed by a partner—"to deal fairly, honestly and openly."<sup>56</sup> In the court's own words, "[t]he 'partnership' expectation of equality of shareholdings carried with it the duty on the part of each principal to disclose to the other the availability of outstanding shares for sale and to afford the opportunity to share in the purchase of such stock."<sup>57</sup>

In contrast, other courts have refused to recognize any fiduciary duty of minority shareholders in a close corporation. For example, in *Johns v. Caldwell*,<sup>58</sup> the Tennessee Court of Appeals denied the existence of any fiduciary duty of shareholders other than those in control. In that case no controlling shareholder existed; therefore, the court found no fiduciary duty.<sup>59</sup> As in *Cressy*, the dispute concerned an effort by one shareholder in a close corporation to obtain control by acquiring additional shares from another shareholder. Unlike in *Cressy*, however, the court found no duty analogous to the duty of one partner to another.

In *Wilkes v. Springside Nursing Home, Inc.*,<sup>60</sup> the Supreme Judicial Court of Massachusetts again considered the relationship between shareholders in a close corporation. In this case, a four-man corporation had been organized under the laws of Massachusetts.

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54. *Id.* at 229, 378 N.E.2d at 945. Despite an earlier opinion of the court of appeals indicating that all close corporations were incorporated partnerships, *Hartung v. Architects Hartung/Odle/Burke, Inc.*, 157 Ind. App. 546, 553, 301 N.E. 2d 240, 243 (1973), the court in *Cressy* made clear that an incorporated partnership would be recognized only when the shareholders expected to act and intended to be treated as partners in their dealings among themselves and no harm to outsiders resulted. 177 Ind. App. at 229, 378 N.E.2d at 945.

55. Note that the dispute did not concern the management of the corporation's affairs. Moreover, there were no express restrictions on the transfer of the corporations' stock nor an express agreement between the shareholders concerning stock transactions. The view expressed by the court was advocated in Conway, *The New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures*, 30 *FORDHAM L. REV.* 297 (1961).

56. *Cressy*, 177 Ind. App. at 229, 378 N.E.2d at 945.

57. *Id.*

58. 601 S.W.2d 37 (Tenn. Ct. App. 1980).

59. *Id.* at 41-42.

60. 370 Mass. 842, 353 N.E.2d 657 (1976).

Each shareholder was also a director and an officer. After some years the relationship among the shareholders became strained, and at a board of directors meeting, three of the directors established salaries for themselves while excluding the absent director, Wilkes. Subsequently, Wilkes was not re-elected as a director.<sup>61</sup>

The court affirmed that majority shareholders in a close corporation owed a fiduciary duty to the minority, but maintained that the majority had "certain rights to what has been termed 'selfish ownership'."<sup>62</sup> The court then stated that the majority's right of self-interest had to be balanced against the fiduciary duty owed to the minority, and held that such a balancing of interests included a determination of whether the minority had been denied its justifiable expectations by the action of the majority, whether the majority could demonstrate a "legitimate business purpose for its action," and whether an alternative course of action was less harmful to the minority's interests.<sup>63</sup> In applying these tests, the court held that the majority shareholders had breached their fiduciary duty to the minority shareholder.<sup>64</sup> As in *Cressy*, the court in *Wilkes* emphasized the parties' expectations at the time of incorporation—that each shareholder would be a director, would participate actively in the management of the business, and would receive equal amounts of money from the corporation.

In dicta, the courts in both *Donahue* and *Wilkes* stated that all shareholders, not just a majority or those in control of the board of directors, owed a fiduciary duty to their fellow shareholders.<sup>65</sup> In *Smith v. Atlantic Properties, Inc.*,<sup>66</sup> the Massachusetts Court of Appeals applied this dictum when the majority shareholders sought protection from a minority shareholder. Atlantic Properties had been organized under the laws of Massachusetts with four shareholders, each owning equal amounts of stock. Both the articles of organization and the bylaws contained a provision requiring the approval of eighty percent of the outstanding voting capital

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61. *Id.* at 847, 353 N.E.2d at 661.

62. *Id.* at 850-51, 353 N.E.2d at 663.

63. *Id.* at 851, 353 N.E.2d at 663.

64. *Id.* at 852, 353 N.E.2d at 663-64.

65. *Id.* at 848-49, 353 N.E.2d at 662; *Donohue v. Rodd Electrottype Co.*, 367 Mass. 579, 587, 328 N.E.2d 505, 512 (1975).

66. 12 Mass. App. 201, 422 N.E.2d 798 (1981).

stock for any act by the board of directors or shareholders.<sup>67</sup> After a number of years of harmonious relations, ill will arose among the shareholders. One shareholder, Dr. Wolfson, refused to vote for any dividends despite warnings that the Internal Revenue Service could impose a penalty for the unreasonable accumulation of corporate earnings and profits. As a result of Dr. Wolfson's failure to vote for a dividend, the corporation was penalized by the Internal Revenue Service.<sup>68</sup> After reviewing *Donahue* and *Wilkes*, the Massachusetts Court of Appeals affirmed the trial judge's decision that Dr. Wolfson breached his fiduciary duty of "utmost good faith and loyalty" to the other shareholders.<sup>69</sup>

### C. *The Contrast Between Publicly Held and Close Corporations*

The cases make it quite clear that a fiduciary relationship exists among shareholders and is associated with control. Some of these cases suggest that this duty is enhanced among shareholders in a close corporation. Cases such as *Donahue* and *Wilkes* emphasize this distinction and state that the shareholders in the close corporation have the duty of partners to each other. *Smith* applies this rule to a shareholder who had only transactional rather than corporate control. The distinction is not without theoretical validity. In the close corporation, the expectations of the parties generally are that they will participate and benefit just as if the enterprise were a partnership, and it is this expectation, rather than the rights of the shareholders under corporation law, that these cases have protected. On the other hand, the expectations of the shareholder in a publicly held corporation are generally something less than that. In *Zahn*<sup>70</sup> and *Perlman*,<sup>71</sup> the minority's rights under

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67. In full, the provision read:

No election, appointment or resolution by the Stockholders and no election, appointment, resolution, purchase, sale, lease, contract, contribution, compensation, proceeding or act by the Board of Directors or by any officer or officers shall be valid or binding upon the corporation until effected, passed, approved or ratified by an affirmative vote of eighty (80%) per cent of the capital stock issued outstanding and entitled to vote.

*Id.* at 202, 422 N.E.2d at 799.

68. *Id.* at 203, 422 N.E.2d at 800.

69. *Id.* at 209, 422 N.E.2d at 803.

70. 162 F.2d 36 (3d Cir. 1947).

71. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

corporation law itself were protected. That is, in both cases the majority was found to have misappropriated a corporate asset—corporate control in *Perlman* and inventory appreciation in *Zahn*. When the justifiable expectations of the shareholders in a publicly held corporation are greater than the mere expectation to benefit from general corporation law, such expectations should be protected.

The difference between the protection provided minority shareholders in close and publicly held corporations therefore appears to arise from the expectations of the parties. In both types of corporations, the controlling shareholder has a fiduciary duty to the other shareholders not to defeat their proper expectations. In the context of each type of enterprise, however, the expectations are often different.

#### IV. THE LIABILITY OF CONTROLLING SHAREHOLDERS FOR BREACH OF FIDUCIARY DUTY BY DIRECTORS

The notion that the corporation's owners, as such, owe some duty to their creation, the corporation, is often found in the corporate literature and cases, and there is some justification for it. The relationship among parties in a corporation is consensual, and interference with that relationship by one party should be actionable by one or more of the others. The parties are the shareholders, the directors, the officers, and the corporation itself. If a controlling shareholder influences a director subservient to him to act not in the best interest of the corporation, and thus to violate his duty to the corporation, the corporation should have a cause of action against that shareholder based on the law of agency.

Numerous cases support the proposition that shareholders will be held liable to their corporation for causing a director to act against the corporate interests. Here the liability is not a direct liability from shareholders to corporation but arises out of an agency relationship. An example is *Wright v. Heizer Corp.*,<sup>72</sup> in which a controlling shareholder caused the directors to authorize a pledge of corporate assets to such shareholder on unfair terms. The

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72. 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

court found the shareholder liable to the corporation in a derivative action.<sup>73</sup>

*Sinclair Oil Corp. v. Levian*<sup>74</sup> was a derivative action against a majority shareholder for breach of fiduciary duty to the corporation. The court found the majority shareholder liable because it had caused the corporation to refrain from proceeding against another subsidiary of the majority shareholder for breach of contract. The court stated, "A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings."<sup>75</sup> The court went on to find that there had been such dealings and that the duty had been breached.<sup>76</sup> Here again, the shareholder was found liable on the basis of agency law for having procured the breach of duty by directors.

*Perlman*<sup>77</sup> appears to be the only case in which shareholders were found to have a direct rather than vicarious fiduciary duty to their corporation, and even there the opinion does not clearly articulate this finding. That such a duty on the part of shareholders was found, however, can be seen from the fact that the action complained of was one that was not in the power of directors, but could be taken only by the controlling shareholder. In addition, the action, being derivative, was brought to enforce a corporate right. The award was made to the minority shareholders only as a matter of convenience.

## V. THE FIDUCIARY DUTY OF DIRECTORS TO SHAREHOLDERS

The director is, of course, accountable to the corporation, the entity for whose management he is responsible, for a breach of duty.<sup>78</sup> Many courts, however, have found directors liable to shareholders when the director dealt as an individual with the shareholder, and they seem to have applied a fiduciary standard in determining liability. These cases generally involve the sale or surrender by the shareholder of his stock under circumstances con-

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73. *Id.* at 251.

74. 280 A.2d 717 (Del. 1971).

75. *Id.* at 720.

76. *Id.* at 723.

77. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

78. *Chenery Corp. v. SEC*, 128 F.2d 303 (D.C. Cir. 1942), *aff'd*, 318 U.S. 80 (1943). "[T]he general rule is that . . . directors occupy a trust relation to the corporation. . . ." *Id.* at 307.

stituting a breach of trust. In one such case, *Sher v. Sandler*,<sup>79</sup> one who was a director, officer, and principal shareholder was held liable for having purchased shares from another shareholder without making adequate disclosure. The general rule, however, seems to deny the existence of a fiduciary obligation running from the director acting in his individual capacity to the shareholder with whom he deals unless "special facts" exist.<sup>80</sup> It should also be pointed out that this rule concerns the responsibilities of directors in their individual capacities, whereas the focus of this Article is the fiduciary responsibilities among the parties in a corporation acting in their proper role.

The idea that directors acting in their proper capacity owe a duty to shareholders is frequently encountered in the cases and the literature. In *Remillard Brick Co. v. Remillard Dandini Co.*,<sup>81</sup> the California Court of Appeal stated:

It is hornbook law that directors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit.<sup>82</sup>

Statements such as this are found regularly in the cases. It is not surprising, therefore, that they are included in the opinions in the recent Delaware decisions referred to at the beginning of this Article. They are subject to the interpretation that in some circumstances the director has an individual duty to the shareholder. Historically, case law supporting this interpretation has been virtually nonexistent. In those cases imposing on directors a liability running to shareholders, the directors either have been controlling shareholders or have been acting for controlling shareholders.<sup>83</sup>

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79. 325 Mass. 348, 90 N.E.2d 536 (1950).

80. See *Strong v. Repide*, 213 U.S. 419 (1909); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933).

81. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

82. *Id.* at 419, 241 P.2d at 74.

83. See, e.g., *Chounis v. Laing*, 125 W. Va. 275, 23 S.E.2d 628 (1942). Defendants, who were shareholders, directors, and officers, wrongfully caused the sales function of three coal mining companies to be conveyed to a new company jointly owned by the defendants. They also arranged an exclusive sales agreement between the new corporation and the others. The court stated that officers and directors owed a fiduciary duty to shareholders. The court also

On the other hand, in several cases courts have expressly denied that directors have any specific fiduciary duty to shareholders. In *Strong v. Repide*,<sup>84</sup> the United States Supreme Court stated that "no relationship of a fiduciary nature exists between a director and a shareholder in a business corporation."<sup>85</sup> There the Court indicated that its finding of liability was based not on the defendant's position as a director, but on his position as majority shareholder. As majority shareholder, he owed a fiduciary duty to the remaining shareholders in certain aspects of his exercise of control.

In *SEC v. Chenery Corp.*,<sup>86</sup> the Supreme Court clearly confirmed the rule that directors have no fiduciary liability to shareholders. In that case, officers, directors, and controlling shareholders bought preferred stock of a corporation in reorganization under the Holding Company Act<sup>87</sup> at prices lower than the book value of the shares of a proposed successor corporation they planned to organize, without disclosing the disparity in value to the sellers of the stock. The preferred shares were to be convertible into shares of the new corporation. The SEC disapproved the reorganization unless the stock so acquired was not permitted to be ranked on a

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observed that in a derivative action the recovery ordinarily should go to the corporation. In this case, however, more than 95% of the corporation's stockholders approved a settlement agreement making only partial restitution. The court concluded, therefore, that the award should go directly to the plaintiffs. *Id.* at 297, 23 S.E.2d at 640.

In *Nelms v. Weaver*, 681 S.W.2d 547 (Tenn. 1984), *cert. denied*, 476 U.S. 1118 (1986), the Tennessee Supreme Court held that when a corporation issued shares contrary to a shareholders' resolution granting the shareholders preemptive rights to the shares, any shareholder could compel the corporation to rescind the improper issue. The court observed that "officers and directors of the corporation occupy a fiduciary relationship to their shareholders, as, indeed, do majority stockholders toward minority stockholders." *Id.* at 549. The plaintiff, a stockholder and president of the corporation, sought a declaratory judgment validating the issue. The court held against him on the basis that issue of the stock in question violated his fiduciary duty, and it directed rescission of the issue of shares. *Id.* at 550-51.

84. 213 U.S. 419 (1909).

85. *Id.* at 431 (citing *Board of Comm'rs v. Reynolds*, 44 Ind. 509, 509-15 (1873)); see also *Farmers' & Merchants Bank v. Downey*, 53 Cal. 466 (1879) (observing that officers and directors were trustees of the stockholders); *Farwell v. Pyle-Nat'l Elec. Headlight Co.*, 289 Ill. 157, 124 N.E. 449, (1919) (although the stockholders lost, the court stated that the directors were trustees for all of the stockholders); *Brown v. Little, Brown & Co.*, 269 Mass. 102, 168 N.E. 521 (1929) (a corporation and all directors were enjoined from denying a shareholder his rights as a holder of common stock because plaintiff's rights were individual and were related to an attempt by the defendants to compel him to sell his stock).

86. 318 U.S. 80 (1943).

87. 15 U.S.C. § 79 (1982 & Supp. III 1985).

parity with other convertible preferred stock. The SEC maintained that the purchases without adequate disclosure were a breach of the fiduciary duty of the purchasers to the corporation and its shareholders. The United States Court of Appeals for the Second Circuit held, however, that although directors generally were trustees of the corporation and of the shareholders as a group with respect to the business and property of the corporation and its management, they were not trustees of the individual shareholder because these directors had no control over the shareholder's shares.<sup>88</sup> The Supreme Court affirmed.<sup>89</sup>

Although several well-known cases have established that a fiduciary responsibility runs from the director acting in his proper capacity to the shareholder,<sup>90</sup> these decisions are not inherently inconsistent with *Chenery Corp.* or *Strong*. As mentioned earlier, it is significant that in all such cases that have come to the attention of the writer, the director either was a controlling shareholder or was controlled by a shareholder who was favored by the action of the director. This is true even in *Remillard Brick Co.*, which concerned directors' action at the direction of the controlling shareholders that was detrimental to the minority. The directors in this case may have been liable to shareholders not because of their breach of duty as directors but because of their action as agents of the controlling shareholder who breached his fiduciary duty to the minority.

Recent cases interpreting Delaware law might presage a change. The most significant is *Smith v. Van Gorkom*,<sup>91</sup> in which directors were held liable for damages directly to shareholders for failure to exercise due care in ascertaining the best interests of shareholders in a corporate acquisition. In its opinion, the court did not develop any theory of liability of directors to shareholders, nor did it ac-

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88. *Chenery Corp. v. SEC*, 128 F.2d 303 (D.C. Cir. 1942), *aff'd*, 318 U.S. 80 (1943). One might question the meaning of the statement, often repeated in this case and in many others, that the directors are trustees to the shareholders as a body. This means merely that the shareholders may compel the directors to carry out their responsibilities to the corporation.

89. *Chenery Corp.*, 318 U.S. 80.

90. North Carolina has codified this relationship. A North Carolina statute provides that "[o]fficers and directors shall be deemed to stand in a fiduciary relation to the corporation and its stockholders." N.C. GEN. STAT. § 55-35 (1982).

91. 488 A.2d 858 (Del. 1985).



knowledge this remarkable aspect of its decision in any way. The fact remains, however, that director liability to shareholders was found. In this case the court did not suggest that the defendant directors were acting as agents of controlling shareholders who breached their duty to the other shareholders. These directors were clearly independent, and the worst that could be said of them is that they relied too heavily on the chairman of the board on which they served. The court, however, held that they had breached a direct obligation to the shareholders.<sup>92</sup>

The one basis that the court found for imposing direct liability to shareholders on the directors apparently was the two-step merger process provided by Delaware law<sup>93</sup> and the laws of many other states. This process specifies that directors "shall adopt a resolution approving an agreement of merger" before submitting it to shareholders for their approval.<sup>94</sup> Implicit in the court's decision was its understanding that this requirement placed on directors a duty to submit to shareholders only those mergers they recommended for approval. Admittedly, that was not done. The directors recognized that they had not made an adequate determination of the fairness of the price being offered, but they thought this could be cured by submitting the proposition to the vote of shareholders.<sup>95</sup>

This conclusion that the statute imposes on directors a direct responsibility to shareholders is not unreasonable. Once this conclusion is accepted, it follows that directors should have the same duties of care and loyalty in discharging this responsibility that they have with respect to their other duties, and that they should be protected to the same extent in the exercise of their business judgment.

The court and the parties also seemed to recognize a duty of directors to shareholders that transcended the Delaware merger statute. In the merger agreement that was finally executed, the following clause, illustrative of the opinion of the parties, was included:

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92. *Id.* at 893.

93. DEL. CODE ANN. tit. 8, § 251(b) (1987 Interim Supp.).

94. *Id.*

95. *Van Gorkom*, 488 A.2d at 889.

The Board of Directors shall recommend to the stockholders of Trans Union that they approve and adopt the Merger Agreement . . . and to use its best efforts to obtain the requisite votes therefor. *GL acknowledges that Trans Union directors may have a competing fiduciary obligation to the shareholders under certain circumstances.*<sup>96</sup>

The court also believed that a such fiduciary duty existed. It gave great weight to its interpretation of the evidence that the board did not have the right to withdraw from the agreement and accept any higher offer received before the meeting of the shareholders. Furthermore, the court clearly couched its decision in terms of a violation of the duty of care,<sup>97</sup> one aspect of fiduciary responsibility.

Perhaps outside directors of publicly held corporations have been enjoined from violating their fiduciary duty in the past; however, no other instance in Delaware case law can be found in which directors have been found liable for damages to shareholders except where the directors were acting on behalf of a controlling shareholder, and the rationale of these findings has been explained previously. That aspect of the decision is novel. The court cites many cases to support other aspects of its decision, but none in support of its finding of a direct, independent duty of directors to shareholders.

More recent cases have begun to develop theoretical support for the holding in *Van Gorkom* that under certain circumstances directors have a direct fiduciary duty to shareholders. In fact, they might even indicate that Delaware courts are willing to find other nonstatutory bases for imposing direct liability to shareholders. In *ConAgra, Inc. v. Cargill, Inc.*,<sup>98</sup> the Supreme Court of Nebraska determined that under Delaware law a contractual commitment that directors would use their best efforts to effectuate a merger would not override the fiduciary duty of directors to exercise their business judgment for the benefit of the corporation and its stockholders. In this case ConAgra and the target company had entered into a merger agreement containing a best-efforts clause that in-

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96. *Id.* at 879 (emphasis in original).

97. *Id.* at 893.

98. 222 Neb. 136, 382 N.W.2d 576 (1986).

cluded a proviso that "nothing herein contained shall relieve either Board of Directors of their continuing duties to their respective shareholders."<sup>99</sup> The target board of directors then determined not to submit the agreement to its shareholders.<sup>100</sup> The opinion does not clearly state whether the individual directors were parties to the contract, nor is this relevant, because the action was brought against the competing offeror, Cargill, and the target rather than the directors of the target. It seems elementary, however, that the fiduciary duty of directors is personal and that the corporation they serve should not be able to contract it away.

The court held that ConAgra had not committed a breach of contract because the directors were permitted under the contract to perform their "continuing fiduciary duty" to their respective shareholders, and the board had the duty to advise shareholders on the basis of its business judgment.<sup>101</sup> The court also pointed out that absent shareholder approval the board was without power to commit the target to a merger. The court further reasoned that since neither the target nor its directors was prohibited by the best-efforts clause from discharging the fiduciary duties of directors, Cargill also was not liable.<sup>102</sup> At most, Cargill had persuaded the target and its directors to observe their fiduciary duties.

This interpretation of the role of the board of directors in a merger is consistent with that in *Van Gorkom*. The entire reasoning of the court in *ConAgra* is based on the assumption that directors have a fiduciary duty to shareholders in a cash-out merger, and there is a hint that the same would be true in other cases in which a shareholder vote was required.<sup>103</sup> The court made the express observation that the duties of "fidelity, good faith and prudence" were applicable to a director's acts in recommending a proposed merger.<sup>104</sup> The court then referred to the director's duty under the Delaware Code to submit to shareholders only those mergers recommended by the board.<sup>105</sup>

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99. *Id.* at 155, 382 N.W.2d at 587.

100. *Id.* at 152-53, 382 N.W.2d at 586.

101. *Id.* at 155, 382 N.W.2d at 587.

102. *Id.* at 153-54, 382 N.W.2d at 586.

103. *Id.* at 154, 382 N.W.2d at 586.

104. *Id.*

105. *Id.*

In *Moran v. Household International, Inc.*,<sup>106</sup> the adoption by the board of directors of a defensive mechanism providing for the issue to shareholders of certain rights in the event that a raider obtained more than a certain percentage of Household's outstanding stock was found to be valid. In reaching this conclusion, the Delaware Supreme Court determined that the business judgment rule was applicable to the transaction and that the directors had established that they had adopted the Rights Plan on the basis of their business judgment.<sup>107</sup> Significantly, the court observed that "Household did not adopt its Rights Plan during a battle with a corporate raider, but as a preventive mechanism to ward off future advances."<sup>108</sup> The court did not indicate the significance of this remark, which leads to speculation whether the decision would have been the same if the action had been taken in the heat of battle.

The court also observed that "when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."<sup>109</sup> This finding that a board's consideration of takeover strategy is one of the circumstances in which directors appear to have a direct fiduciary duty to shareholders seems to be an extension of the concept derived from *Van Gorkom* and *Cargill* that directors have such a duty in the context of a proposed merger. The court went on to state that "in that respect a board's duty is no different from any other responsibility it shoulders. . . ."<sup>110</sup>

The accuracy of this statement is questionable. In most instances, directors discharge any obligation under the business judgment rule by a decision made in the good-faith belief that it is in the best interest of the corporation, without regard to the interests of shareholders. With respect to a merger proposal or tender offer, however, the court in *Household International* acknowledged that the interests of the shareholders had to be considered. The court in effect determined that shareholders' rights were not yet on the line. The court said, however, that "when the Household Board

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106. 500 A.2d 1346 (Del. 1986).

107. *Id.* at 1356-57.

108. *Id.* at 1349.

109. *Id.* at 1350 (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)).

110. *Id.*

of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer."<sup>111</sup>

In response to the argument that the shareholders' rights plan would result in "a fundamental transfer of power from the stockholders to the directors," the court stated that the same was true of any tender offer defense mechanism and observed that many had been approved by Delaware courts.<sup>112</sup> The court seemed to view the building of these institutional defenses as conceivably justified irrespective of any effect this process might have on the shareholders as investors.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>113</sup> Revlon and its directors were enjoined from taking certain action that would have prevented maximization of shareholder profit in a sale of the corporation. As a defensive measure against a threatened takeover by Pantry Pride, Inc., Revlon had authorized and issued to shareholders rights to exchange their shares for one-year notes, such rights to be exercisable only in the event that someone acquired less than all but more than twenty percent of Revlon stock. The rights were not exercisable by the shares that were acquired, however. Furthermore, all rights could be redeemed by Revlon for \$0.10 each.<sup>114</sup>

Pantry Pride made a cash tender offer, and Revlon thereupon self-tendered for and obtained approximately one-third of its outstanding common stock in exchange for a package of securities, including notes containing covenants limiting Revlon's ability to incur new debt, sell assets, or pay dividends unless approved by nonmanagement directors. Pantry Pride then revised its tender offer.

Up to this point the board had acted only in a manner designed to protect Revlon and continue it as a going concern. The court determined that the measures taken prior to this time were consistent with the directors' fiduciary duty to the corporation. When Pantry Pride increased its offer, however, "it became apparent to all that the break-up of the company was inevitable."<sup>115</sup> The court

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111. *Id.* at 1354.

112. *Id.*

113. 506 A.2d 173 (Del. 1986).

114. *Id.* at 177.

115. *Id.* at 182.

observed that "the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."<sup>116</sup> The court evaluated the actions of Revlon directors after this time and found that they had engaged in "selective dealing" to fend off Pantry Pride, whereas "obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action."<sup>117</sup>

The court thus found that in these special circumstances the directors did indeed have a direct obligation to shareholders, an obligation in which the corporation itself really had no interest.<sup>118</sup> Per-

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116. *Id.*

117. *Id.*

118. One curious aspect of the *Revlon* decision is the fact that although the Chancery Court found that Revlon directors had breached a duty of loyalty they owed to shareholders, the Supreme Court of Delaware concluded that it was a breach of the duty of care. *Revlon*, 506 A.2d at 175 ("the Court of Chancery found that the Revlon directors had breached their duty of care"). This is emphatically not the case. The Chancery Court specifically found a breach of duty of loyalty. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250 (Del. Ch. 1985). It mentioned the duty of loyalty twice and later twice referred to the "fiduciary duty" of the board. *Id.* at 1250-51. The lower court made no other mention of fiduciary duties of any kind.

After originally characterizing the Chancery Court decision as one based on breach of the duty of care, the Delaware Supreme Court then stated, "[T]he trial court concluded that Revlon directors had breached their duty of loyalty . . ." 506 A.2d at 179. The court finally concluded, without analysis, that the directors had breached a duty of care. *Id.* at 185.

This conclusion is a double enigma. The inconsistent characterization of the basis of the decision of the Chancery Court and the unreasoned manner in which the Supreme Court approached the subject are puzzling. Furthermore, the facts of the case do not support a finding of a breach of the duty of care, and the court cites none. It is clear that the Revlon directors made a well-informed decision. The Chancery Court opinion contains the following observation: "The board may have been informed, but its performance did not conform to the other component of the business judgment rule—the duty of loyalty." 501 A.2d 1250. Could the court have had a policy reason for its decision to broaden the concept of the duty of care and to narrow the concept of the duty of loyalty?

In *Revlon*, the distinction between the duty of care and the duty of loyalty was of no significance. In the future, however, this distinction could be of great significance in an action for damages against directors in a context such as the attempted takeover of Revlon, and perhaps the court was aware of that. On June 10, 1986, three months after the *Revlon* decision, a bill introduced in the Delaware legislature proposed to amend § 102 of the Delaware General Corporation Law to permit Delaware corporations to adopt by amendment to the certificate of incorporation a provision "eliminating or limiting the personal liabilities of a director to the corporation or its stockholders for monetary damages" for what can safely be paraphrased as the good-faith breach of the duty of care. DEL. CODE ANN. tit. 8, § 102(b)(7) (1988). This bill reportedly was a reaction to the decision in *Van Gorkom*, in

haps it can be said that the status of directors changed from the *sui generis* position the law accords directors to one of agency or trusteeship, in which the directors were acting as and were in fact agents or trustees of the shareholders.

One wonders whether directors in such circumstances would be found to have all the duties of a trustee or an agent. If so, they would be liable directly to the shareholders and for the first time a rational basis would exist for supporting the common expression that directors have a fiduciary duty to the corporation *and its shareholders*.

The concept of such a relationship between the directors of a publicly held corporation and its shareholder would work a profound change in the law. For example, in the face of such a concept, a privately negotiated side benefit by a director of a merged corporation would have to be given over to shareholders. Furthermore, the director unquestionably would be required to disclose to shareholders all information concerning asset valuations or prior negotiations for the merger or sale of the company. Also, complaining shareholders would be able to proceed directly against directors, thus avoiding the procedural impediments associated with a derivative action. At present, the theory of director agency or trustee liability to shareholders in negotiations for the sale or merger of a corporation is only suggested in *Revlon*, but it appears to be the theory that was applied in *Van Gorkom*. Its further development, if any, will be watched with interest.<sup>119</sup>

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which directors were found liable in damages to shareholders for such a breach. The bill passed both houses promptly and was signed into law by the governor on June 18, 1986.

119. Delaware courts continue to cast the shadow of change on this area. In the recent case of *In re Anderson* (Clayton Shareholders' Litigation), 519 A.2d 669 (Del. Ch. 1986), the court stated:

First, and most importantly, the question whether shareholders have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made, is not a decision concerning the management of the business and affairs of the enterprise . . . of the kind the business judgment rule is intended to protect; it is rather a matter relating to the directors' duty to shareholders who are technically outside of the corporation.

*Id.* at 675. Here the court again articulates the idea that in a circumstance involving a potential sale of the corporation, directors have a direct obligation to shareholders, rather than to the corporation, to act in their interests.

## VI. CONCLUSION

It is reasonably clear from the cases that a shareholder exercising control is, to the extent of that control, a fiduciary to the other shareholders, and that he, as well as directors who do his bidding, are liable to other shareholders for breach of that duty. This imposition of fiduciary duty is justified by the fact that when shareholders exercise such control, the organization is no longer being managed according to the traditional concept of a corporation. As a consequence, the law applicable to corporate management is no longer relevant. Instead, relevant law is either trust law or that which would normally govern the relations of two or more persons associating directly in business—the law of agency.

Courts have much precedent in corporate law justifying their disregard of the corporate fiction in those instances in which the parties themselves do so, and it would seem that the principles developed in such cases should also be applicable to the cases discussed earlier in this Article. In each such case, the assessment of liability against the controlling shareholder in favor of the minority can be justified on the basis that the controlling shareholder occupied a position analogous to that of a partner, and as such was the agent in control of the business and had all the duties of an agent to the other shareholders.

There is also little question that where the controlling shareholders cause directors to breach their fiduciary duty to their corporation, they are liable to their corporation for having procured that breach. In such a case the offending shareholders have interfered with the justifiable expectations of parties to a consensual relationship.

As to the rights of shareholders versus directors, it was said more than fifty years ago that “[a]ny fair statement of the law would have to be based on the theory that the fiduciary duties of the director were limited to the corporation.”<sup>120</sup> Apparently, until recently that assessment has continued to be true in spite of the lip service paid to the duty of directors to shareholders. Recent interpretations of Delaware law, however, indicate a change when the director steps outside his traditional role of management oversight

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120. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 226 (1932).



and takes action directly affecting the shareholder. The making, soliciting, or discouraging of offers for a shareholder's interest is certainly such a circumstance.