Shareholder Duties under State Law

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SHAREHOLDER DUTIES UNDER STATE LAW

M. Thomas Arnold*

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I. INTRODUCTION

Corporate officers and directors owe significant duties to the corporation. Generally shareholders do not. This article reviews the role of shareholders in a corporation and the distinction between corporate and individual assets, and discusses the impact of these factors upon the extent of the duties imposed on shareholders. It then discusses the duties of a shareholder regarding shareholders' meetings and the voting of shares, the duties of a controlling shareholder, the duties of a shareholder in a closely-held corporation, and the duties of a shareholder selling or buying shares. The primary focus of the article is the duties of shareholders under state corporation law, with occasional references to duties which may exist under federal securities law. The purpose of the article is not only to discuss the specific legal doctrines regarding the duties of shareholders, but also to point out the connection between those doctrines and several more general ideas imbedded in the law of corporations.

II. THE ROLE OF SHAREHOLDERS IN CORPORATE AFFAIRS

Modern corporation statutes generally provide that the business and affairs of a corporation shall be managed by or under the direction of its board of directors, which is expected to act on behalf of all shareholders. Absent special circumstances, the shareholders of a corporation have no right to participate in the management of the business. While

1. Generally, the liability of shareholders to a corporation is limited to paying for the shares issued to them. See Revised Model Business Corp. Act § 6.22(a) (1984).


   Considerable evidence suggests that directors of publicly held corporations do not in fact perform the functions contemplated for them by corporation statutes, but instead play a much less significant role. See Myles L. Mace, Directors: Myth and Reality—Ten Years Later, 32 Rutgers L. Rev. 293 (1979).

3. Zahn v. Transamerica Corp., 162 F.2d 36, 45 (3d Cir. 1947) (holding that when a director votes as a director he or she represents all shareholders).
they may elect directors, adopt or alter bylaws, express their views on the management of the business, and approve or disapprove of certain extraordinary transactions proposed by the board of directors, they lack the power to initiate corporate action.

In most cases a requirement that shareholders approve corporate action would be unwise since a shareholder usually lacks the information necessary to decide how to vote on the matter and, in many cases, would view the cost of informing herself on and evaluating a matter as outweighing the expected benefit to her from the decision. For example, assume the potential benefit to a small shareholder from a change in suppliers is $10 and the cost to obtain adequate information and to evaluate it in order to vote is $50. In such a case, the rational economic decision for the shareholder is to be apathetic. In addition, many corporations could not function if shareholders were given a broad role in management. Thus, it is likely that most shareholders view the corporate managers as better able to decide most issues relating to the business of the corporation.

A majority of state corporation statutes permit the powers of the

7. See Auer v. Dressel, 118 N.E.2d 590, 593 (N.Y. 1954) (permitting shareholders to express opinion on removal of president even though they were powerless to reinstate him).
8. See, e.g., Revised Model Business Corp. Act §§ 10.03 (amending of articles of incorporation), 11.03 (plan of merger or share exchange), 12.02 (sale of all or substantially all of assets other than in regular course of business), 14.02 (dissolution) (1984).
9. See Gashwiler v. Willis, 33 Cal. 11, 19-20 (1867) (holding that shareholders have no power to authorize conveyance of corporate property). Under the modern view, action by a sole shareholder binds the corporation on the theory that the shareholder is the equitable owner of the assets of the corporation. See, e.g., L.R. Schmaus Co. v. Commissioner, 406 F.2d 1044, 1045 (7th Cir. 1969) (authorizing payment of bonuses by corporation); Rapp v. Felsenthal, 628 S.W.2d 258, 260 (Tex. App.—Fort Worth [2d Dist.] 1982, writ ref’d, n.r.e.) (holding corporation bound by employment contract entered into by shareholder even though directors never formally authorized the contract). Similarly, a corporation is generally bound by an act that is approved, even informally, by all shareholders unless the rights of corporate creditors are involved. See Philadelphia Life Ins. Co. v. Crosland-Cullen Co., 234 F.2d 780, 783 (4th Cir. 1956) (estopping corporation from denying assignment of life insurance policy because no rights of creditors shown to be involved); Snyder v. Freeman, 266 S.E.2d 593, 597-99 (N.C. 1980) (allowing plaintiff to prove alternatively that corporation was bound to a contract approved by all shareholders); Burger v. Western Sand & Gravel Co., 237 S.W.2d 725, 730 (Tex. Civ. App.—Amarillo, 1950, writ ref’d, n.r.e.) (holding corporation bound by lease renewal approved by all shareholders where corporation had no debts).
11. See Melvin A. Eisenberg, The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking, 57 Cal. L. Rev. 1, 10-12 (1969).
board of directors to be limited and the powers of shareholder to be expanded by the articles of incorporation.\textsuperscript{13} In addition, the Revised Model Business Corporation Act permits dispensing with the board of directors in corporations with 50 shareholders or less. To do so, the articles of incorporation must specify a person or group who will perform the duties of the board.\textsuperscript{14} The Delaware statute also permits the articles of incorporation to dispense with the board of directors with no limit on eligibility based upon the number of shareholders in the corporation.\textsuperscript{15} The shareholders exercising powers normally vested in the board of directors are subject to duties of directors where the articles of incorporation restrict the powers of the board of directors by requiring shareholder approval of an action or dispense with the board of directors by authorizing management by the shareholders.\textsuperscript{16}

A number of states have special statutory provisions permitting great flexibility in structuring the pattern of management for a close corporation. Generally an election is required in order for a corporation to be a statutory close corporation.\textsuperscript{17} Statutory close corporation status is often available only to corporations with a limited number of shareholders.\textsuperscript{18} These close corporation statutes usually validate shareholder agreements regulating the management of corporate affairs.\textsuperscript{19} A number of the statutes also permit the articles of incorporation of a close corporation to provide for operation without a board of directors.\textsuperscript{20}

In sum, state corporation statutes do not establish shareholder participation in management as the norm, but instead contemplate management by or under the direction of the board of directors. However,

\textsuperscript{13} See, \textit{Cal. Corp. Code} § 300(a) (West 1990) (permits setting limits in the articles of incorporation requiring an action to be approved by shareholders or by outstanding shares); \textit{Del. Code Ann. tit. 8, § 141(a)} (1991); \textit{N.Y. Bus. Corp. Law} § 620(b), (c) (McKinney 1986) (stating that provision is valid where articles of incorporation were approved by all incorporators or shareholders of record, but only if corporation's shares are not publicly traded); \textit{Revised Model Business Corp. Act} § 8.01(b) (1984); \textit{Model Business Corp. Act} § 35 (1969).

\textsuperscript{14} \textit{Revised Model Business Corp. Act} § 8.01(c) (1984).

\textsuperscript{15} \textit{Del. Code Ann. tit. 8, § 141(a)}.


\textsuperscript{18} See, e.g., \textit{Cal. Corp. Code} § 158(a) (limiting election to corporations with no more than 35 shareholders); \textit{Del. Code Ann. tit. 8, § 352 (limiting election of close corporation status to corporations with no more than 30 shareholders). But see Model Statutory Close Corp. Supp. § 3 & official cmt. (allowing all corporations except those having more than 50 shareholders at the time of the election to become a close corporation) (1984).}


modern corporation statutes provide the flexibility to tailor an alternative management structure.

III. THE IMPACT OF THE ROLE OF SHAREHOLDERS ON THEIR DUTIES

As discussed in the last section, the role of shareholders in the management of a corporation is generally very limited. Under the traditional rules of corporation law, a shareholder is an investor and the corporation is a vehicle to accumulate the funds of investors. Management is not viewed as a function of investors, but rather is a separate function which is centralized in the board of directors. In sum, shareholders are investors, not managers, and usually express their views on corporate management by buying and selling shares. In other words, they vote with their feet. Ultimately, however, the existence of shareholder voting rights makes it possible for the shareholders to change managers or to transfer their shares to a new investor who desires to install new managers.

The separation of the functions of management and investment creates a potential divergence in the interests of the managers of the corporation and its shareholders. The managers of a publicly-held corporation may own only a small percent of the corporate shares. If the managers divert a dollar of corporate assets or earnings into their own pockets, the majority of the cost will be borne by those shareholders who are not also managers. For example, if the managers own five percent of the corporate shares, then only five cents of every dollar they divert will be borne by them. The other ninety-five cents will be borne by other shareholders, presumably in the form of a reduced value for their shares. The same analysis applies where the managers shirk their duties. If a manager imposes costs on the corporation by shirking his or her duties,

22. Id. at 261.
23. Easterbrook & Fischel, supra note 12, at 396-97 (discussing this view).
24. Id. at 406-08 (noting that voting rights allow takeovers to occur).
26. This separation of ownership and control in the publicly-held corporation has been extensively discussed in the corporation law literature beginning with ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

While many authors have viewed the phenomenon as a source of grave concern, others have viewed it primarily as an efficient form of economic organization. Compare the articles cited in note 25 supra.
he or she will only have to bear a small portion of the costs. The imposition of fiduciary duties upon corporate managers operates to deter corporate managers from straying too far from the pursuit of the interests of the shareholders as residual claimants. If a manager violates his or her fiduciary duty to the corporation, the corporation or a shareholder acting on behalf of the corporation may sue to remedy the injury.

In view of the limited role that a shareholder plays in the management of a corporation, it is not surprising that the law has generally imposed minimal duties upon shareholders. There is no duty even to participate in the selection of the managers of the corporation or to vote upon extraordinary transactions proposed by those managers. There are special situations, however, where the law imposes duties upon shareholders. Determining when these situations exist and what the duties of a shareholder are in each situation often requires close analysis of the role of the particular shareholder.

First, the law imposes significant duties upon a shareholder who steps outside of the role of mere investor and either assumes or has the option to assume the role of manager. Predictably, these duties are similar to the duties imposed upon other corporate managers. Secondly, the law prohibits the sale of votes for a consideration which is personal to the shareholder or the sale of a corporate office. This is because the sale of votes or of a corporate office makes it less likely that the corporate manager or the decision of the managers approved or disapproved by the shareholders will benefit all investors. Or, put another way, it increases the risk that decisions will not maximize shareholder wealth. Thirdly,

27. See John A. MacKerron, Shareholder Derivative Litigation and the Nexus of Contracts Corporation, 40 KAN. L. REV. 679, 709-10 (1992) (fiduciary duties fill the gaps in the contract between the shareholders and the corporate managers; the duties help define the discretion of managers).

Fiduciary duties do not operate alone to reduce agency costs. There are a number of other factors which operate to align the interests of managers with those of shareholders and, thus, reduce agency costs. See, e.g., Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1, 18-32 (1990) (discussing a number of constraints on management conduct); Fischel, supra note 25, at 919 (discussing market mechanisms which minimize the divergence of managers' interests from those of shareholders).

28. See generally MacKerron, supra note 27. If a suit brought by a shareholder is successful, the amount recovered goes to the corporate treasury, but the shareholder-plaintiff may recover his or her legal expenses from the common fund. In theory, this avoids the "free rider" problem which would exist if the shareholder bringing the suit had to bear all the costs involved while at the same time sharing any benefits with the other shareholders. See Clark, supra note 10 at 786-87 (derivative suit solves collective action problem by allowing shareholder to hire an agent to seek a collective benefit and requiring the agent to be compensated by all shareholders if he or she succeeds).

29. See discussion infra part V.B.
30. See discussion infra parts V.E-F.
31. See discussion infra part V.D.
32. See discussion infra part VII.D.
the trend in the law is to impose the duties of partners upon shareholders in close corporations. The shareholders in a close corporation are commonly more than mere investors who contribute capital to be managed by others. Instead, the shareholders often contribute land or equipment, organizational skills, services, secret formulae, etc. More importantly, they often play an active role in corporate affairs. In short, there is often no clear separation of management and investment functions. Thus, the rules applicable to partners seem more appropriate than the rules applicable to shareholders in large publicly held corporations.

IV. THE IMPORTANCE OF CATEGORIZING ASSETS AND OPPORTUNITIES

It is hornbook law that a corporation is a legal entity separate from its shareholders with the capacity to own property in its own name. It is equally well-settled that shares of a corporation are the personal property of the shareholders who may transfer the shares and retain any gain. This distinction between corporate property and the property of individual shareholders is fundamental to determining the duty of a shareholder in many situations.

While a shareholder generally has no duty when dealing with an asset or opportunity that belongs to him or her, he or she may be liable when he deals with an asset or opportunity that fairly belongs to the corporation or where his or her negligence results in injury to or loss of corporate assets. For example, a controlling shareholder may not usurp a corporate opportunity. Similarly, where a transfer of shares includes compensation to the shareholder for the concomitant transfer of a corporate asset or opportunity, liability may be imposed upon the shareholder. Or where shares are transferred to another under circumstances which suggest that the purchaser may loot corporate assets, liability may be imposed upon the seller if such looting occurs.

33. See discussion infra part VI.A.
34. See Manne, supra note 21, at 278. See also discussion infra part VI.
35. See discussion infra part V.A.
38. See discussion infra parts V.E, VII.B, and VII.E.
39. See discussion infra part V.E.
40. See discussion infra part VII.E.
41. See discussion infra part VII.B.
It can be argued that viewing the corporation as a person is misleading since the corporation is merely the "nexus" of a set of contracts among various persons, such as managers, investors, employees, creditors, suppliers, etc. However, even under a nexus of contracts approach to the corporation, the shareholders are viewed as the residual owners of the corporation. In other words, the terms of their contract entitle them to any gains that exist after the legitimate claims of other contracting parties, including the managers, are met. The fiction of the corporate person and the concept of corporate assets helps demarcate the legally protected residual interest of corporate shareholders. The implicit contract between shareholders and corporate managers gives the managers extensive discretion to use corporate assets for corporate purposes, but prohibits them from using such assets for personal purposes.

V. FIDUCIARY DUTIES OF A SHAREHOLDER

A. In General

Absent special circumstances a shareholder does not stand in a fiduciary relationship to the corporation or to other shareholders in regards to the affairs of the corporation. Thus, a shareholder has no duty to participate in shareholder meetings. In addition, a shareholder may generally act in his or her own self-interest in voting or in granting a

42. Butler & Ribstein, supra note 27, at 7 (corporation is product of contracts among participants in the business); Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416, 1426 (1989) (personhood of corporation "is a matter of convenience rather than reality;" corporation is disparate independent actors; the arrangements among the actors depend upon contract and not the status of the corporation as a legal person); Fischel, supra note 25, at 917 (corporation is merely legal fiction which serves as nexus of contracts among individuals).

43. MacKerron, supra note 27, at 703 (shareholders are residual claimants to cash flow or liquidation proceeds after the contract claims of other participants are satisfied); Terry A. O'Neill, Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations, 22 SETON HALL L. REV. 646, 655 (1992) ("The notion that shareholders are residual claimants, and not owners, is a central insight offered by the contract theory of the firm.").

44. In this regard, it might be observed that the law recognizes that a partnership may own property in its own name, UNIFORM PARTNERSHIP ACT § 8, 6 U.L.A. 1, 115 (1969), even though the partnership is not a legal entity. Here too, attributing ownership of the assets of the business to the business itself rather than to the owners of the business permits the enforcement of rules designed to limit and to remedy the diversion of assets and the earnings from those assets in violation of the implicit contract of the parties. Cf. UNIFORM PARTNERSHIP ACT § 21, 6 U.L.A. 1, 258 (1969) (partner must account to the partnership for any benefit derived from use of partnership property without the consent of the other partners) and id. § 25(2)(a), 6 U.L.A. at 326 (partner has right to possess partnership property for partnership purposes, but not right to possess for any other purpose without consent of other partners).


46. See discussion infra part V.B.
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proxy appointment, but is usually proscribed from selling his or her vote.

A controlling shareholder who enters into a transaction with the corporation is, however, subject to a fiduciary duty of intrinsic fairness to the corporation where the shareholder controls the transaction and dictates the term. In addition, a controlling shareholder may not usurp opportunities which fairly belong to the corporation or use the power to control the corporation in a manner that benefits herself at the expense of the interests of the minority shareholders.

Finally, in some jurisdictions the case law holds that shareholders in a closely-held corporation owe each other fiduciary duties similar to those owed by the partners in a partnership, although it is possible to contract out of these duties.

B. Failure or Refusal to Participate in Shareholder Meetings

Absent special circumstances, a shareholder has no obligation to attend or to participate in shareholder meetings. Therefore, a court will not compel a shareholder to attend a shareholder meeting in order to ensure the existence of a quorum. As a result, a shareholder who holds enough shares can exercise a stay away veto by refusing to attend meetings of shareholders. In one case, for example, the holder of fifty percent of the shares in a corporation refused to attend any shareholder meetings in order to prevent the election of new directors. Since no new directors could be elected, the old board of directors, controlled by the recalcitrant shareholder, continued in office. The case holds that a court may not compel the shareholder to attend the meeting since the shareholder is under no legal duty to attend.

Arguably the refusal of a shareholder to attend shareholder meetings is oppressive conduct where the refusal results in a lack of a quorum.
for the meetings. However, one case holds that the failure of the controlling shareholders in a corporation to attend two special shareholder meetings called by a minority shareholder is not oppressive conduct since a shareholder has no affirmative duty to attend or participate in shareholder meetings. The opinion notes that the plaintiff was not injured by the failure of the controlling shareholders to attend the meetings and that the controlling shareholders attended the annual meeting of shareholders three months after the meetings called by shareholders. Where the refusal of a controlling shareholder to attend shareholder meetings extends over a long time period and actually causes injury to minority shareholders, a court might find that such conduct is oppressive because it defeats reasonable expectations of the minority shareholders which were central to their decision to join the enterprise, such as the expectation that they could participate in the election of directors.

In some states a shareholder may be able to bring an action to compel an annual meeting of shareholders regardless of the refusal of a shareholder to attend. For example, the Delaware statute provides that if the annual meeting is not held within 30 days of the date designated for the meeting or, if no date is designated, within 13 months of incorporation or of the last annual meeting, "the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director." Similarly, the California statute permits the superior court of the proper county to summarily order a shareholder meeting upon the application of any shareholder if there is a failure to hold the annual meeting for a period of 60 days after the date designated for the meeting or, if no date is designated, for a period of 15 months from the date of organization of the corporation or of its last annual meeting. Both the California and Delaware statutes provide that the shares present in person or by proxy constitute a quorum for the purpose of the meeting regardless of any provision to the contrary in the articles of incorporation or bylaws.

59. Judicial dissolution of a corporation may be authorized if the directors or those in control of the corporation act in an oppressive manner. See, e.g., REVISED MODEL BUSINESS CORP. ACT § 14.30(2)(i) (1984); MODEL BUSINESS CORP. ACT § 97(a)(2) (1969).
61. Id.
63. Cf. Hall v. Hall, 506 S.W.2d 42, 45-46 (Mo. Ct. App. 1974) (conceding that the failure of one equal shareholder to attend the annual shareholders' meeting rendered the other shareholder's shares impotent and injured the shareholder by "preventing her from participating in the management of the corporation").
64. DEL. CODE ANN. tit. 8, § 211(c) (1991).
65. CAL. CORP. CODE § 600(c) (West 1990).
66. Id.; DEL. CODE ANN. tit. 8, § 211(c).
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Under many modern corporation statutes the requirement of a board of directors may be dispensed with so that a corporation may be managed by its shareholders. Where management of a corporation is placed in the hands of the shareholders, the shareholders are subject to the duties of directors, including the duty of due care. Case law establishes that the duty of care requires a director to attend meetings of the board of directors as a regular practice, although missing a single meeting for adequate reasons is not a breach of duty. Presumably shareholders who have the power to manage a corporation's affairs are subject to an obligation to attend shareholder meetings on a regular basis and are not privileged to exercise a stay away veto.

C. Voting in Self-interest

A shareholder is not disqualified from voting on a matter at a meeting of shareholders merely because the shareholder has a personal interest in the matter. Absent special circumstances a shareholder may vote even though he or she is motivated by selfishness or by mere whimsy, and is not required to vote in a manner that sacrifices his or her interests to those of the other shareholders. For example, one case holds that a majority shareholder is not disqualified from voting on the question of

67. See, e.g., DEL. CODE ANN. tit. 8, §§ 141(a), 351 (respectively requiring inclusion in articles of incorporation provision for eliminating board of directors, and allowing statutory close corporations to be managed by shareholders if articles of incorporation so provide); REVISED MODEL BUSINESS CORP. ACT § 8.01(c) (1984) (allowing corporations with 50 or fewer shareholders to dispense with board of directors as long as articles of incorporation so provide).
68. DEL. CODE ANN. tit. 8, §§ 141(a), 351; MODEL BUSINESS CORP. ACT ANN. § 8.01 official cmt. (3d ed. 1992).
71. Id. v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924) (noting that director had attended the first of two meetings and holding that he had an adequate excuse for his missing the second).
72. Compare the majority and dissenting opinions in Gearing v. Kelly, 182 N.E.2d 391 (N.Y. 1962), in which a director refused to attend board meeting to prevent a quorum. Directors are also obliged to obtain a rudimentary understanding of the corporation's business and to keep informed about the activities of the corporation. See Francis, 432 A.2d at 821-22 (explaining duties of corporate director).
75. See Tanzer, 379 A.2d at 1123-24 (addressing merger between parent and subsidiary corporation); Kentucky Package Store v. Checeni, 117 N.E.2d 139 (Mass. 1954) (reviewing shareholder vote on whether corporation should repurchase the shares of the majority shareholder).
whether the corporation should exercise an option to purchase her shares.\textsuperscript{76} Further, a majority shareholder is not disqualified from voting on the question of whether the corporation should merge with the majority shareholder.\textsuperscript{77} Similarly, a shareholder may vote on a question of corporate policy even though he or she is related to someone who favors or opposes the policy.\textsuperscript{78}

The rule that a shareholder may vote in his or her self-interest does not prevent a court from reviewing a transaction which requires the approval of shareholders where a shareholder is on both sides of the transaction.\textsuperscript{79} A controlling shareholder has a fiduciary duty to deal fairly with the corporation in any transactions with it.\textsuperscript{80} Thus, a majority shareholder does not have the power in his or her capacity as shareholder to ratify a sale of corporate assets to himself or herself at an inadequate price\textsuperscript{81} or to ratify a sale of his property to the corporation on unfair terms.\textsuperscript{82} Similarly, a court may review the fairness of merger between a corporation and a controlling shareholder in spite of shareholder approval of the merger.\textsuperscript{83} In jurisdictions which hold that shareholders in close corporations owe each other fiduciary duties similar to those owed by partners in a partnership,\textsuperscript{84} a court may review transactions approved by shareholders to determine whether the transaction represents a breach of fiduciary duties.\textsuperscript{85}

In summary, the rule that a shareholder is not disqualified from voting because of self-interest is rule of convenience. First, a rule requiring disqualification due to self-interest would be unworkable when applied to many closely-held corporations.\textsuperscript{86} In these corporations many decisions

\begin{itemize}
\item \textsuperscript{76} Kentucky Package Store, 117 N.E.2d at 141-42.
\item \textsuperscript{77} Tanzer, 379 A.2d at 1123-24.
\item \textsuperscript{78} Du Pont v Du Pont, 256 F. 129, 185 (3rd Cir.), cert. denied, 250 U.S. 642 (1919).
\item \textsuperscript{79} See, e.g., Solomon v. Atlantis Dev., 516 A.2d 132 (Vt. 1986) (addressing purchase of corporate assets by a shareholder).
\item \textsuperscript{80} See discussion infra part V.F. Cf. A.L.L., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 5.01 (Proposed Final Draft 1992) (expounding duties of loyalty of directors, senior executives, and controlling shareholders) [hereinafter PRINCIPLES].
\item \textsuperscript{81} See Chicago Hansom Cab Co. v. Yerkes, 30 N.E. 667 (Ill. 1892).
\item \textsuperscript{82} Cf. Gamble v. Queens County Water Co., 25 N.E. 201 (N.Y. 1890) (ordering new trial at which trial court should examine whether discrepancy between price of sale ratified by majority of disinterested shareholders and value of the property to the corporation was so great that it should be condemned as fraud).
\item \textsuperscript{83} See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
\item \textsuperscript{84} See discussion infra part VLA, B.
\item \textsuperscript{85} See, e.g., Solomon v. Atlantis Dev., 516 A.2d 132 (Vt. 1986) (holding that under Massachusetts law, the sale of assets to a shareholder which was approved by three of the four principle shareholders after a discussion and the rejection of various alternatives did not constitute breach of fiduciary duties).
\item \textsuperscript{86} Stevens v. Richardson, 755 P.2d 389, 394-95 (Alaska 1988).
\end{itemize}
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have a financial impact on shareholders. Requiring disqualification of interested shareholders would often give minority shareholders a veto power over corporate action.87 Second, it is easier for a court to “examine, appraise, and adjust the fairness of the ultimate results, than it is to attempt to divine and adjudicate the validity of the complex factors that motivate shareholder voting.”88 Similar considerations apply to the decision of a shareholder to appoint a proxy.89

While shareholders may vote in their own self-interest, they generally may not sell their votes.90 In addition, there is “radical difference” when a shareholder-director is voting as a director; a director must act for the benefit of all shareholders and may not act for his or her personal benefit at the expense of the other shareholders.91 The distinction between actions as a shareholder and as a director is illustrated by a case which holds that a director who votes in favor of a sale of corporate assets may vote against the proposal as a shareholder and seek an appraisal of his or her shares.92 Even where the sale is in the best interests of the corporation, the shareholder-director has no fiduciary duty to vote his or her shares for the benefit of the corporation and other shareholders.93

Some corporation statutes provide that the votes of interested shareholders are not counted in determining whether a transaction in which a director has a conflicting interest is immune from attack on the basis of that conflict of interest.94

87. Id. In Stevens, a real estate commission was paid to an officer-director-shareholder. The court rejected a rule requiring disqualification of that shareholder because it would give veto power to the minority and lead to unfairness.


89. Du Pont v. Du Pont, 251 F. 937, 945 (D. Del. 1918) (refusing to inquire into the motive of shareholders in appointing proxies), aff’d as modified, 256 F. 129 (3rd Cir.), cert. denied, 250 U.S. 642 (1919).

90. See discussion of selling votes, infra part V.D.

91. See Zahn v. Transamerica Corp., 162 F.2d 36, 45 (3rd Cir. 1947).


93. Id. at 583-84.

94. See CAL. CORP. CODE § 310(a)(1) (West 1990) REVISED MODEL BUSINESS CORP. ACT §§ 8.61(b)(2), 8.63 (1984) (amending and replacing former §§ 8.31 and 8.32); Some states have enacted control share statutes that prohibit an acquirer of a threshold level of shares from voting those shares without the approval of the shareholders of the target corporation. In addition, some states have enacted business combination statutes that prohibit an acquirer of a threshold level of shares from entering into certain business transactions with the corporation unless specified conditions are met. See generally Evelyn Sroufe & Catherine Gelband, Business Combination Statutes: A “Meaningful Opportunity” For Success?, 45 BUS. LAW. 891 (1990).
D. Selling Votes

Generally a contract in which voting rights are sold for a consideration personal to the shareholder is against public policy and not enforced. In addition, an action may be brought to enjoin the voting of shares pursuant to such an agreement or to disallow votes cast pursuant to the agreement. A contract in which a shareholder receives consideration personal to the shareholder in return for not voting or participating in corporate affairs is subject to the same rules as a contract to sell votes.

The improper consideration promised or provided to a shareholder in return for his or her vote can include money, employment by the corporation, employment of a family member by the corporation, or any further consideration personal to the shareholder. In fact, one author argues that a "standstill agreement" in which an entity that owns shares in a corporation agrees to vote the shares in elections of directors in the manner directed by the management of the corporation in return for representation on the board of directors, securities registration rights, and/or other consideration constitutes the illegal sale of votes.

95. Dieckmann v. Robyn, 141 S.W. 717, 718 (Mo. Ct. App. 1911) (sustaining grant of demurrer in suit by shareholder seeking promised consideration). See also N.Y. Bus. Corp. Law § 609(e) (McKinney 1986); Restatement (Second) of Contracts § 193 cmt. a (1981).


98. See Brady v. Bean, 221 Ill. App. 279, 283-84 (1921) (disallowing as contrary to public policy a sale whose only supporting consideration was shareholder's agreement to make no further objection to a sale of corporate property).

99. Macht, 194 A. at 22 (finding that preferred shareholders were paid money in return for depositing their shares with a "protective committee").

100. Cone Ex'rs v. Russell, 21 A. 847, 848 (N.J. Ch. 1891) (employment as manager of corporation for a fixed term at a fixed salary).


102. Id. See also Chew v. Inverness Management Corp., 352 A.2d 426 (Del. Ch. 1976) (holding that in sale of shares with a negative book value, proxies given in return for ten cents per share for an option to buy the shares at prices of from $20 to $80 was improper consideration); Dieckmann v. Robyn, 141 S.W. 717 (Mo. Ct. App. 1911) (ruling that promise to pay one-half of all money in excess of $12,500 less commission paid by corporation for land sold to it by the defendant was improper consideration).


Some authors have argued that a person who is seeking control of a large corporation should be permitted to purchase the proxies of shareholders, subject to specified limits, as an alternative to a traditional proxy fight or tender offer. See Thomas J. Andre, Jr., A Preliminary Inquiry into the
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The sale of votes in return for a consideration personal to the selling shareholder is against public policy because it is viewed as a breach of duty to the other shareholders. In theory, each shareholder in a corporation is protected by the tendency of other shareholders to "promote the best interests of all, in order to promote his individual interests [as a shareholder]." The shareholder who sells his or her vote gives up the right to exercise discretion on the question of how to vote and, consequently, other shareholders may be injured.

However, injury to the corporation or to the other shareholders is not the inevitable effect of vote selling. Therefore, an agreement in which a shareholder exchanges his or her vote in return for a consideration personal to the shareholder should not be per se invalid, but rather should merely be subject to a rebuttable presumption of invalidity. The agreement should be valid if it is intrinsically fair to the other shareholders or if it is approved by a majority of the independent shareholders after full disclosure of all material facts. In addition, where all shareholders consent to the vote selling transaction, the agreement is enforceable.

A significant Delaware case holds that an agreement involving the sale of votes is not per se invalid. The case involved a proposed merger between two corporations. A shareholder of one of the corporations held all the shares of one class of shares and consequently had the power under the corporation's articles of incorporation to block the merger by voting against it. The shareholder opposed the merger because it would impose a large income tax burden on it. In order to overcome the resistance of this shareholder, the corporation in which the shareholder owned shares provided the shareholder with a loan so that it could avoid the adverse tax consequences of the merger by exercising


104. See Macht v. Merchants Mortgage Credit Co., 194 A. 19, 22 (Del. Ch. 1937) ("in fraud of the other stockholders"); Dieckmann v. Robyn, 141 S.W. 717, 718 (Mo. Ct. App. 1911) (finding constructive fraud on the corporation and the other shareholders); RESTATEMENT (SECOND) OF CONTRACTS § 193 cmt. a (1981) (promise violates or tends to induce violation of fiduciary duties).


106. See Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (finding that purpose of the challenged agreement was to benefit all shareholders).


110. Schreiber, 447 A.2d at 25.
certain warrants. The loan was contingent upon a vote of the other shareholders, who overwhelmingly approved it after disclosure of all material facts. The court held that the sale of votes by a shareholder is not per se invalid, but rather is "a voidable transaction subject to a test for intrinsic fairness," and is susceptible to ratification by a majority of the independent shareholders.

The holding in the case is sensible. The shareholder receiving the loan in return for not opposing the merger is entitled to vote in its own interest and against the merger. The wealth of shareholders as a group is maximized by a rule which upholds the vote selling arrangement where the other shareholders, after full disclosure, ratify it or where it is proven that all shareholders benefit from the transaction.

An agreement by a shareholder to vote in a certain manner solely in return for a benefit "that will accrue to all shareholders through the ownership of shares" is not invalid as against public policy. For example, where a shareholder of a corporation that is in financial difficulty agrees to vote for a person as a director in return for a sizeable loan to the corporation, the agreement is enforceable. The arrangement benefits all the shareholders of the corporation and, in addition, it is not unreasonable for the lender to desire the ability to protect his or her interest as a creditor.

An agreement solely among shareholders to vote their shares in a particular manner in order "to obtain the advantages of concerted action" is not vote selling and is not against public policy. In fact, most modern corporation statutes expressly authorize such shareholder voting agreements.

E. Fiduciary Duties of a Controlling Shareholder

A shareholder who exercises control over or "dominates" a corporation's affairs is a fiduciary. A controlling shareholder performs the
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function of and is subject to the duties of a director. In other words, he or she is more than a mere investor. If a controlling shareholder is not subject to a fiduciary duty, "then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs." Thus, a shareholder who controls a corporation is subject to a fiduciary duty not to use control over the corporation to obtain a benefit at the expense of the corporation or the minority shareholders. For example, where a parent corporation enters into a contract with a subsidiary, breaches the contract, and causes the subsidiary to refrain from enforcing the contract, the parent corporation must prove that its actions were intrinsically fair to the subsidiary. Where the breach involves failure of the parent to make timely payments and failure to order the minimum quantities required by the contract, the parent receives a benefit to the detriment of the minority shareholders and must account for the damages caused by its breach of contract.

As a fiduciary, a controlling shareholder may not, for example: (1) usurp corporate opportunities belonging to the corporation; (2) use corporate assets to pay for the purchase of shares; (3) appropriate the

F.2d 369, 372 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942). See also Principles, supra note 80, § 5.11.


Where a shareholder holds shares with less than a majority voting power, proof of actual exercise of control by the shareholder is necessary to establish that he or she is a controlling shareholder. See Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971); Principles, supra note 72, § 1.10 (defining "controlling shareholder"). However, the mere fact that a shareholder joins in a majority vote does not make him or her a controlling shareholder. See Stringer v. Car Data Sys., Inc., 821 P.2d 418, 419-20 (Or. Ct. App. 1991), in which 32 shareholders were able to outvote four other shareholders by 57% to 43% on an issue.

Additionally, a large shareholder who is making a hostile bid for the corporation's shares is clearly not a controlling shareholder and thus has no fiduciary duties to other shareholders. In re Sea-Land Corp. Shareholders' Litig., No. Civ. A. 8453, 1988 WL 49126 at *2-3 (Del. Ch. May 13, 1988).

121. Allied Chem. & Dye Corp. v. Steel & Tube Co., 120 A. 486, 491 (Del. Ch. 1923) (explaining that when majority shareholders determine the policy of the corporation "they are, for the moment, the corporation").

122. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971).

123. Id.

124. Id.

125. Schreiber v. Bryan, 396 A.2d 512, 518-19 (Del. Ch. 1978) (relying on Equity Corp. v. Milton, 221 A.2d 494, 497 (Del. 1966), and denying summary judgment because fact issue existed as to whether a corporate opportunity was usurped); David J. Greene & Co. v. Dunhill Int'l, 249 A.2d 427, 434-35 (Del. Ch. 1968); Principles, supra note 80, § 5.12.

126. Maggiore v. Bradford, 310 F.2d 519, 521-22 (6th Cir. 1962) (holding that in a derivative suit, rescission of a transaction before the court had an opportunity to decide the merits of the case did not defeat the right of minority shareholders to recover attorneys' fees), cert. denied, 372 U.S. 934 (1963).
going concern value of a profitable corporation by, for example, dissolving the corporation and purchasing its assets; use its voting power to amend the articles of incorporation to benefit one class of shareholders at the expense of another in order to further its own interests; use its control over the corporation to appropriate the value of appreciated corporate assets to the exclusion of the other shareholders; or time a corporate action or transaction so as to injure the minority shareholders while benefiting the controlling shareholder.

While an action that benefits the controlling shareholder and harms the corporation or the minority shareholders is subject to a test of intrinsic fairness, an action that benefits all shareholders on a pro rata basis is subject to the business judgment rule. Thus, the decision of a subsidiary corporation to declare a lawful dividend in excess of its current earnings, allegedly because of the parent corporation's need for cash is subject to the business judgment rule where the minority shareholders receive a proportionate share of the funds.

Some authority suggests that it is a breach of fiduciary duty for a controlling shareholder to use his or her control over the corporation to obtain a benefit that is not available to other shareholders even where there is no harm to the minority shareholders. In one well-known case the majority shareholders in a savings and loan transferred their shares to a holding corporation in exchange for shares of the holding corporation. The minority shareholders were not offered an opportunity to exchange their shares. The holding corporation, which held over 85% of the shares of the savings and loan, then made public offers of its shares. Since the book value of the savings and loan shares was very high, the availability of the lower priced shares of the holding company apparently

132. Id. at 720-22. The court noted in dicta that where a corporation has two classes of shares, one held by the controlling shareholder or parent corporation and the other by minority shareholders, the declaration of a dividend on only the class held by the majority shareholder might be subject to the intrinsic fairness test. Id. at 721.
133. See PRINCIPLES, supra note 80, § 5.11(a)(2). The receipt of a premium price for controlling shares is not, however, a violation of a controlling shareholder's fiduciary duties. See discussion infra part VII.C.
decreased in the marketability of minority's shares in the savings and loan.\textsuperscript{135} Eventually the holding corporation offered to exchange its shares for those of the minority shareholders in the savings and loan, but on terms much less favorable than those received by the majority shareholders.\textsuperscript{136}

The case holds that majority shareholders "may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."\textsuperscript{137} The power to control the corporation, according to the court, must be used "to benefit all shareholders proportionately ...."\textsuperscript{138} The court was troubled by the fact that the majority shareholders formed a holding corporation in order to create a market for the shares of the savings and loan instead of simply splitting the savings and loan's shares.\textsuperscript{139} Thus, the creation of the savings and loan took the place of a corporate transaction for the benefit of all the corporation's shareholders. The court concluded that the majority had a duty to offer the minority an opportunity to exchange their shares in the savings and loan for shares in the holding corporation on the terms available to the majority shareholders. While the case includes broad statements regarding the use of control to benefit all shareholders, the opinion suggests that the actions of the majority shareholders actually injured the minority shareholders by destroying any market for their shares in the savings and loan.\textsuperscript{140}

Most cases finding breach of fiduciary duty by a controlling shareholder involve an element of harm to the minority shareholders.\textsuperscript{141} An exception is found in several cases holding that a parent corporation may not retain the entire tax savings which result from the filing of a consolidated return with its subsidiary.\textsuperscript{142}

\textsuperscript{135} Id. at 476.

\textsuperscript{136} The majority shareholders received 250 shares in the holding corporation for each share in the savings and loan. \textit{Id.} at 467. The minority shareholders were offered 51 shares for each share of the savings and loan. \textit{Id.} at 468.

\textsuperscript{137} Id. at 471.

\textsuperscript{138} Id.

\textsuperscript{139} Id. at 475.

\textsuperscript{140} Id. at 476.

\textsuperscript{141} \textit{Cf.} Crain v. Elec. Memories & Magnetics Corp., 123 Cal. Rptr. 419, 427-28 (Cal. Ct. App. 1975) (holding that complaint stated cause of action by alleging that majority shareholder generated for its own purposes substantial cash from sale of corporate assets and left plaintiffs locked into ownership of a shell corporation).

F. Self-Dealing by a Controlling Shareholder

A controlling shareholder who causes the corporation to enter into a transaction with himself or herself is under a duty of intrinsic fairness towards the corporation. If the transaction is challenged, the controlling shareholder bears the burden of showing that the transaction is intrinsically fair to the corporation unless it is approved by the disinterested minority shareholders after full disclosure of all material facts regarding the transaction and the controlling shareholder's interest in it. Approval of the transaction by the disinterested minority shareholders after full disclosure shifts the burden of proof to any shareholder who challenges it. A fact is material to a transaction if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

One form of controlling shareholder is the parent corporation. Contracts between parent and subsidiary corporation, therefore, are subject to an intrinsic fairness test. In addition, mergers between a parent and a subsidiary corporation are subject to scrutiny under the intrinsic fairness test. If the contract or merger is approved by the disinterested minority shareholders after full disclosure of all material facts, the burden of proving that the transaction is unfair shifts to the shareholder challenging it. However, the parent corporation as controlling shareholder bears the burden of proving that all material facts were revealed.

The business judgment rule applies to a transaction between a controlling shareholder and a corporation where the terms of the transaction

A.2d 789, 792-94 (Del. Ch. 1967) (holding that it is impossible to set fair standards for allocation since that question is one of business judgment); Case v. New York Cent. R.R., 204 N.E.2d 643, 647 (N.Y. 1965) (finding no loss or disadvantage to subsidiary, and that subsidiary benefited from disputed agreement).

143. Seventeen Stone Corp. v. General Tel. Co., 204 F. Supp. 885 (S.D.N.Y. 1962) (majority shareholder allegedly purchased $14,000,000 of shares for $7,000,000); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (involving parent corporation). See also Principles, supra note 80, § 5.10.

144. Sinclair Oil Corp., 280 A.2d at 720.

145. Schreiber v. Pennzoil Co., 419 A.2d 952, 957-59 (Del. Ch. 1980) (approval by 96% of shares voted after full disclosure); Principles, supra note 80, § 5.10(b). Approval by the disinterested outside directors may have the same effect. See Furn v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (transaction between corporation and holders of 44% of shares; valuation by majority of independent directors assisted by independent experts; business judgment test applied).


149. Rosenblatt, 493 A.2d at 937; Weinberger, 457 A.2d at 703.

150. Rosenblatt, 493 A.2d at 937; Weinberger, 457 A.2d at 703.
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are determined by competitive bidding or where the transaction involves fungible goods or services offered to the general public by the shareholder at terms fixed in advance. Similarly, where the terms of a transaction between a controlling shareholder and the corporation are set by the state or federal government rather than by the shareholder, the transaction is subject to the business judgment rule and not the intrinsic fairness test. The fact that specific transactions are approved as fair by the state or federal government does not, however, immunize from review under the intrinsic fairness test the policy of a parent corporation of treating a subsidiary corporation as a captive market. The approval of a specific transaction or series of transactions does not import approval of a policy of denying a subsidiary the opportunity to choose when and with whom to contract. Thus, a corporation that treats its subsidiary as a captive market for the sale of airplanes is required to account for any damages to the subsidiary resulting from the inability of the subsidiary to obtain needed aircraft from other sources. The fact that the parent eventually sells airplanes to the subsidiary on fair terms approved by the federal government does not prevent application of the intrinsic fairness test to the policy of the parent.

The business judgment rules also applies to a transaction between a large shareholder and the corporation where the shareholder does not control the corporation. One case holds that a shareholder who owned 23% of the shares in General Motors Corporation and designated five of its thirty-four directors was not a controlling shareholder. Thus, transactions between the shareholder and the corporation were not subject to the intrinsic fairness test. However, a shareholder who does not have absolute control by virtue of ownership of a majority of voting shares may still have working control by virtue of a substantial minority


153. Trans World Airlines, 374 A.2d at 12.

154. Id. See also Summa Corp. v. Trans World Airlines, 540 A.2d 403, 407-09 (Del. 1988) (affirming lower court findings on amount of damages caused by policy of treating subsidiary as a captive market).

155. See, e.g., Gottesmann, 279 F. Supp. at 383-84 (imposing fiduciary duty only where shareholder dominates affairs of corporation).

156. The court also held that the transactions in question were fair since they were negotiated in the same manner as any similar transaction. Thus, the corporation paid no more than the price available from other suppliers, and the quality of the goods and services was at least equal to that offered by other sources. Id. at 385.
share interest combined with control over the corporation's proxy machinery.\textsuperscript{157} Whether a shareholder has working control is therefore a question of fact.\textsuperscript{158}

VI. FIDUCIARY DUTIES OF A SHAREHOLDER IN A CLOSELY-HELD CORPORATION

A. The Duty and Its Limits

The closely-held corporation is usually an intimate business relationship that bears a greater resemblance to a partnership than to a publicly held corporation.\textsuperscript{159} "[C]lose corporations frequently originate in the context of relationships personal in nature, often undertaken by family members or friends."\textsuperscript{160} The minority shareholder in a closely-held corporation often invests a substantial amount of time or money in the business, and may rely heavily on the expectation of a return on this investment in the form of a salary or dividends.\textsuperscript{161} Unfortunately, however, a minority shareholder in a closely-held corporation is more vulnerable to oppression by the majority shareholder than minority shareholders in publicly-held corporations.\textsuperscript{162} Unlike shareholders in a corporation whose shares are publicly traded, a minority shareholder in a closely-held corporation by definition has no ready market for the sale of his or her shares and, thus, cannot escape an oppressive situation through the sale of the shares.\textsuperscript{163}

In recognition of the plight of minority shareholders in closely-held corporations and the resemblance of a closely-held corporation to a partnership, the clear trend in the case law is to impose on the shareholders in a closely-held corporation fiduciary duties analogous to those owed by a partner in a partnership.\textsuperscript{164} In the leading case of \textit{Donahue v. Rodd}

\textsuperscript{157} See Adolf A. Berle, Jr., "Control" in Corporate Law, 58 Colum. L. Rev. 1212, 1213 (1958) (discussing working control).

\textsuperscript{158} Cf. Essex Universal Corp. v. Yates, 305 F.2d 572, 579 (2d Cir. 1962) (upholding contract calling for resignation and replacement of board in connection with purchase of shares as not against public policy if shares represented working control).

\textsuperscript{159} See \textit{Donahue v. Rodd Electrotype Co.}, 328 N.E.2d 505, 512 (Mass. 1975).

\textsuperscript{160} Fought v. Morris, 543 So. 2d 167, 171 (Miss. 1989).


\textsuperscript{162} \textit{Donahue}, 328 N.E.2d at 513-15.

\textsuperscript{163} Id. at 514.

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Electrotype Co., a group of shareholders owning enough shares to control a closely-held corporation caused it to repurchase 45 shares for $800 per share. The shares were purchased from the father of three shareholders in the controlling group. The minority shareholders in the corporation offered to sell their shares to the corporation on the same terms given to the father of the other shareholders, but were informed that the corporation would not purchase the shares. The minority shareholders then brought suit, seeking rescission of the share repurchase.

The case holds that the shareholders in a closely-held corporation "owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another." According to the court, this duty is a strict duty of good faith and loyalty. The court found that this duty is violated when a member of the controlling group of shareholders is given an opportunity to sell his or her shares to the corporation while a minority shareholder is denied an equal opportunity to sell a ratable number of shares. The member of the controlling group is provided benefits not available to the minority, namely a market for his or her shares and access to corporate assets for personal use. The court remanded the case to the trial court for a determination of appropriate relief which, according to the court, may be either rescission of the share repurchase or purchase by the corporation of the shares of the minority shareholders at a price of $800 per share.

Several post-Donahue decisions also deal with the propriety of share repurchases by a closely-held corporation. In one case, a shareholder in a closely-held corporation caused the corporation to repurchase the shares of another shareholder in order to perpetuate his control of the corporation by preventing the purchase of the shares by a third shareholder. The court held that the duty of good faith required the corporation to authorize the repurchase of the shares of the third shareholder.

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165. 328 N.E.2d 505.
166. Id. at 515 (footnote omitted).
167. Id.
168. Id. at 520.
169. Id. at 518-19.
170. Id. at 520-21.
on the same basis as the other shares.\textsuperscript{172} In another case minority shareholders in a closely-held corporation filed suit against the majority shareholders and the corporation alleging that the corporation had repurchased shares owned by the majority shareholders at an excessive price.\textsuperscript{173} The court reversed the dismissal of the complaint by the lower court.\textsuperscript{174} It agreed with the court in \textit{Donahue} that the failure to provide all shareholders with an equal opportunity to sell their shares to the corporation provides the majority shareholders with benefits unavailable to the minority and is a breach of the majority shareholders’ fiduciary duty.\textsuperscript{175}

While \textit{Donahue} and the cases discussed above seem to adopt a per se rule that the minority shareholders in a closely-held corporation are entitled to an equal opportunity to sell their shares to the corporation,\textsuperscript{176} one post-\textit{Donahue} case has rejected a per se approach.\textsuperscript{177} In this case a closely-held corporation had voting common shares owned equally by two shareholders as well as nonvoting common shares owned by the holders of the voting shares and by several others. In order to avoid dissolution of the corporation by one of the two holders of voting common shares, a third person purchased all the voting shares and a portion of the nonvoting shares of the shareholder favoring dissolution. As part of the arrangement, the corporation purchased the remainder of the shareholder’s nonvoting shares. A holder of nonvoting shares brought suit, arguing that the corporation was obligated to purchase her shares as well.

The court rejected a per se equal opportunity rule.\textsuperscript{178} It stated that all relevant factors must be considered in determining whether a selective share repurchase by the corporation is a breach of duty, and that one relevant factor is the purpose of the repurchase.\textsuperscript{179} There is no breach of fiduciary duty, according to the court, if the directors reasonably conclude that it is in the best interests of the shareholders to repurchase the shares of a particular shareholder in order to avoid the possibility of an involuntary dissolution.\textsuperscript{180}

\begin{itemize}
  \item \textsuperscript{172} \textit{Id.} at 281.
  \item \textsuperscript{174} \textit{Id.} at 618.
  \item \textsuperscript{175} \textit{Id.} at 619. The opinion also states that the directors have a fiduciary duty to buy shares for the corporation at the lowest available price. \textit{Id.}
  \item \textsuperscript{176} See also Estate of Schroer v. Stamco Supply, Inc., 482 N.E.2d 975 (Ohio Ct. App. 1984) (appearing to adopt a per se rule).
  \item \textsuperscript{177} Toner v. Baltimore Envelope Co., 498 A.2d 642 (Md. 1985).
  \item \textsuperscript{178} \textit{Id.} at 650.
  \item \textsuperscript{179} \textit{Id.}
  \item \textsuperscript{180} \textit{Id.} at 652.
\end{itemize}
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Other cases since Donahue indicate that a court should consider not only the effect of a corporate action on minority shareholders but also any business justification for the action. Another leading case decided by the same court as Donahue is Wilkes v. Springside Nursing Home.\(^{181}\) The corporation involved had four equal shareholders who were all employed by the corporation at set salaries. The corporation never declared a dividend. After the relations between the shareholders became strained, one of the shareholders was not selected as a director or as an officer, and was informed that his services were no longer desired. The net result was to deny the shareholder any return from his investment.\(^{182}\)

The court expressed concern that standard enunciated in Donahue might unduly restrict legitimate actions of majority shareholders in managing the corporation. It determined that when an action by a majority shareholder is challenged as a breach of the strict duty of good faith, the majority shareholder is entitled to demonstrate a legitimate business purpose for its action.\(^{183}\) If the majority shareholder advances a legitimate business purpose for the action, then the minority shareholders may "demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest."\(^{184}\) The court found that no business purpose was shown for terminating the shareholder after he invested over fifteen years in the corporation with the expectation that the policy of employing each shareholder would continue.\(^{185}\)

In summary, the Wilkes case modifies the Donahue decision by permitting the majority shareholder to show a legitimate business purpose for an action that is challenged as a breach of fiduciary duties. Since the majority shareholders in Donahue did not suggest a legitimate business purpose for the selective repurchase of corporate shares, the result in the case would not change under the standard announced in Wilkes.

B. Some Specific Applications of the Duty

As discussed above, the fiduciary duty of a shareholder in a closely-

\(^{182}\) Id. at 664.
\(^{183}\) Id. at 663.
\(^{184}\) Id.
\(^{185}\) Id. at 663-64.
held corporation can be breached by selective repurchases by the corpo-
ration of its shares or by the termination of the employment of a share-
holder-employee.186 The case law indicates that the duty may be violated
by other types of behavior including: (1) purchasing the shares of another
shareholder in violation of a share redemption agreement among the
shareholders;187 (2) causing the corporation to favor entities owned by
one shareholder over those owned by another shareholder in paying the
debts owed by the corporation;188 (3) causing the corporation to breach
its contract with a corporation owned by another shareholder;189 (4) issu-
ing shares in order to upset the balance of control agreed upon by the
shareholders;190 (5) purchasing corporate shares without disclosing to
another shareholder the availability of corporate shares and affording the
other shareholder the opportunity to purchase a portion of the shares,
where the purchase of the shares upsets an agreed upon control struc-
ture;191 or (6) causing the corporation to pay constructive dividends to
some shareholders without permitting other shareholders to participate
in the payments.192

A shareholder in a close corporation may bring a cause of action
alleging a breach of fiduciary duties by another shareholder even where
the complaining shareholder is entitled to seek dissolution of the corpo-
ratin under the applicable corporation statute.193 In an appropriate
case, even a minority shareholder in a close corporation is liable for
breach of the fiduciary duty of strict good faith. For example, in one case
a closely-held corporation had four equal shareholders, each of whom
had a veto power over corporate decisions.194 One of the four minority
shareholders used his veto to prevent the corporation from distributing
any earnings as dividends. As a result, the corporation was subject to a
tax penalty for unreasonably accumulating earnings and also incurred

186. See Donahue, 328 N.E.2d 505 (selective share repurchase); Wilkes, 353 N.E.2d 657 (termi-
nation of shareholder-employee). See also discussion supra part VI.A.
189. 68th Street Apartments, Inc. v. Lauricella, 362 A.2d 78 (N.J. Super. 1976), aff'd, 374 A.2d
that the control gained by the issuance of shares was used to discharge two shareholder-employees,
thus denying them any return from the corporation).
discussion infra part VIII.
for a determination of whether constructive dividends were paid).
shareholder).
legal fees related to the penalty taxes. The unreasonable refusal of the shareholder to permit the payment of dividends was held to be a violation of the minority shareholder's fiduciary duty, rendering him liable to the corporation for its out-of-pocket expenditures for the penalty taxes and related lawyers' fees.\textsuperscript{195} The case shows that the actions of a minority shareholder in a close corporation can inflict serious damage on a majority shareholder. Such actions constitute a breach of fiduciary duty by the minority shareholder where taken in bad faith.\textsuperscript{196}

The actions of a shareholder in a closely-held corporation are not a breach of fiduciary duty, in spite of an adverse impact on another shareholder, where there is a legitimate business justification for the action and the shareholder who is affected is unable to show the availability of less harmful alternative course of action.\textsuperscript{197} Thus, one case holds that it is not a violation of fiduciary duty for a shareholder of a corporation to buy the corporate assets for a dollar where the corporation is financially distressed, the shareholder agrees to assume all the liabilities of the corporation, the purchaser is a minority shareholder, the purchase is approved by two of the other three shareholders, and alternative courses of action are considered and rejected.\textsuperscript{198} Under the circumstances, the sale of the corporate assets to the shareholder is a legitimate and reasonable business decision.\textsuperscript{199}

In addition, a shareholder in a closely-held corporation is not under a fiduciary duty to purchase the shares of a deceased shareholder or to cause the corporation to purchase the shares even if the inability of the estate to dispose of the shares causes difficulty in settling the estate.\textsuperscript{200} Neither the corporation nor the majority shareholder is under an obligation to create a market for the shares of a minority shareholder unless corporate assets are used to provide a market for the shares of another shareholder.\textsuperscript{201} Similarly, a shareholder who acquires control of a
closely-held corporation by purchasing with his or her personal funds the shares of some shareholders is under no obligation to purchase the shares of other shareholders at the same price.\textsuperscript{202} The majority shareholder has not used corporate funds to provide a benefit to shareholders on a selective basis.\textsuperscript{203}

Finally, the strict fiduciary duty of good faith and loyalty is limited to shareholders in closely-held corporations.\textsuperscript{204} A closely-held corporation is characterized by a small number of shareholders and the lack of a ready market for its shares.\textsuperscript{205} One case holds that the common law definition of a closely-held corporation does not apply where a close corporation statute sets out the conditions for a court-ordered buy-out of a shareholder's shares.\textsuperscript{206} The case holds that under those circumstances, the statutory definition controls and that the corporation involved did not meet that definition.\textsuperscript{207}

C. Contracting Out of the Duty

Shareholders in a closely-held corporation have the ability to contract out of the application of the strict fiduciary duty of good faith and loyalty. In \textit{Donahue v. Rodd Electrottype Co.},\textsuperscript{208} the court found that the selective repurchase of shares by a corporation was, under the facts of the case, a breach of fiduciary duty by the controlling group of shareholders. In a footnote, however, the court stated: "[A] close corporation may purchase shares from one stockholder without offering the others an equal opportunity if all other stockholders give advance consent to the stock purchase arrangements through acceptance of an appropriate provision in the articles of incorporation, the corporate by-laws or a stockholder's agreement."\textsuperscript{209} For example, where all the shareholders enter

\textsuperscript{202} Cf. Kennedy v. Titcomb, 553 A.2d 1322 (N.H. 1989) (holding that the equal opportunity rule did not apply to the facts of the case and declining to accept or reject the rule).

\textsuperscript{203} Cf. \textit{Donahue}, 328 N.E.2d at 511 (noting that corporate funds were used to repurchase shares selectively).

\textsuperscript{204} See id. (limiting holding to cases involving close corporations).

\textsuperscript{205} See Estate of Schroer v. Stamco Supply, Inc., 482 N.E.2d 975, 978 (Ohio Ct. App. 1984). Additionally, the \textit{Donahue} court mentioned a third factor: "substantial majority stockholder participation in the management, direction and operations of the corporation." \textit{Donahue}, 328 N.E.2d at 511.

\textsuperscript{206} Sundberg v. Lampert Lumber Co., 390 N.W.2d 352, 356-57 (Minn. Ct. App. 1986) (defining close corporation, according to state statute, as corporation having not more than a specified number of shareholders).


\textsuperscript{208} 328 N.E.2d 505 (Mass. 1975).

\textsuperscript{209} Id. at 518 n.24 (citations omitted). Cf. \textit{generally} Butler & Ribstein, \textit{supra} note 27 (arguing
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into an agreement in advance for the corporation to repurchase the shares of any shareholder who dies, "questions of good faith and loyalty do not arise." Further, some persons may prefer to do business among themselves "strictly in accord with the norms of general corporation law."

One approach is to draft a provision that attempts to provide a blanket waiver of the strict fiduciary duty of good faith and loyalty. Another is to draft a narrow provision that exempts a particular type of transaction or transactions, such as repurchases of shares by the corporation, from the strict fiduciary duty. Presumably the fiduciary duty also applies to the execution of a provision waiving the duty. If so, a provision that is narrowly tailored and comprehensible is more likely to be upheld if challenged than a blanket waiver. Where a blanket waiver of the duty is desired, a blanket waiver can be coupled with non-exclusive, narrowly drafted provisions covering specific transactions.

VII. DUTIES REGARDING THE SALE OF Shares

A. In General

Absent special circumstances a shareholder may sell his or her shares to whomever he or she pleases, or may refuse to sell such shares. A shareholder is not obligated to offer his or her shares to the corporation or to other shareholders before selling them and, in addition, is not obligated to disclose his or her intention to sell the shares. In favor of private ordering of fiduciary duties of corporate managers as opposed to a system of mandatory rules).


212. See Rainer L.C. Frost, Note, Contractual Disclaimers of the Donahue Fiduciary Duty: The Efficacy of the Anti-Donahue Clause, 26 B.C.L. Rev. 1215, 1233-37 (1985) (discussing and giving examples of provisions attempting to provide blanket waivers and provisions that are more narrowly drafted).

213. Id. at 1244.

214. See id. at 1243-47 (discussing enforceability of disclaimers of fiduciary duty in the close corporation context).

215. See id. at 1235 n.243 for examples.

216. See Treadway Co. v. Care Corp., 638 F.2d 357, 376-78 (2d Cir. 1980) (stating that shareholder has right to sell without offering shares to corporation or disclosing to corporation facts regarding sale); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985) (validating right to sell without disclosing negotiations to corporation); Glass v. Glass, 321 S.E.2d 69, 75-76 (Va. 1984) (noting in dicta that shareholder has right to not sell).

217. See Treadway Co., 638 F.2d at 376-78; Frantz Mfg., 501 A.2d at 408. Both of these cases involve shareholder-directors.

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addition, a controlling shareholder is not obligated to sell his or her shares to a third person where the sale would benefit the minority shareholders.\footnote{218} However, a controlling shareholder has a duty not to transfer his or her shares where he or she is on notice that the purchaser intends to or is likely to loot the corporation.\footnote{219} In addition, a shareholder's right to transfer his or her shares may be subject to lawful transfer restrictions imposed by the corporation's articles of incorporation or by-laws, or by an agreement to which he or she is a party.\footnote{220}

A shareholder is generally entitled to sell his or her shares at a premium price without any obligation to offer other shareholders an opportunity to sell a pro rata portion of their shares\footnote{221} or, alternatively, to share the premium with other shareholders.\footnote{222} Where the premium price is received in return for the sale of a corporate office, asset, or opportunity, the corporation may recover the premium.\footnote{223} In addition, if the shareholder receiving the premium employs wrongful means to assist the purchaser in acquiring the share of other shareholders, he or she may be required to share the premium with those shareholders.\footnote{224}

B. Sale to a Looter

A controlling shareholder is under a duty not to transfer control to another where the circumstances surrounding the proposed transfer are sufficient to put the shareholder on notice that the purchaser may loot the corporation.\footnote{225} Where the circumstances are sufficient to put a prudent person on guard, the controlling shareholder has a duty before selling the shares to conduct a reasonable investigation into whether the purchaser intends to defraud the corporation.\footnote{226} The shareholder breaches his or her duty if he or she sells without any investigation or
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sells after an inadequate investigation. On the other hand, the duty is not breached by sale of the shares where a reasonable investigation discloses facts from which a prudent person would conclude that no fraud is intended or is likely to occur.227

A controlling shareholder is under no duty to investigate a prospective purchaser of his or her shares absent circumstances that put him or her on notice that the purchaser intends or is likely to loot the corporate assets.228 Circumstances which may put the seller on notice of the purchaser’s intent to defraud the corporation include but are not limited to: (1) facts suggesting that the purchaser intends to finance the purchase or to secure the purchase price with corporate assets;229 (2) the knowledge that the corporation was the subject of looting in the past;230 (3) a request by the purchasers that assets of the corporation be converted into cash prior to the closing on the sale of shares and/or that the purchasers have access to its liquid assets immediately after closing;231 (5) the payment of an excessive price for the shares given the nature of the corporation’s assets;232 (6) unfavorable credit reports on the purchaser or businesses controlled by the purchaser;233 and (7) prior frauds committed by the buyer on the seller.234 Evidence of facts that a reasonable investigation would reveal are not relevant to the question of whether the seller is on notice of facts suggesting that the buyer intends to or is likely to loot the corporation since no duty to investigate exists absent such notice.235

Generally more than one of these factors is present in the cases in

227. Compare Insuranshares Corp., 35 F. Supp. at 25-27 (holding that seller did not make an adequate investigation), with Swinney v. Keebler Co., 480 F.2d 573 (4th Cir. 1973) (holding that investigation conducted by the seller was adequate to avoid liability under the circumstances).


229. Insuranshares Corp., 35 F. Supp. at 25; DeBaun, 120 Cal. Repr. at 357 (noting that sellers knew buyer could make payments only by resorting to presale retained earnings and assets). Compare Swinney, 480 F.2d 573 (noting that seller made clear that buyer must consummate the purchase with buyer’s own funds and it appeared that buyer had the financial ability to do so).


231. Id. at 26.

232. Id. (applying rule to investment company); Dale v. Thomas H. Temple Co., 208 S.W.2d 344, 351-52 (Tenn. 1948) (holding that selling price was so far in excess of market price that it constituted “a badge of fraud”). Cf. Gerdes v. Reynolds, 28 N.Y.S.2d 622, 654-58 (N.Y. Sup. Ct. 1941) (investment company whose assets could be substantially duplicated within several days; under these circumstances, excessive price charged seller with notice of fraudulent intent on the part of the buyer). But cf. Levy v. American Beverage Corp., 38 N.Y.S.2d 517, 526 (N.Y. App. Div. 1942) (holding that under the circumstances, receipt of a premium price for the shares of a mercantile firm did not suggest presence of fraud).


234. Id. (finding that fraud was committed on seller’s predecessor in interest).

which a seller of control is held to be on notice that the purchaser intends or is likely to loot the corporation. Thus, in the leading case of *Insurance-shares Corp. v. Northern Fiscal Corp.*,\(^\text{236}\) the circumstances which put the sellers on notice included an excessive price in light of the corporation's assets, prior looting of the corporation, reason to suspect that the purchaser intended to finance the purchase with corporate assets, and a request that a large part of the corporation's assets be converted to cash which was available to the purchasers immediately after closing.\(^\text{237}\) In another well-known case, the circumstances placing the seller on notice include knowledge that the purchaser needed to resort to the corporation's presale assets and retained earnings in order to make the payments on the shares, a very unfavorable credit report on the purchaser and entities which he controlled, and a prior fraud by the purchaser against the seller's predecessor in interest.\(^\text{238}\) In most cases an excessive price for the shares is insufficient by itself to put a seller of control on notice of a prospective purchaser's fraudulent intent,\(^\text{239}\) although an excessive price is notice of possible fraudulent intent by the purchaser where the seller is aware that the purchaser has neither the assets nor the credit necessary to pay the purchase price.\(^\text{240}\)

Where the controlling shareholder retains a significant and valuable relationship with the corporation as a result, for example, of a substantial lease between the shareholder and the corporation or of the shareholder's status as an unsecured creditor of the corporation, a court is less likely to find that the shareholder is on notice of potential looting by the purchaser of his or her shares.\(^\text{241}\) In this type of situation the shareholder has substantial financial incentives not to sell to a purchaser whom he or

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\(^{236}\) 35 F. Supp. 22 (E.D. Pa. 1940).

\(^{237}\) Id. at 25-26. Additionally, the sellers' attorney warned them of the dangers of selling to persons about whom they knew very little. Id. at 26.

\(^{238}\) DeBaun, 120 Cal. Rptr. 354.

\(^{239}\) Cf. Clagett v. Hutchison, 583 F.2d 1259 (4th Cir. 1978). In *Clagett*, minority shareholders had sued personally to recover the loss in the value of their shares. The court held that the 400 percent premium was not so unreasonable as to put the seller on notice of the likelihood of fraud by the purchaser and found no evidence of looting.

\(^{240}\) See Dale v. Thomas H. Temple Co., 208 S.W.2d 344 (Tenn. 1948) (passing on sale in which seller extended $225,000 in credit to a corporation with no credit or assets). Compare *Swiney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973) (noting that although it did not do so, purchaser had the financial ability to consummate the purchase with its own funds).

she suspects intends to loot the corporation. Presumably the existence of this financial interest gives rise to an inference of lack of notice.

Some scholars argue that a controlling shareholder should have a duty to investigate a prospective purchaser of his or her shares regardless of the absence of suspicious circumstances. Arguments supporting the imposition of such a duty include the possibility of substantial harm to the minority from a transfer of control, the fact that an investigation is unlikely to be very costly or difficult, and the fact that such investigations are already commonly done because sellers are concerned about the financial ability of the parties with whom they are negotiating. Thus, a strong argument can be made that the cost of imposing a duty on a seller of control to investigate the reputation and financial ability of a prospective purchaser of his or her control is outweighed by the potential harm such sales can cause to the minority.

On the other hand, some scholars question the wisdom of cases imposing liability for sale of control to a looter, arguing that it is difficult to detect potential looters, that looters acquire a reputation that prevents them from looting again, that most refusals to sell after a reasonable investigation are “false positives,” and that the best way to deter looting is to punish looters very severely. These scholars conclude that a duty to investigate potential purchasers of control is costly and deters many beneficial transactions. This view is subject to several criticisms, including that it places the whole loss caused by looting on the innocent minority shareholders and creditors of the corporation while absolving the controlling shareholder who sold to the looter and who retains the benefits of the sale.

The duty of the controlling shareholder not to sell when he or she is

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242. Harman, 520 F.2d at 1335 (noting that defendant suffered, rather than profited, from the looting of the corporation).
243. See Alfred Hill, Sale of Controlling Shares, 70 HARV. L. REV. 986, 1025-28 (1957) (posing that inquiry should encompass “the probable impact of the transfer of control upon the remaining shareholders”).
244. Id. at 1026-27.
246. See Hill, supra note 243, at 1025.
248. Id. at 719.
249. See Hamilton, supra note 245, at 266-68 (also questioning whether most refusals to sell will be false positives).
on notice of potential looting by the purchaser is a duty to the corporation. The duty may also be owed to minority shareholders. If the duty is breached, the damages to the corporation include the value of any corporate assets lost as a result of the looting as well as the amount necessary to discharge any obligations incurred by the corporation as a result of the looting such as, for example, the amount of employee health insurance premiums embezzled by the purchaser. In addition, one case holds that the corporation may recover a goodwill factor measured on the basis of future net income reasonably to be anticipated from the corporation's past earnings record. Further, another case suggests that the corporation may recover both damages to the corporation and the amount by which the price of the shares sold to the looter exceeded the value of the shares. The seller is not, however, liable merely because of fear that the buyer is unable to pay for the shares without looting the corporation's assets or that the buyer will otherwise harm the corporation where there is no allegation or proof that the feared events have occurred.

Finally, looting cases must be distinguished from leveraged buyouts in which all of a corporation's shares are purchased and corporate assets are used to finance the transaction. Where the purchaser buys all of the outstanding shares there can be no liability for looting, even though the transaction might be a fraudulent transfer in violation of the rights of corporate creditors.

C. Sale at a Premium

Absent special circumstances, a controlling shareholder may sell his or her shares in a private sale at a premium price without any obligation to share the premium with other shareholders or to offer them an equal

251. See DeBaun v. First W. Bank & Trust Co., 120 Cal. Rptr. 354, 361 (Cal. Ct. App. 1975) (holding that duty runs both to the corporation and to the minority shareholders).
252. Id. at 361-62; see also Dale v. Thomas H. Temple Co., 208 S.W.2d 344 (Tenn. 1948) (ruling on suit brought by receiver of corporation based on a civil conspiracy theory against both sellers of and purchasers of majority of corporation's shares).
254. See Gerdes v. Reynolds, 28 N.Y.S.2d 622, 659 (N.Y. Sup. Ct. 1941). Compare PRINCIPLES, supra note 80, § 5.16 cmt. e (seller is liable for damages equal to greater of amount of injury to corporation or the premium received).
256. See Hamilton, supra note 245, at 268 n.54.
opportunity to participate in the sale of shares. A potential purchaser of controlling shares who believes that better management of the corporation's assets can produce gains will pay a premium for the opportunity to manage the firm's assets. The premium over market price is the amount that the purchaser "is willing to pay for the privilege of directly influencing the corporation's affairs." Under current law this premium belongs to the seller of the controlling interest, is not a corporate asset, and need not be shared with other shareholders. In addition, the purchaser in a private sale of controlling shares has no duty to purchase all shares at the same price.

Arguably, allowing controlling shareholders to obtain a premium increases shareholder wealth by encouraging the sale of controlling shares to purchasers who will manage the corporate assets more efficiently. Under this view, a rule requiring a controlling shareholder to share the premium with other shareholders discourages the sale of controlling interests to such persons. On the other hand, even assuming that sale of control produces gains, the purchaser of a controlling interest might not share those gains with the minority shareholders, preferring instead to increase management perquisites while placing the shareholders on "starvation returns." Indeed, a potential purchaser of a controlling interest might be motivated by the belief that current management is inefficient in obtaining perks and may be willing to pay a premium for the opportunity to enjoy increased perks. Some scholars argue that the minority shareholders should share pro rata in any premium which a purchaser of a controlling interest is willing to pay.

258. McDaniel v. Painter, 418 F.2d 545 (10th Cir. 1969) (majority of shares were sold at a price not available to minority shareholders); Ritchie v. McGrath, 571 P.2d 17 (Kan. Ct. App. 1977) (majority of shares sold for $80 per share; minority of shares sold for $50.20 per share); Zetlin v. Hanson Holdings, Inc. 397 N.E.2d 387 (N.Y. 1979) (per curiam) (sale of 44.4% of the outstanding shares of a corporation for $15 per share at a time when the market price was $7.38 per share); Shoaf v. Warlick, 380 S.E.2d 865 (S.C. Ct. App. 1989).

259. See Easterbrook & Fischel, supra note 247, at 705.


261. See cases cited in note 251.

262. See discussion infra part VII.E.

263. A number of scholars argue that the rule should be otherwise. See discussion infra part VII.H.


265. See Easterbrook & Fischel, supra note 247, at 708-11. Some scholars argue that a rule requiring the sharing of the premium would not discourage beneficial transactions. See discussion infra part VII.H.

266. See Hamilton, supra note 245, at 256-57. See also Richard W. Jennings, Trading in Corporate Control, 44 CAL. L. REV. 1, 14-16 (1956) (discussing exploitation of corporate control for personal advantage).


268. See, e.g., William D. Andrews, The Stockholder's Right to Equal Opportunity in the Sale of
although the courts have consistently held that minority shareholders have no right to share in the premium.\textsuperscript{269}

A shareholder is not entitled to retain any premium that represents a payment for sale of a corporate office,\textsuperscript{270} asset, or opportunity.\textsuperscript{271} In addition, a controlling shareholder may be forced to disgorge a premium paid by a purchaser where the shareholder unfairly assists the purchaser in obtaining the minority's shares by, for example, misrepresenting the amount he or she is receiving for his or her shares.\textsuperscript{272}

A careful lawyer can advise sellers of controlling shares to attempt to convince the buyer to purchase the shares of the minority at the same price per share that the controlling shareholder receives.\textsuperscript{273} Where the purchaser plans to offer to purchase the shares of the minority shareholders at a lower price per share than that paid to the controlling shareholder, the controlling shareholder should make certain that this fact is revealed to minority shareholders in order to avoid any potential liability under a nondisclosure theory.\textsuperscript{274} In addition, the seller can also seek an agreement by the purchaser to indemnify the seller against claims by other shareholders arising out of the price differential.\textsuperscript{275}

Where a tender offer is made for shares of a publicly-held corporation, federal law requires that the bidder must open the offer to all holders of the class of shares, pay all shareholders who tender shares the highest price paid to any other shareholder during the tender offer, and purchase a pro rata amount of each tendering shareholder's shares if the offer is oversubscribed.\textsuperscript{276}

\begin{thebibliography}{99}
\bibitem{Hills} Shares, 78 Harv. L. Rev. 505, 506 (1965); Jennings, supra note 266, at 31. Professors Andrews and Jennings argue that minority shareholders should be afforded an opportunity to participate ratably in any offer to purchase a controlling interest in the corporation. See also discussion infra part VII.H.
\bibitem{Brecher} See, e.g., Brecher v. Gregg, 392 N.Y.S.2d 776 (N.Y. Sup. Ct. 1975). See also discussion infra part VII.D.
\bibitem{Perlman} Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955). See also discussion infra part VII.E.
\bibitem{Dunnett} See Roby v. Dunnett, 88 F.2d 68, 69 (10th Cir.), cert. denied, 301 U.S. 706 (1937); Porter v. Healy, 91 A. 428 (Pa. 1914). See also discussion infra part VII.G.
\bibitem{Hill} See Hill, supra note 243, at 987. See also Andrews, supra note 268, at 506 ("Careful practitioners have therefore been concerned about the risks in any sale of controlling shares at a premium over the price available on the market to other shareholders."); John W. Herz, The Sale of Control, 23 Corp. Prac. Commentator 381, 396 (1981) ("Seller should, where practicable, seek to have the buyer offer to purchase the shares of all the shareholders at the same price the seller receives.").
\bibitem{Hamilton} See Hamilton, supra note 245, at 280 & n.103.
\bibitem{Herz} Herz, supra note 273, at 397.
\end{thebibliography}
D. Sale of Corporate Office

A corporate office is not the individual property of the officeholder to be disposed of as he or she wishes.277 Thus, a contract in which a corporate office is sold or in which control of a corporation unaccompanied by any shares is sold is unenforceable and a breach of the officeholder's duties to the corporation.278 For example, one case holds that a contract in which the seller of corporate shares promises to make the purchaser the manager and a principal officer of a corporation at a fixed salary is void as against public policy.279 Another holds that the former president-director of an insurance corporation is accountable to the corporation for money he received for resigning as president and director, procuring the resignations of other directors, and insuring that the vacancies are filled with specified individuals.280 In summary, contracts for the illegal sale of corporate office or for the sale of control are unenforceable, and the seller under such a contract is accountable to the corporation for any proceeds received from the transaction. Additionally, the appropriate court may remove the purchaser of office from his or her office.281

On the other hand, it is axiomatic that the owner of a majority of the voting shares of a corporation can elect a majority of the directors. Therefore, a purchaser of these shares can eventually elect a majority of the directors. If the terms of the directors are not staggered, a purchaser of a majority of the voting shares can elect a majority of the board at the next annual meeting of shareholders.282 If the terms of the directors are staggered, however, it can take more than a year for the purchaser of a majority of the shares to elect a majority of the board.283 It is not against public policy to accelerate the transfer of control to the purchaser of a

278. See, e.g., McClure v. Law, 55 N.E. 388 (N.Y. 1899) (finding former president and director of corporation accountable to corporation for money received for procuring the resignations of the corporation's directors and the appointment of designated individuals as their successors); Fennessy v. Ross, 39 N.Y.S. 323 (N.Y. App. Div. 1896) (holding contract involving sale of office unenforceable).
279. Fennessy, 39 N.Y.S. at 323.
280. McClure, 55 N.E. at 388.
282. See, e.g., San Remo Copper Mining Co. v. Moneuse, 133 N.Y.S. 509 (N.Y. App. Div. 1912) (involving purchaser of "vast majority" of corporate shares who had ability to elect a board of directors at the next annual shareholders' meeting).
283. See, e.g., Essex Universal Corp. v. Yates, 305 F.2d 572, 575-76 (2d Cir. 1962) (involving a purchaser of enough shares to provide "working control" who could not, in the normal course of events, elect a majority of the board until approximately eighteen months after the purchase).
majority of the corporate shares by, for example, having existing directors replace themselves by resigning seriatim and filling the vacancies with persons designated by the purchaser.\textsuperscript{284} There is "no reason why a purchaser of majority control should not ordinarily be permitted to make his control effective from the moment of the transfer of stock."\textsuperscript{285} Thus, a contractual provision requiring a transfer of control as a condition of sale of a majority of the voting shares is not objectionable.\textsuperscript{286}

In some cases the holder of less than a majority of the voting shares is able to elect a majority of the corporation's board of directors. If the shareholder owns enough shares to exercise "working control" over the management of the corporation, the immediate transfer of control of the board to a purchaser of shares does not offend public policy.\textsuperscript{287} The transfer of control merely accelerates an inevitable process. On the other hand, where the shares transferred are insufficient to provide the purchaser with working control, an agreement to transfer control to the purchaser is against public policy.\textsuperscript{288} In such a case, any premium received by the seller of the shares is in fact received for the sale of a corporate office.\textsuperscript{289} Arguably the distinction between a sale of shares carrying "working control" and one that does not is also supportable on the theory that "[o]ne who buys a controlling bloc of shares cannot hurt the corporation without hurting himself too."\textsuperscript{290} Under this view, a buyer willing to purchase a substantial stake in the corporation is, in effect, posting "a bond for honest conduct."\textsuperscript{291}

Whether a block of shares carries with it "working control" is a question of fact.\textsuperscript{292} A block should not be found to carry working control unless it is a practical certainty that the ownership of the block guarantees the voting power necessary to choose a majority of the directors of

\textsuperscript{284} See \textit{San Remo Copper Mining Co.}, 133 N.Y.S. at 509 (upholding sale to purchaser of over 420,000 shares in corporation with 500,000 authorized shares); \textit{cf. Essex Universal Corp.}, 305 F.2d at 576 (upholding sale of 28.3\% of shares).

\textsuperscript{285} \textit{Essex Universal Corp.}, 305 F.2d at 579.

\textsuperscript{286} \textit{Cf. id.} at 577 (remanding question of whether 28.3\% of shares constituted "working control").

\textsuperscript{287} \textit{Id.}

\textsuperscript{288} \textit{In re Caplan's Petition}, 246 N.Y.S.2d 913 (N.Y. App. Div. 1964) (vacating appointment as directors of persons designated by the purchaser of three percent of the outstanding shares in corporation).

\textsuperscript{289} Brecher v. Gregg, 392 N.Y.S.2d 776 (N.Y. Ct. App. 1975) (holding that premium received in exchange for promise to transfer control was contrary to public policy as a matter of law where only 4\% of the outstanding shares were transferred).

\textsuperscript{290} Easterbrook & Fischel, \textit{supra} note 247, at 722.

\textsuperscript{291} \textit{Id.}

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the corporation or, in other words, ownership of the block is equivalent to ownership of a majority block. An important consideration in answering this question is the size of the block of shares transferred. If the block transferred is large in relation to any other organized block of shares, it is reasonable to infer that shares confer working control. Conversely, if the block transferred is very small, it is reasonable to infer that the shares do not confer working control. In addition, an inference of control may arise if the directors designated by the buyers are subsequently elected directors at the annual meeting of shareholders.

Arguably the ability of the seller of the block of shares to exercise working control before the sale permits an inference that working control is transferred to the purchaser. On the other hand, presumably the focus is on whether working control is transferred to a particular purchaser. It is possible that other shareholders will organize to create a block of shares sufficient to prevent a purchaser from exercising working control. If a party challenging the transaction can prove that this is likely to happen, then working control is not transferred.

One way of testing whether the purchaser of a block of shares obtains control of the corporation by virtue of ownership of the block is to have an election of directors by the shareholders. If the purchaser’s designees are elected, then presumably his or her shares confer working control. Obviously such an election is a mere formality where the purchaser has approximately 50 percent or more of the outstanding voting shares of a publicly-held corporation. Where, however, the block of shares transferred is significantly less than 50%, immediate transfer of control

293. Id. (Lumbard, J.); cf. id. at 581 (Friendly, J., concurring) (suggesting that often the question of whether working control is transferred can only be determined by an election).

294. Cf. id. at 580 (Clark, J., concurring in result) (“Surely in the normal course of events a management which has behind it 28.3 percent of the stock has working control . . . .”).

295. See Brecher v. Gregg, 392 N.Y.S.2d 776 (N.Y. Sup. Ct. 1975) (concluding as a matter of law that the premium received by seller of four percent of outstanding shares was not for practical control); cf. In re Caplan’s Petition, 246 N.Y.S.2d 913 (N.Y. App. Div. 1963) (addressing transfer of 3% of outstanding shares), aff’d, 249 N.Y.S.2d 877 (1964).


297. Id. at 380 (noting that 10% of shares was sufficient for several years to control corporation’s board of directors).

298. See Essex Universal Corp. v. Yates, 305 F.2d 572, 579 (2d Cir. 1962) (placing burden of proof on party challenging the transaction since 28.3% of voting shares of a public corporation is “usually tantamount to majority control”).

299. Id. at 581 (Friendly, J., concurring) (expressing a preference for a “mere formality” standard); Martin v. Marlin, 529 So. 2d 1174, 1178 (Fla. Dist. Ct. App. 1988) (holding, under facts of case, that new elections were “mere formality”).
of the board to the purchaser can assist the purchaser in obtaining control by avoiding the risk of an election and, similarly, in retaining control by providing control over the corporate proxy machinery. In this situation, control does not derive entirely from the ownership of the shares themselves. A court should find that the holder of a block of shares has working control only if the risk posed by rival groups in an election of directors is minimal even without access to the corporate proxy machinery.

Where a transfer of control via the seriatim resignation and replacement of directors occurs in connection with the purchase of more than five percent of a class of equity securities registered under the Securities Exchange Act of 1934, the corporation must file with the Securities Exchange Commission and provide specified information about the directors and the principal shareholders to shareholders "who would be entitled to vote at a meeting for election of directors." This requirement applies to purchases of shares in both private transactions and tender offers.

E. Sale of Corporate Asset or Opportunity

Where the premium received by the seller of corporate shares is actually compensation for sale of a corporate asset or for a corporate opportunity, the premium is recoverable by the corporation. In the well-known case of Perlman v. Feldmann, a controlling block of 37 percent of a corporation's shares was sold for $20 per share to an end-user of steel, the corporation's product. The sale took place at a time of short supply in the steel market. The market price of the corporation's shares had not exceeded $12 per share. One of the selling shareholders was not only the dominant shareholder in the corporation, but was also the president and the chairman of the board. A derivative suit was brought

300. See Hill, supra note 243, at 998-99.
301. Id. at 999.
302. Id.
305. See Securities Exchange Act of 1934 §§ 13(d), 14(d), (f); 15 U.S.C. §§ 78m(d), 78n(d), (f) (1988).
306. Commonwealth Title Ins. & Trust Co. v. Seltzer, 76 A. 77, 79-80 (Pa. 1910) (finding profits on sale of shares were incident to sale of corporate real estate).
308. The shareholder, his family members, and his personal corporation owned 33 percent of the outstanding shares. Id. at 174 n.1.
seeking recovery of alleged illegal gains received by the sellers as compensation for the sale of corporate asset. The alleged asset sold was the ability to control the allocation of the corporation’s product, steel, in a time of market shortage. The trial court found that the price of $20 per share was a fair price for a control block of shares, but also noted that the evidence did not show what the shares were worth if stripped of the power to control the allocation of the corporation’s scarce product.309

On appeal, the trial court was reversed. The appellate court noted that the corporation derived two potential benefits from the steel shortage. These were, first, the ability to obtain interest free loans from prospective purchasers of steel in return for a commitment to the purchasers of future production and, second, the ability to use the shortage to build up patronage in geographical areas in which the corporation could complete after the shortage ended.310 The court held that the burden rests with the fiduciary in this type of situation to negate any possibility of gain to the corporation from the opportunities and that the defendants had not met the burden in the case.311

The case generated a significant amount of commentary, and scholars disagree on the real basis for the court’s decision to impose liability. One interpretation is that the case is best explained as a disguised premium for a corporate product, steel, which was in short supply, and that all shareholders should share equally in any profit resulting from a high demand for the corporation’s product.312 For example, one way in which all shareholders can share in the profit is through a merger with an end-user of steel. The majority shareholder (who was also president of the corporation) was in fact approached with a merger offer on terms very favorable to the shareholders and, in his capacity as president, rejected the offer.313 Thus, one can argue that an opportunity to enter into a favorable corporate transaction was usurped.314 A similar interpretation is that the case is best explained as a corporate opportunity case in which the defendants were forced to disgorge the value of a usurped opportunity, namely the opportunity to utilize the steel shortage to obtain

309. See id. at 175. The court found the book value to be $17.03 per share. Id.
310. Id. at 177.
311. Id. at 176-77.
313. See Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952) (ruling on securities fraud claim based on the transaction that gave rise to Perlman).
314. See Hamilton, supra note 245, at 275; see also Jennings, supra note 266, at 22-29 (discussing corporate transaction theory); cf. Andrews, supra note 268, at 543-45 (discussing the equivalent effect of share purchases and purchases of assets from a corporation).
interest free financing or to build up patronage.\textsuperscript{315} One commentator argues that the case involved a breach of the duty not to sell control in circumstances in which the corporation is threatened with significant harm from the seller and, thus, that the case falls in the category of the looting cases.\textsuperscript{316} Still others suggest that the control of a corporation itself is an asset that belongs to a corporation, and that the case moves in the direction of requiring a seller of control to account for any amount above the value of the shares without control.\textsuperscript{317}

Regardless of any broader implications, at a minimum Perlman establishes that where a controlling shareholder receives a premium that represents the payment for an asset or an opportunity belonging to the corporation, the shareholder may be forced to account for and to disgorge the profit. The case law rejects the arguments that corporate control itself is a corporate asset and that any control premium must be shared by all shareholders.\textsuperscript{318} "The law of the marketplace dictates that a shareholder who has a controlling interest in a corporation will likely be able to receive a higher price per share than a minority shareholder."\textsuperscript{319}

However if something more than the control inherent in the shares is transferred, the shareholder may be required to disgorge the premium. For example, in one case the president of a corporation was approached about the sale of the corporation's major asset, real estate, at a favorable price. He rejected the offer, but agreed to sell enough shares to provide control of the corporation.\textsuperscript{320} He then purchased enough additional shares to fulfill his obligation under the contract without revealing the facts to the shareholders selling their shares to him. The corporation's principal asset was then sold to a corporation owned by the new controlling shareholders at a price that was not shown to be inadequate. The court found that the sale of the shares and the sale of the real estate were fairly considered as part of one transaction so that the profit to the shareholder derived from the sale of the corporation's property rather than from the sale of its shares.\textsuperscript{321} The purchasers wanted the property and

\begin{footnotes}
\item[315] Jennings, supra note 266, at 11-13.
\item[316] Hill, supra note 243, at 989-90.
\item[318] See generally discussion supra part VII.C and infra part VII.H.
\item[320] Commonwealth Title Ins. & Trust Co. v. Seltzer, 76 A. 77 (Pa. 1910).
\item[321] Id. at 79.
\end{footnotes}
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were willing to pay a price for it. Knowing this, the shareholder-president sold shares for the purpose of diverting a portion of the price into his own pocket.322 Each shareholder was entitled to recover the share of the profits that he or she would have received if the real estate had been sold by the corporation.323

Presumably the premium is recoverable even where the shareholder receiving the premium in return for a corporate asset or opportunity is not a controlling shareholder. Thus, one case holds that a shareholder who receives $9,000 for shares with a market value of $51.88 in exchange for an agreement to discontinue a derivative suit without notifying the other shareholders or seeking court approval must account to the corporation.324

The portion of the premium recoverable is the amount paid for the corporate asset or for giving up the corporate opportunity. In Perlman v. Feldmann,325 the court stated that defendants were entitled to retain the value of their shares "without the appurtenant control over the corporation's output of steel."326 It is very difficult in many cases to establish the value of shares aside from the corporate asset transferred or corporate opportunity given up. This makes the question of the allocation of the burden of proof critical. Perlman allocates the burden to the shareholder receiving the premium.327

Where the premium price a shareholder receives upon the sale of his or her shares is in return for the sale of a corporate asset or for giving up a corporate opportunity, the action to recover the premium belongs to the corporation and any recovery goes to the corporate treasury.328 In exceptional cases, a court may allow an individual recovery by the shareholders in a derivative suit. For example, the court in Perlman allowed recovery by the minority shareholders, citing its desire to prevent the purchaser of the controlling interest from participating in the recovery.329

322. Id.
323. Id. at 80. Due to the unusual facts, the court approved the trial court's decision to permit the shareholders to sue individually rather than derivatively. Id.
326. Id. at 178. On remand, the court found the "enterprise value" of each share to be $14.67. See Perlman v. Feldmann, 154 F. Supp. 446 (D. Conn. 1957).
327. Perlman, 219 F.2d at 178.
328. See id. at 180 (Swan, J., dissenting).
329. Id. at 178; see also Commonwealth Title Ins. & Trust Co. v. Seltzer, 76 A.77, 80 (Pa. 1910)
F. The Corporate Transaction Theory

An argument can be made that a controlling shareholder should be accountable to the minority shareholders whenever he or she uses his or her control to obtain a benefit not available to minority shareholders by entering into a personal transaction instead of a corporate transaction for the benefit of all shareholders. Under this approach, a controlling shareholder is liable whenever he or she uses a personal sale of shares to "intercept profits in connection with a corporate transaction." Several cases reach results consistent with a corporate transaction theory. In these cases the purchaser of the controlling shares initially expressed interest in purchasing all of the corporation's shares or in purchasing the assets of the corporation itself. In addition, in each case the purchaser was instead sold either controlling shares or the shares of the directors and of some favored shareholders at a premium.

In these cases the shareholders were required to share the premium or to pay damages under one theory or another. In one case, the court based liability upon the failure of the majority to inform the minority of the purchaser's preference for an asset sale. The court found injury resulted from the fact that the minority, if informed, could have refused to sell their shares except on same terms as those available to the majority. In another case, the court apparently was heavily influenced by the fact that the offer to purchase control of the corporation was initially made to the defendants in their capacities as officers and directors, and

(allowing individual recovery on the grounds that, among other things, the corporation had "practically gone into liquidation"); Jennings, supra note 266, at 22-29 (suggesting that a shareholder bringing a derivative suit to recover a premium should join an individual or class claim where the applicable rules of procedure permit the joinder of such claims). Cf. Fed. R. Civ. P. 18(a) (joinder of claims). For example, the court in Perlman allowed recovery by the minority shareholders, citing its desire to prevent the purchaser of the controlling interest from participating in the recovery.

330. See Jones v. H.F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969) (majority shareholders transferred their shares to a holding corporation in order to deal with high book value instead of splitting the shares); Jennings, supra note 266, at 22-29; see generally discussion supra part V.E. But cf. Tryon v. Smith, 229 P.2d 251 (Or. 1951) (refusing to hold liable majority shareholder, president, and director, who was approached about sale of all shares of corporation and sold his shares and those of associates for $460 per share while minority shareholders received $220).

331. Jennings, supra note 266, at 22.

332. See Brown v. Halbert, 76 Cal. Rptr. 781, 783 (Cal. Ct. App. 1969) (president and majority shareholder of corporation asked at business office of corporation whether corporation was for sale); Low v. Wheeler, 24 Cal. Rptr. 538, 541 (Cal. Dist. Ct. App. 1962) (purchaser initially interested in asset purchase); Forinash v. Daugherty, 697 S.W.2d 294, 297 (Mo. Ct. App. 1985) (purchaser approached board about buying control; board arranged for sale of shares of the directors and those of selected other shareholder); Porter v. Healy, 91 A. 428, 429 (Pa. 1914) (purchaser interested in purchasing all of the shares of the directors in order to have corporate property and franchises).

333. Low, 24 Cal. Rptr. at 544-45.
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not in their capacities as shareholders. In a third case, liability appears to be based on the fact that the purchasers placed a portion of the purchase price in a “control fund” payable to the seller only after control was transferred to the purchaser. Thus, this case can be viewed as a sale of office case. While none of the three cases explicitly adopts a corporate transaction theory, the results indicate that there is some risk to a controlling shareholder in structuring a transaction as a sale of control shares at a premium where the purchaser is primarily interested in the corporate assets and/or initially approaches the board of directors and officers regarding the purchase of control.

On the other hand, under existing law there is no liability for receipt of a premium where the purchaser initially approaches the controlling shareholder regarding the purchase of his or her shares at a premium. Other shareholders may not complain that the sale took the place of a corporate transaction since the controlling shareholder is not obligated to sell his shares or to vote the shares in favor of a corporate transaction. In one case, though, the court held that under the facts of the case the majority shareholder had a duty to seek substantially the same benefits for the minority shareholders as he or she received. Although the result in the case can be justified on other grounds, this case comes the closest to adopting a corporate transaction rationale.

G. Misrepresentation Regarding or Nondisclosure of Premium

A controlling shareholder who receives a premium price not available to the minority shareholders is required to share the premium with the other shareholders if he or she assists the purchaser in acquiring the shares of the minority by misrepresenting the price paid for his or her shares. In one case the controlling shareholders and the purchaser represented to the minority shareholders that the price paid for all shares

334. Forinash, 697 S.W.2d at 299-300.
335. Porter, 91 A. at 430, 432.
336. The sellers in this case also assisted the purchaser in acquiring the shares of the minority shareholders by misrepresenting that the sellers received the same amount that the purchaser offered the minority shareholders for their shares. Id. at 430. See discussion supra part VII.D.
337. See discussion supra part VII.C.
338. See discussion supra part VII.A.
339. See discussion supra part IV.A.
341. See discussion of this case infra part VII.H.
342. Cf. Brown, 76 Cal. Rptr. at 794-95 (Draper, J., concurring) (referring to, among other things, refusal of majority shareholder to entertain an offer for all the corporate assets as a justification for decision).
343. Dunnet v. Arn, 71 F.2d 912 (10th Cir. 1934).
was $165 per share, but secretly agreed upon an additional payment of $86,830 to the controlling shareholders. The minority shareholders were permitted to recover a proportionate share of the secret bonus.344 In order to recover in such a situation a minority shareholder must prove that he or she was induced to sell his or her shares by the misrepresentation.345

The A.L.I. Principles of Corporate Governance go further and would impose upon a controlling shareholder a duty to disclose to minority shareholders the terms of sales at a premium where the controlling shareholder deals with the minority shareholders in connection with the transaction.346 The duty applies, for example, where the controlling shareholder helps the purchaser of his or her shares convince the other shareholders to sell on terms less favorable than those he or she receives.347

H. The Equal Opportunity Theory

A number of scholars argue that minority shareholders should have an equal opportunity to participate in any sale of a controlling interest in a corporation.348 They argue that an equal opportunity rule discourages sales of controlling interests where there is a risk of harm to the corporation through looting or mismanagement. Unless all shares are purchased, the controlling shareholder is a minority shareholder after the sale of control and therefore will be hesitant to sell to someone who will injure the value of the shares he or she retains.349 In addition, the sale of controlling shares in a corporation is analogized to a sale of corporate assets with a portion of the purchase price financed by the minority shareholders. Proponents of the theory urge that the sale of controlling shares is essentially a "corporate transaction" in which all shareholders should participate equally.350

A number of scholars challenge the equal opportunity theory on the

345. Roby v. Dunnett, 88 F.2d 68, 69 (10th Cir.) ("no proof that these plaintiffs were deceived or induced to act by anything the defendants did or failed to do."), cert. denied, 301 U.S. 706 (1937).
346. PRINCIPLES, supra note 80, § 5.16(a).
347. PRINCIPLES, supra note 80, § 5.16 cmt. d.
348. See Andrews, supra note 268; Jennings, supra note 266, at 29-33.
350. Id. at 520-21; Jennings, supra note 266, at 22-29 (discussing the corporate transaction theory); see also discussion supra part VII.F.
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grounds that it would deter many beneficial transactions. Some controlling shareholders will not want to become minority shareholders in the corporation; perhaps some purchasers will not want a substantial minority shareholder to remain after the purchase. Further, some purchasers will be unwilling or unable to buy all the corporate shares in order to avoid these problems. Professor Andrews, a leading proponent of the equal opportunity theory, argues that beneficial transactions generally will not be deterred since: (1) if the purchaser is optimistic about the possible gains from a change in management he or she will agree to buy all the shares; (2) if the controlling shareholder is optimistic about possible gains he or she will agree to retain some of his or her shares; and (3) if the minority shareholders are optimistic about possible gains they will waive their right to participate in the sale.

It is clear that an equal opportunity rule would result in a smaller number of private sales of control. Indeed, the proponents of the theory believe it would deter some sales of control — those that are harmful to minority shareholders. The ultimate question then is whether private sales of control generally benefit the corporation and the economy by enabling control of corporate assets to be transferred to more efficient managers. Unfortunately, the answer to this question is not yet clear.

It is possible that a rule requiring sharing of the premium from a sale of control shares would have costs apart from any deterrent effect on beneficial transfers of control. Perhaps some entrepreneurs who are considering business ventures that would require additional financing from minority shareholders would be deterred from embarking on the venture by a rule requiring them to share any premium they receive if they subsequently sell their controlling shares.

In any event, the equal opportunity theory is not currently accepted by the courts. Various reasons are cited in the opinions for rejecting

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354. See Hamilton, supra note 245, at 252-61 (discussing, among other things, the empirical evidence on this question).
the theory including: (1) precedent; (2) the desirability of legislative consideration of radical departures from existing law; (3) a belief that the rule would prevent many sales of control; and (4) the person nature of a sale of shares.\(^{357}\)

One case, if read broadly, appears to come close to adopting an equal opportunity approach.\(^{358}\) In the case, the president and dominant shareholder of a savings and loan was approached on the question of whether the savings and loan was for sale. He responded that it was not, but that he and his wife would entertain an offer for their shares. The shares were subsequently sold for $1,548 per share. With the assistance of the seller, the purchaser then acquired all but a few of the shares of the minority for prices of from $611 to $650 per share. The court stated:

> The rule we have adopted here simply is that 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, to act affirmatively and openly with full disclosure so that every opportunity is given to obtain the same advantages that such fiduciary secured and for the full protection of the minority.\(^{359}\)

A close examination of the case suggests, however, that the court's primary concern was not equal opportunity, but rather harm to minority shareholders. Two bases of possible harm to the shareholders are readily discernible from the facts of the case. The first is based upon the apparent initial interest of the purchaser in purchasing the entire association. Arguably the majority shareholders usurped an opportunity for the corporation to sell its assets, a transaction which benefits all shareholders.\(^{360}\) The second is based upon the actions of the majority shareholder-president in assisting the purchaser in its attempt to acquire the minority shares. These actions included, among other things, discontinuing dividend payments, and are clearly inconsistent with the fiduciary duties the majority shareholder owed to the minority.\(^{361}\) In sum, the case does not

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357. Claggett, 583 F.2d at 1263-64 (precedent; stifling of financial transactions); McDaniel, 418 F.2d 548 (precedent; discouraging of investments); Yerke, 376 N.E.2d at 1214-15 (precedent; personal nature of transaction); Zetlin, 397 N.E.2d 387 (precedent; desirability of legislative consideration).


359. Id. at 793-94.

360. See discussion supra parts VII.E-F. But cf. Tryon v. Smith, 229 P.2d 251 (Or. 1951) (finding no breach of duty in failing to apprise minority of offer or in selling at premium price not available to minority even though initial offer to seller, who was president and director of bank, was to purchase all outstanding shares).

361. See discussion supra part V.E.
represent a clear, unconditional acceptance of the equal opportunity theory.

An interesting variation of the equal opportunity problem arises when a controlling shareholder deals with a potential purchaser who either desires to or is willing to purchase at a premium more shares than the controlling shareholder holds. Authority suggests that the majority shareholder may favor one shareholder or group of shareholders over others in negotiating with the potential purchaser.\(^{362}\) If this is the case, a shareholder may offer an opportunity to selected shareholders to participate in a sale of control without incurring an obligation to extend the opportunity to all shareholders or to justify the discrimination, for example, by proving that the preferred minority is in fact part of a unitary group.\(^{363}\)

The Securities Exchange Act of 1934 adopts an equal opportunity approach to the purchase of shares of a publicly held corporation through a tender offer. The offer must be open to all holders of the class of shares sought, a shareholder tendering shares must receive the highest price paid by the tender offeror to another shareholder during the tender offer, and the tender offeror must purchase a pro rata amount of the shares tendered by each shareholder where the offer is oversubscribed.\(^{364}\)

VIII. DUTIES REGARDING THE PURCHASE OF SHARES

Shares in a corporation are the property of the individual shareholders, and the disposition the shares is generally not a concern of the corporation.\(^{365}\) Absent special circumstances, a shareholder does not violate any duty to the corporation by purchasing corporate shares from another shareholder.\(^{366}\) This is true even where the corporation's shares are closely-held, the purchase is at a favorable price, and the purpose of the purchase is to gain control of the corporation.\(^{367}\) "[T]here is normally no special corporate interest in the opportunity to purchase its own

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362. See Clagett v. Hutchison, 583 F.2d 1259, 1264 n. 5 (4th Cir. 1978) (issue raised and decided implicitly); Martin v. Marlin, 529 So.2d 1174, 1179 (Fla. Dist. Ct. App. 1988) ("If there is no duty to share one's own profit, there is no duty to share one's friends' profits").
363. Cf. Clagett v. Hutchison, 583 F.2d 1259, 1266-67 (4th Cir. 1978) (Butzner, J., dissenting) (arguing that persons in control of corporation may not use their control to discriminate among shareholders of the same class).
shares."368 Further, a shareholder's failure to disclose his or her motive in purchasing corporate shares is not a breach of duty to the corporation even where the motive is to liquidate the corporation.369 Where, however, a corporation has a special interest in the opportunity to purchase its shares, a shareholder who stands in a fiduciary capacity to the corporation, such as an officer, director, or controlling shareholder, may not usurp that opportunity.370

Several cases indicate that in limited circumstances a shareholder's purchase of corporate shares from another shareholder is a breach of fiduciary duties to the other shareholders. In one case a shareholder in a closely-held corporation purchased the shares of another shareholder despite the fact that the shares were subject to a share redemption agreement among the shareholders.371 The agreement provided that a shareholder who desired to dispose of his or her shares was obligated to offer the shares first to the corporation and then to other shareholders on a pro rata basis. Since almost all of the corporate shares were held by three equal shareholders before the sale, the prior balance of power among the shareholders in the corporation was destroyed.372 The court decided that the trial court erred in failing to find that the shareholder who purchased the shares in violation of the agreement breached his fiduciary duties to the other shareholders.373 The case holds that the shareholders in a close corporation owe each other a strict duty of good faith similar to the duty a partner owes to his or her co-partners374 and that the purchase of the shares without compliance with the share redemption agreement fell short of this good faith standard.375

In another case, two shareholders in a closely-held corporation each held 425 of the 1,000 authorized corporate shares.376 The two shareholders, acting as directors, approved a resolution authorizing one shareholder, as president, to borrow money and, if a loan were not readily available, to sell additional shares. Soon afterwards the shareholder-

368. Id. at 1093.
370. See, e.g., Sladen v. Rowse, 347 A.2d 409 (R.I. 1975) (shareholder-director purchased shares that the corporation was interested in purchasing).
372. The spouses of the three shareholder each held one share. Id. at 169. Presumably this did not effect the balance of power in the corporation.
373. Id. at 171-73.
374. Id. at 171. See generally discussion supra part VI.A.
375. Fought, 543 So. 2d at 173.
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president sold 30 shares to his parents. Meanwhile, the other shareholder purchased 75 shares that were held by the treasurer of the corporation. Eventually each shareholder challenged the actions of the other.

The trial court held that the shareholders intended to be equal partners and invoked its equity powers to amend the articles of incorporation to provide for two classes of shares, one voting and the other nonvoting. The appellate court reversed on the grounds that absent statutory authority, courts lack the power to amend a corporation’s articles of incorporation. However, the appellate court stated that shareholders in “incorporated partnerships” owe each other “a fiduciary duty to deal fairly, honestly and openly.” The court found that the evidence supported the trial court’s determination that the parties intended equal control and ownership of the business. Therefore, the trial court was justified under the facts of the case in finding that the shareholders owed each other a fiduciary duty to disclose “the availability of outstanding shares for sale and to afford the opportunity to share in the purchase of such stock,” and that both shareholders breached this duty. The case was remanded to the trial court which, according to the appellate court, may properly enter an order requiring the shareholders to exercise their voting rights according to their agreement or requiring the sale of “equalizing shares.”

In sum, in jurisdictions in which the shareholders of closely-held corporations are subject to fiduciary duties analogous to those of a partner, the purchase of shares from another shareholder is a breach of the purchasing shareholder’s fiduciary duties where it violates an agreement among the shareholders restricting the transfer of the shares, where the corporate shareholders intend a particular balance of power that is upset by the purchase, or where there is other evidence of lack of good faith towards other shareholders on the part of the shareholder buying the shares. Where, however, the shareholders of the closely-held corporation do not intend to be subject to fiduciary duties analogous to those of a partner, a court may apply the general norms of corporation law and find that the purchase of corporate shares is not a breach of fiduciary duties.

377. Id. at 945.
378. Id.
379. Id.
380. Id. at 946.
381. See generally discussion supra parts VI.A-B.
382. Cf. Cressy, 378 N.E.2d at 945 n.6 (shareholders in closely-held corporation may intend to do business among themselves “strictly in accord with the norms of general corporation law”). See
IX. CONCLUSION

An understanding of the role of shareholders in a corporation and an attentiveness to the distinction between assets and opportunities which belong to the corporation and those which do not are essential as one sorts through the duties of shareholders in differing situations. In counseling a shareholder in a planning context or defending a shareholder in litigation, the attorney who has acquired such an understanding and attentiveness can use the case law effectively to plan a course of action or a legal argument. The attorney should be alert to situations in which a shareholder exercises or has the power to exercise control over the corporation and to situations in which a shareholder deals with or causes foreseeable injury to corporate assets or opportunities. In addition, the attorney should remember that shareholders in closely-held corporations are generally subject to the same duties as partners. Finally, he or she should be aware that structuring a transaction as a personal transaction rather than a corporate transaction can involve some risk of liability.

also discussion supra part VI.C. on disclaimer of fiduciary duties in the closely-held corporation context.