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THE FIDUCIARY RELATION OF THE DOMINANT SHAREHOLDER TO THE MINORITY SHAREHOLDERS

By DAVID FINCH* and ROBERT LONG*

When Judge Leahy of the Federal District Court of Delaware says,

> "The doctrine of the fiduciary relation is one of the most confused and entangled subjects in corporation law,"[1]

one is inclined to believe that it is so. The statement is challenging; one which should not be allowed to remain standing.

The focus of the following discussion is upon the doctrine as it relates to the exercise by the dominant shareholder of powers conferred upon him (or it) by statute or articles of incorporation. Such powers, for example, as the power to transfer the corporate enterprise by sale of all properties and franchises, the power to amend the corporate charter[2] or the more subtle, indirect power to cause preferred shares to be called for redemption, are powers the exercise of which may result in serious financial loss to those minority shareholders who have no voice nor veto.

A considerable amount of the confusion may stem from the lack of clarity as to the meaning of the word "fiduciary." This word has several meanings and hence, standing alone, is ambiguous. The variation in meaning of the word is not so much in its definition as in the intensity of the application of its concepts of *good faith and fair dealing*. A parallel may be seen in the field of negligence, where "standard of conduct" is greater or lesser depending upon the relation of the parties, although the term may always be defined the same. Leaving the rest to the semanticist, let us simply say the concepts of "fiduciary" are applied in various *degrees of intensity*.[3] It is clear that a trustee is a fiduciary but it is not at all correct to say that a fiduciary is a trustee. The terms are not coextensive. In the case of a trustee the fiduciary element is more intense than in the case, say, of an agent or a partner, an attorney or a corporate director.[4] A trustee is forbidden to take to himself a profit by dealing with the property he holds in trust. The same cannot be said of a dominant shareholder.

There is no law against the dominant shareholder's entering a contract with his company by which he profits. Take for example, the case of a manufacturing company affiliated (by ownership of a controlling interest) with a sales company. There is no legal objection to a contract by which dis-

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1 Geller v. Transamerica Corp., 53 F. Supp. 625, 629 (D. Del. 1943).

2 Since this power is ordinarily exercisable by vote of the majority of the shareholders as distinguished from the vote of a majority of the shares, a variation in the problem is presented. The same principles should govern however. Berle, *Corporate Powers As Powers In Trust,* 44 HARV. L. REV. 1049, 1067 (1931).

3 Scott, *The Trustee's Duty of Loyalty,* 49 HARV. L. REV. 521 (1936).

4 *Id.* at 521; RESTATEMENT, RESTITUTION § 190, comment (a) (1935).

tribution of the former's product is carried out by the latter.[5] A minority shareholder in a suit to rescind this contract would have to show, therefore, something more than that the dominant shareholder dealt for profit with his corporation.

It is the thesis of this article that the "something more" is yet something less than a violation of the ordinary rules of law. Let us put it this way; if we concede that dominant shareholders are not trustees in the technical sense, that they may deal even for profit with the corporation they control and in which others are financially interested, then should the court say that such dealings are unobjectionable so long as the letter of the law has been followed? Is modern jurisprudence to content itself with ancient rules with a justification somewhat like that given by the rich attorney for his elderly, ugly daughter as a bride in Gilbert's *Trial by Jury* when he said;

"She may very well pass for forty-three
In the dusk, with the light behind her!" ?

The understanding and utilization of fiduciary concepts makes it possible to answer both of these questions in the negative with equal vehemence.

In imposing fiduciary duties upon the dominant shareholder two approaches may be taken. The difference between the two is perhaps more formal than substantial, but the picture is more complete and comprehensible when both are understood. One is a *direct approach* by which one, attentive to the principles of equity, looks at the relation of the dominant shareholder to the other shareholders and concludes as a matter of law that it is a fiduciary relation. The other is an *indirect approach* by which one looks in the first instance at the relation of the directors to shareholders and concludes that if a shareholder dominates the corporation through his influence over the directors he must bear an identical relation to the minority shareholders.

Direct or Equitable Principles Approach

It may be said generally that a fiduciary relation arises in those cases wherein one holds a position of superiority and influence over the interests of another[6] such that the latter is forced to rely upon the good faith and fair dealing of the former and without regard to the origin or source of the relation.[7] It should be noted especially that the concept embraces fair dealing and good faith rather than technical legal obligation.[8]

[5] Western Pac. R. Corp. v. Western Pac. R. Co., 197 F.2d 994, 1000 (9th Cir. 1952). "Even the corporation which dominates its subsidiary, with the resultant fiduciary relationship, properly deals with its affiliate for profit as long as there is no overreaching or unfairness."

[6] Schweickhardt v. Chessen, 329 Ill. 637, 649, 161 N.E. 118, 123 (1928).

[7] Small v. Nelson, 137 Me. 178, 180, 16 A.2d 473, 475 (1940); Posey v. Brixley, 133 Okla. 98, 100, 271 Pac. 230, 232 (1928); Quinn v. Phipps, 93 Fla. 805, 113 So. 419 (1927); Stahl v. Stahl, 214 Ill. 131, 73 N.E. 319 (1905).

[8] Kinzbach Tool Co. v. Corbett-Wallace Corp., 138 Tex. 565, Civ. App. 568, 160 S.W.2d 509, 512 (1942).

A shareholder who has control of the voting stock has the right to determine the policy to be pursued by the directors; in practical effect, to direct and manage the affairs of the corporation. He may not choose to exercise this right in which case there is no occasion to impose fiduciary obligations.[9] But when the controlling shareholder chooses to dominate the corporation, upon him devolves the power to deal with property in which minority shareholders are financially interested. It is at the point of domination by the controlling shareholders, therefore, that, under the general principles, the fiduciary relation arises.

This approach may be summed up in the words of Justice Brandeis:

> "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority; as much as the corporation itself or its officers and directors. . . . *It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation.*"[10] (Emphasis supplied)

Indirect or Directors Approach

This approach to the imposition of fiduciary duties upon the dominant shareholder requires an examination in the first instance of the relation in which directors stand to the shareholders. That the directors in carrying out their functions, though given considerable discretion by the articles and bylaws,[11] are fiduciaries for the benefit of the corporation and the shareholders in a rather strict sense is universally recognized.[12] This duty extends to *all* of the shareholders[13] and includes the obligation to so manage the affairs of the corporation as to produce to the best of a reasonable ability the highest possible return on each individual's investment.[14] It is not to be supposed, however, that directors are trustees in the technical sense. The early common law rule identifying directors with trustees is declining if it has not yet fallen. Today the courts do not use the language of trusts, but are concerned with whether, after a close scrutiny of the transaction complained of, there has been any substantial degree of over-

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[9] Recognizing that transactions by the dominant shareholder with the corporation will be "viewed by the courts with jealousy, and set aside on slight grounds," the court in *Rothchild v. Memphis & C. R. Co.*, 113 Fed. 476 (C.C. W.D. Tenn. 1902) found no breach of fiduciary obligations in absence of a showing that the majority shareholder actually controlled the affairs of the corporation for its own benefit and to the prejudice of the minority.

[10] Southern Pacific Co. v. Bogert, 250 U.S. 483, 487 (1918). That this case is subject to the criticism that a just result could have been achieved without the aid of the fiduciary concept is noted in 36 CALIF. L. REV. 325 (1948). However, this criticism does little to impeach the proposition stated.

[11] Atkins v. Hughes, 208 Cal. 508, 282 Pac. 787 (1929).

[12] BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS § 84 (1949 ed.) Directors are required to act "in the highest good faith and loyalty and with a view to the best interests of the corporation which they represent."

[13] See 19 C.J.S., *Corporations* § 764 (1940) and cases there cited.

[14] FLETCHER, PRIVATE CORPORATIONS § 838 (perm. ed. rev. repl. 1950).

reaching or unfairness on the part of the directors.[15] A number of states have adopted statutes which articulate the general fiduciary duty of directors and officers in the exercise of their powers[16] while liberalizing the severe and impractical rule of early common law.

Where the transaction is one in which participation of the directors is necessary (the normal case) and in which the directors are said to bear a fiduciary relation to the shareholders, then the conclusion seems unassailable that the dominant shareholder at whose instigation the directors act bears an identical relation to the minority; for between the board of directors and the dominant shareholder arises a "puppet-puppeteer" relationship.[17]

In approaching the problem of the duty of dominant shareholders via the generally conceded fiduciary duty of directors, an important distinction is to be noted. It is the distinction between cases in which the directors are acting *qua* directors in the management of corporate affairs and cases in which the directors are dealing at arms length with shareholders in transactions outside the scope of the corporate enterprise. In cases of the latter type no fiduciary duty is found by most courts, at least in the absence of special circumstances. Suppose, for example, a director of a corporation seeks to purchase shares from one of its shareholders without disclosing the fact that property of the corporation had just been sold at a handsome profit, and the shareholder ignorantly sells his shares for a price below their actual value. Does the fiduciary duty that directors owe to the corporation and shareholders in the management of corporate affairs extend to transactions of this sort? In a decision representative of the majority view the New Jersey court held it does not.[18] A minority of the courts take the opposite view,[19] basing the rule they invoke on the general principle that a fiduciary relation arises where one party to the transaction has superior knowledge of the matter which is itself derived from a fiduciary relation or a position of influence such that an unfair advantage in a trans-

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15 Note, 61 HARV. L. REV. 335 (1948) shows the practical disadvantage and the judicial discard of "trust" concepts at pp. 335, 336.

16 CAL. CORP. CODE § 820 (1947); GA. CODE ANN. § 22-708 (1936); MICH. STAT. ANN. § 21.13(5) (Henderson 1937); Note, 23 CORN. L.Q. 445 (1938); Note, 61 HARV. L. REV. 335, 339 (1948). The Harvard note writer's conclusion that the California statute obviates the necessity of showing fairness if the contract is ratified by an independent majority of the board or by the shareholders is not warranted. BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS § 84 (1949 ed.).

17 Zahn v. Transamerica Corp., 162 F.2d 36, 46 (3d Cir. 1947).

18 "A director or the treasurer of a corporation is not, because of his office, duty bound to disclose to an individual stockholder, before purchasing his stock, that which he may know as to the real condition of the corporation affecting the value of that stock. He is, to be sure, to some extent, trustee for the stockholders as a body, in respect to the property and business of the corporation, but does not sustain that relation to stockholders with respect to their several holdings of stock over which he has no control." Crowell v. Jackson, 53 N.J.L. 657, 23 Atl. 426 (1891). See cases in 84 A.L.R. 615 (1933).

19 Northern Trust Co. v. Essaness Theatres Corp., 348 Ill. App. 134, 108 N.E.2d 493 (1952); Manning v. Mills, 193 Ga. 82, 17 S.E.2d 261 (1941).

action is probable.[20] The complete picture is more complex, however, than one of extreme views. Many courts while recognizing the majority general rule have come also to recognize an exception popularly termed the "special facts" doctrine.[21] Assuming that no fiduciary relation exists in the purchase by directors of shares from the corporation's shareholders, special circumstances may be present giving rise to an equitable obligation to make a full disclosure of relevant facts. Such, for example, is the case in which the director volunteers some, while concealing other, information. Having undertaken to inform the selling shareholder in some respects, the buying director must make full disclosure of *all* the facts.[22]

When counsel is arguing to the court the proposition that the dominant shareholder bears a fiduciary relation to the others, using as his major premise that directors stand in that relation and as his minor premise that the dominant shareholders are in substance the directors (because they are dominant), he must be sure either that the directors were acting *qua* directors or that the transaction is one in which the court will impose fiduciary duties upon the directors under the minority rule or the "special facts" doctrine.

In cases where the action taken was by the board of directors only after a vote by the majority or where, either by statute or by-laws, ratification of a board resolution by vote of the majority of the shares was prerequisite to action by the directors, the *direct approach* of applying general fiduciary principles to the position of superiority and influence of the majority would seem to be most sound.

The Nature of the Duty

As suggested above the nature of the duty is best determined from an examination of the particular transaction involved under the flickering light of decisions in point. Although the attitudes as to the *intensity* of the fiduciary element have varied somewhat among the judges before whom many different sorts of transactions have been aired, the language either applied or recognized as correct is almost uniform. It is to the effect that transactions by a parent corporation or other controlling shareholder with the corporation are *rigorously scrutinized* to see whether domination exists and if so, whether that domination has resulted in any *overreaching or un-*

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[20] See Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929, 933 (1916).

[21] For a good discussion of this phase of the law citing decisions and text writers, see American Trust Co. v. California Western States Life Ins. Co., 15 Cal. 2d 42, 98 P.2d 497, 504 (1940), where the court left open the question whether California follows the majority rule as modified by the "special facts" doctrine, or the majority rule.

[22] Dunnett v. Orn, 71 F.2d 912, 918 (10th Cir. 1934); Poole v. Camden, 79 W. Va. 310, 92 S.E. 454, 457 (1917); The "special facts" doctrine was first announced in Strong v. Repide, 213 U.S. 419 (1909) which held that a director of a corporation who concealed his exclusive knowledge of an impending sale of corporate assets from a shareholder from whom he purchased shares, thereby violated his duty of disclosure which arose under those circumstances.

fairness which will raise a presumption of fraud. This was substantially the language used by the court in the widely quoted case of Pepper v. Litton[23] which held that the burden is upon the dominating shareholder to show the inherent fairness *as well as* the good faith of the transaction. Such, obviously, is the language of fiduciary concepts. When, therefore, even a learned writer,[24] recognizing the judicial concern with fairness and good faith, is able still to conclude that a fiduciary relation does not exist, one suspects that the word "fiduciary" has been identified with the word "trustee."

Exercise of the Power to Call for Redemption

The famous *Transamerica* litigation[25] having arrived at what appears to be its *finis,* a new item may be added to the stock of transactions authorized by law yet circumscribed by equity.

The common practice today where the issuance of preferred shares is authorized is to provide for the call and redemption of these shares, usually at the option of the corporation. Though there is no inherent power in a corporation to call its preferred shares, corporations are generally given this power either by statute or by provisions to this effect in the articles of incorporation.[26] Such provisions are very important economically to the modern corporation for they make it possible to switch from costly stock financing to a less costly bond financing.[27] Since the articles, including the statutory provisions under which they were drawn, constitute a contract between the shareholders *inter sese,* where the articles provide for redemption, a preferred shareholder is by his own contract subject to having his shares called for redemption.

The decision in *Zahn v. Transamerica*[28] declares and holds that with the power to redeem, as with all other corporate powers, goes responsibility in modern corporation law. Plaintiffs were the holders of "class A" shares in a Kentucky tobacco company. These shares were subject to redemption provisions in the corporation's charter. Transamerica Corporation purchased substantially all of the voting "class B" common shares

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23 308 U.S. 295 (1939).

24 See BALLANTINE, CORPORATIONS § 303 (rev. ed. 1946). Note the distinction there drawn between cases where the controlling stockholder has an adverse interest in the transaction and those where the transaction is on behalf of the corporation generally. Yet, without reference to this distinction the conclusion is made that "[i]t can hardly be said that the majority stockholders are fiduciaries in making these decisions (re voluntary dissolution) as they are entitled to decide, if they act in good faith according to their own enlightened self-interest."

25 For the history of this litigation see 54 MICH. L. REV. 971 (1956).

26 11 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5309 (perm ed. 1932).

27 Dodd, *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law,* 89 U. PA. L. REV. 697, 724 (1941).

28 *Supra* note 17.

and elected a majority of the board of directors. Subsequently the value of the tobacco company's leaf tobacco inventory rose from its book value of $6,361,981 to about $20,000,000. The complaint alleged that Transamerica, knowing of this inventory appreciation, conceived a plan to capture for itself the value of the tobacco by a redemption of the "class A" shares, making the redemption appear as though in the best interest of the tobacco company. This plan was carried out; the tobacco company was liquidated, and the proceeds from the sale on liquidation pocketed by Transamerica. The complaint against Transamerica Corporation, seeking damages for fraud, had been dismissed by the district court.[29] On appeal, the circuit court concluded[30] that if the facts stated in the complaint were true, the act of the directors in making the call was to serve no useful corporate purpose, but was made solely to benefit Transamerica; that the board of directors stood in a fiduciary relation to the "class A" shareholders; that since the directors did not act as an independent board, but rather as a puppet under the domination of Transamerica, the latter also stood in a fiduciary relation; and that, therefore, the redemption in the interest of Transamerica and to the detriment of the "class A" shareholders was a breach of fiduciary duties owed by the former to the latter. The court here did not allude to the fact that the charter also conferred upon "class A" shareholders the privilege to convert their shares to "class B" on a one-for-one basis upon call for redemption. This fact, however, provides another basis upon which to impose liability, for the fiduciary Transamerica did not, nor did the board of directors, disclose the fact that the inventory value had increased. Thus the "class A" shareholders were misled to their detriment not to convert. That these conclusions find ample support in reason and judicial precedent should be no longer open to question.[31]

Exercise of the Power to Transfer the Corporate Enterprise

Most if not all corporation statutes authorize the corporations created thereunder to transfer the corporate enterprise to another.[32] This may be done in various ways, all of which fall under the loose label of "merger." One effective method is for shareholders to transfer shares until the acquiring company has obtained a controlling majority of the stock. Another is by way of a sale of corporate assets. In *Ervin v. Oregon Ry. & Nav. Co.*[33] the owner of a majority of the shares of a steamship company entered into a contract with a promoter to sell his controlling block in consideration of cash plus securities to be issued by the new corporation then in the process of formation. Upon formation the new corporation took over the

[29] Zahn v. Transamerica Corp., 63 F. Supp. 243 (D. Del. 1945).

[30] *Supra* note 17.

[31] Weisbecker v. Hosiery Patents, 356 Pa. 244, 51 A.2d 811 (1947); Lebald v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941); Jones v. Missouri-Edison Electric Co., 144 Fed. 765 (8th Cir. 1906), *rev'd.* 199 Fed. 64 (8th Cir. 1912), *cert. denied* 229 U.S. 615 (1913).

[32] Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049, 1069 (1931).

[33] 27 Fed. 625 (C. C. New York S. D. 1886), *appeal dis'm. per stip,* 136 U.S. 645 (1889).

contract of its promoter and soon thereafter assumed the management of the steamship company by election of directors and officers in its interest. *The new company then made an offer to purchase the property and franchises of the steamship company which was accepted by resolution of the board of directors.* The consideration for this purchase, which was *less than full value,* was blithely justified by the directors with the assumption that the steamship company's traffic would soon be depleted by the railroad to be constructed by the new company and that the sale of properties was advantageous under the circumstances. This resolution was subsequently ratified by vote of the majority of stock held by the new company and others interested therein. Pointing out that the defendant new company was entirely within its legal rights under the corporation statutes and the articles, the court, using the *direct approach* held that the essence of the contract between the shareholders and corporation and between the shareholders *inter sese* is that the corporate powers are to be exercised only to the purposes of their existence, and that the majority shall not control those powers to secure profit to themselves in contempt of the interests of the minority; that the *community of interest* of all the shareholders imposes upon those in control the obligation to produce the most that can be obtained for all; and that as fiduciaries the majority who seek to profit at the expense of the minority are guilty at least of constructive fraud. The language of this decision discloses an attitude in favor of fidelity in a very intense degree as the requirement of the relation.[34]

It is important to notice that in the *Ervin* case the court *did not find a breach of duty on the part of the original majority shareholder insofar as was concerned his sale* to the new company of a controlling majority in the steamship company. It was the new company which, as dominant shareholder, dealt unfairly with its subsidiary to the injury of others interested therein.

However, since the corporate enterprise may be effectively transferred by the simple method of transfer of a majority of the voting stock, the question arises as to whether such a transfer itself might be a breach of fiduciary duties. It seems clear under the cases and on principle that the majority shareholder has as much right to sell his shares as do the minority shareholders; and this is true without regard to whether the acquiring party is interested in controlling the enterprise and whether a profit or bonus is made on the sale.[35] Even though the majority shareholder does not dominate his corporation he has a power over it; a power, to wit, to transfer the enterprise to another corporation which *will* exercise its right to dominate. Does the majority shareholder have a fiduciary obligation in connection with this power to transfer?

[34] 27 Fed. at 631. "[W]hen a number of stockholders combine to constitute themselves a majority in order to control the corporation as they see fit, they become for all practical purposes the corporation itself, and assume the trust relation occupied by the corporation toward its stockholders."

[35] See note, 50 A.L.R. 1146, 1147 (1956).

Suppose a majority shareholder of a steel company who does not dominate his board of directors, is approached by the representative of another corporation with an offer to purchase his shares and in addition to the market price to pay him a bonus for the controlling block. The period is one of short steel supply and the offering company is eager to control the allocation of steel produced by the steel company and thus assure supply to its own steel consuming enterprises. This it could do by electing its own nominees to the board of directors. Why should not the majority shareholder accept such an offer?

In the absence of any fiduciary relation the majority shareholder would be unlimited in the exercise of the right to sell his control. The exercise of the right, however, would convert a tremendous corporate advantage, one shared by his coventurers, the minority shareholders, into a private gain; for clearly a period of short supply presents such an advantage to a supplier. Here the general equity principles furnish a just and effective solution. Thus, seeking personal gain, one who uses his position of superiority and influence to the sacrifice of the interests of those who are forced to rely upon him, should be accountable to them for that gain.[36]

The proper test and measuring rod of the duty in any case in which the power to transfer the corporate enterprise has been exercised is whether the majority and/or dominant shareholders have exercised their judgment and discretion in good faith for the benefit of the corporation including the minority.[37]

Conclusion

This comment has not attempted to cover even most of the items involving fiduciary concepts (for such an attempt would seem less productive than ponderous), but tries instead through a few examples to demonstrate the nature of the major problem and suggest methods of disposition.

Two methods have been suggested by which the court in a particular case might reach the conclusion that the majority and/or dominant shareholder stands in a fiduciary relation to the minority. The courts which have used these methods have not taken pains to make clear which of the two was important in each instance. Frequently the distinction has been ig-

[36] Perilman v. Feldman, 219 F.2d 173 (2nd Cir. 1955) *cert. denied,* 349 U.S. 952 (1955). The court was not required to use the direct approach in this case because defendant, prior to sale of his shares, had also been a director of the company. It was pointed out, however, that defendant stood in a fiduciary relationship both as director and as controlling shareholder. The court arrived at this conclusion by a purported use of the *direct approach.* This reasoning seems questionable since the directors as a body were not involved in the transaction. The tenor of the decision, however, suggests that the *direct approach* would have been used had defendant not been a director. See pp. 175, 176.

[37] Mayflower Hotel Stock P. C. v. Mayflower Hotel Corp., 173 F.2d 416 (D. C. Cir. 1949), *aff'd* 84 U.S. 275; Lebald v. Inland S.S. Co., 82 F.2d 351 (7th Cir. 1936); Geddes v. Anaconda Copper Mining Co., 197 Fed. 860 (D. Montana 1912) *aff'd,* 254 U.S. 590 (1912); Barrie v. United Ry., 125 Mo. App. 96, 102 S.W. 1078 (1907); Farmers Loan & Trust Co. v. New York & N. Ry., 150 N.Y. 410, 44 N.E. 1043 (1896).

nored, or only nebulously drawn, between those transactions in which the corporation as such, and all of its shareholders, were interested, and those valid arm's length transactions which concern no one but the parties thereto. Some courts and writers have unwittingly identified the terms fiduciary and trustee and were, therefore, compelled logically to the unfortunate conclusion that a shareholder cannot be a fiduciary to the corporation and those interested therein.

But, when the appropriate distinctions are drawn, a convincing argument can be made for the proposition that the imposition of fiduciary duties upon the majority and/or dominant shareholders when they undertake to exercise corporate powers is both useful and consonant with modern corporation law.

Certainly no legislature, which sees fit to grant corporations within its jurisdiction such powers as the power of redemption and the power to transfer the corporate enterprise, intends that those powers will be used to the advantage of a few and to the injury of many. Writers and judges have pointed out that there is a moral element involved,[38] and experience has shown that, absent the application of equitable principles, the black letter of the law permits considerable immorality.

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[38] Lattin, *EquitableLimitations On Statutory or Charter Powers Given to Majority Stockholders,* 30 MICH. L. REV. 645 (1932).