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The Misguided Doctrine of Stockholder Fiduciary Duties

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I. INTRODUCTION

By now, most courts and commentators have accepted the proposition that controlling stockholders[1] owe fiduciary duties to the other stockholders of the corporation. In close corporations, the premise is described as arising from the partnership-like nature of the close corporation,[2] the need to protect stockholders in light of the economic realities of investments in close corporations,[3] and "settled rule[s] of law."[4] In public corporations, duties are said to arise from the fact of control.[5] In fact, none of these arguments support imposing a fiduciary duty on controlling stockholders. Rather, such a fiduciary duty violates basic principles of American law. Moreover, basic principles of corporate and agency law, properly understood, provide all the protection stockholders need and provide a more workable framework for evaluating stockholder behavior.[6]

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1. The definition of a controlling stockholder includes a stockholder owning a majority of the voting power of the corporation, a stockholder owning less than a majority but a sufficiently large block to exercise de facto control (for example, where thc other shares are widely held), and a stockholder with effective control of the board of directors by contract. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1114-15 (Del. 1994) [hereinafter Lynch 1]; Citron v. Steego Corp., Civ. A. No. 10171, 1988 WL 94738, at *6 (Del. Ch. Sept. 9, 1988). The ALI Principles of Corporate Governance define controlling stockholder as one who either (1) owns and has the power to vote more than fifty percent of the stock, or (2) otherwise exercises a "controlling influence over the management or policies of the corporation or the transaction in question by virtue of the person's position as a shareholder." ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(a)(2) (Proposed Final Draft 1992) (hereinafter PRINCIPLES OF CORPORATE GOVERNANCE). A stockholder who controls more than twenty-five percent of the stock is presumed to exercise a controlling influence unless there is a larger stockholder. *Id.* § 1.10(b). Even a small minority stockholder may become a "controlling" stockholder in some cases, such as where the certificate of incorporation required an eighty percent supermajority for any action by the stockholders. *See* Smith v. Atlantic Props. Inc., 422 N.E.2d 798, 799 (Mass. App. 1981). The twenty-five percent holder, who was exercising his veto power to create deadlock, was therefore treated as a controlling stockholder in the circumstances. *See id.* at 802 n.6; *see also* Med. Air Tech. Corp. v. Marwan Inv., Inc., 303 F.3d 11, 20-21 (1st Cir. 2002); Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 34-38 (1999) (arguing that control should be determined on a transaction-by-transaction basis, not in general).

2. *See infra* Part III.A.

3. *See infra* Part III.B.

4. Singer v. Magnavox Co., 380 A.2d 969, 976-77 (Del. 1977).

5. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 240 (3d ed. 1983).

6. *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 921-24 (1999) (noting that other features of corporate laws protect minority investors).

Part II of this Article briefly describes the current state of the law of controlling stockholders' fiduciary duties. Part III describes the purported bases for those rules and the problems therewith. Part IV describes the ways in which imposing fiduciary duties on stockholders violates basic principles of American law. Part V suggests other, too-frequently ignored, legal doctrines that accomplish the desired results without straining corporate law.

II. THE LAW OF CONTROLLING STOCKHOLDERS' FIDUCIARY DUTIES

The imposition of fiduciary duties upon controlling stockholders derives from two separate legal principles. The first, and much older source of stockholder duties, is the principle that one who exercises power over the assets of another ordinarily owes a fiduciary duty in the exercise of that power. Thus, because a controlling stockholder controls the corporation, which is also property of the minority stockholders, the controlling stockholder owes the minority a fiduciary duty. As discussed at greater length below, this principle is unobjectionable as far as it goes, but it tends to be misapplied in the corporate context. The second, more recently developed basis for stockholder duties is the nature of the relationship between stockholders in closely held corporations, which requires, in equity, that they be held to a fiduciary standard. Under this principle, controlling stockholders in publicly held corporations would not owe fiduciary duties to the public minority. Thus, the law applicable to controlling stockholders in publicly held corporations tends to differ in both substance and rhetoric from the law applicable to stockholders in closely held corporations. Most of the scholarly attention has focused on closely held corporations.

A. Closely Held Corporations

Since *Donahue v. Rodd Electrotype Co.*,[7] many courts have held stockholders in closely held corporations to the high fiduciary standards applicable to partners.[8] As the *Donahue* court described it, controlling stockholders "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the

7. 328 N.E.2d 505 (Mass. 1975).

8. In *Donahue*, the court contrasted the "strict good faith standard" applied to partners with the "less stringent" standard applicable to corporate directors, although its basis for concluding that the corporate fiduciary duty was less strict is not clear. *See id.* at 515-16.

corporation."[9] In that case, the fiduciary duty was held to prohibit a controlling stockholder from using its position to obtain "special advantages and disproportionate benefit."[10] In later cases, the Massachusetts courts relaxed the duty sufficiently to provide some managerial flexibility to controlling stockholders, such that the controlling stockholder may assert a legitimate business purpose as a defense to an action for breach of fiduciary duty.[11] The minority can nevertheless recover if it can show that that purpose could have been achieved by less harmful means.[12]

Although Massachusetts took the lead in imposing heightened partnership-like fiduciary duties upon stockholders in closely held corporations, many other states have followed suit.[13] At least one state, however, has bucked the trend and refused to recognize special rules for controlling stockholders in close corporations.[14] The courts in Delaware have held that, because Subchapter XIV of the Delaware General Corporation Law allows closely held corporations to elect to be governed by the special provisions set forth therein, all corporations not so electing must be governed by general principles of corporate law.[15] Thus, while Massachusetts courts will in some cases protect a minority stockholder's right to be employed by the company,[16] Delaware courts have refused to recognize a stockholder's employment right.[17]

Although many states recognize fiduciary duties of controlling stockholders in close corporations, the parameters of those duties are not particularly clear. Some commentators have suggested, for example, that controlling stockholders should not owe a duty of care, but only a duty of loyalty, because the duty derives from the conflict of interest between the majority and the minority and there is no such conflict with respect to the obligation to take due care in conducting the corporation's

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9. *Id.* at 515.

10. *Id.* at 518.

11. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976).

12. *See id.*

13. *See generally* Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 726-38 (1993); F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7.04 (2d ed. 2001).

14. Controlling stockholders in Delaware are, however, subject to general fiduciary duties. *See infra* notes 15-17 and accompanying text.

15. *See* Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993).

16. *See Wilkes*, 353 N.E.2d at 663-64.

17. *See* Riblet Prod. Corp. v. Nagy, 683 A.2d 37, 39 (Del. 1996).

business.[18] More importantly, it is not clear whether the duty is owed to the other stockholders directly or whether it is owed to the corporation and only derivatively benefits the minority stockholder. Ordinarily, suits for breach of fiduciary duty against those in control of a corporation must be brought derivatively on the corporation's behalf where the injury is to the corporation, rather than to the stockholders directly. In many close corporation cases, however, the injury is to the minority stockholder directly (as in *Wilkes v. Springside Nursing Home, Inc.*, where the alleged breach of duty consisted of terminating the plaintiff-stockholder's employment[19]), and the courts hold, at least implicitly, that the duty is owed directly to the minority stockholder.[20] In cases where the alleged harm is to the corporation, some state courts nevertheless permit the claim to be brought directly, rather than derivatively, to free the plaintiff from the procedural requirements of the derivative suit.[21]

In addition to being subject to liability for breach of fiduciary duties, controlling stockholders in closely held corporations are at risk in some states of having their firms dissolved for "oppression" or, as an alternative remedy, being forced to buy out the minority.[22] This remedy usually derives from a statutory provision such as Section 14.30(2)(ii) of the Model Business Corporation Act, which provides for judicial dissolution upon application by a stockholder if "the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent."[23] Because the statutes do not define oppressive conduct, the courts and commentators have developed

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18. *See* Eric Seiler et al., *Issues Relating to Controlling Stockholders, in* STEPHANIE SELIGMAN & STEVEN SHAPIRO, DOING DEALS (1995); P.L.I., UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 455, 462-63 (1995).

19. *See Wilkes*, 353 N.E.2d at 659.

20. *See* Meyer v. Brubaker, No. G026361, 2002 WL 110411, at *2 (Cal. App. Jan. 29, 2002).

21. *See generally* O'NEAL & THOMPSON, *supra* note 13, § 7.08; *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 7.01(d) (allowing action to be brought directly if doing so does not prejudice the interests of the corporation or its creditors); *id.* cmt. e (discussing reasons why the procedural hurdles to derivative suits are less necessary in close corporations). *But see* Keenan v. Eshleman, 2 A.2d 904, 909-11 (Del. 1938) (holding that the lawsuit must be brought derivatively); Simmons v. Miller, 544 S.E.2d 666, 674 (Va. 2001) (same).

22. *See* Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 761 (2000) (describing dissolution for oppression and breach of fiduciary duty as complementary causes of action for minority stockholders) [hereinafter Moll, *Shareholder Oppression*]; *see also* O'NEAL & THOMPSON, *supra* note 13, § 7.13 (describing the dissolution for oppression remedy).

23. REVISED MODEL BUS. CORP. ACT § 14.30(2)(ii) (1984); *see also* N.Y. BUS. CORP. L. § 1104-a (McKinney 2002) (permitting dissolution upon petition of stockholders holding twenty percent or more of the voting power of the corporation if "the directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions" toward the minority).

a definition that finds oppressive conduct where the reasonable expectations of the minority stockholders have been frustrated.[24] Dissolution of a solvent corporation at the request of a minority stockholder tends to be a draconian remedy, which might lead to "oppression of the majority by the minority."[25] Courts have, therefore, increasingly allowed the minority to force the majority to purchase their shares as an alternative to a court-ordered dissolution.[26]

The dissolution for oppression remedy does not necessarily impose fiduciary duties on controlling stockholders.[27] The extent to which the availability of the remedy increases the obligations of controlling stockholders depends upon the definition of oppressive conduct. If the reasonable expectations of the stockholders are determined, at least in part, at the time of the parties' initial investment in the corporation,[28] some disproportionate rights and benefits accruing to a majority holder should be part of those expectations. In *Nixon v. Blackwell*,[29] for example, the court noted that the corporation had been specifically structured to give control to the employees and to limit the interest of the

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24. *See* Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1001-03 (2001) (describing the reasonable expectation test) [hereinafter Moll, *Reasonable Expectations*]; *see also* O'NEAL & THOMPSON, *supra* note 13, § 7.19-7.20 (describing increasing use of reasonable expectation test); Douglas K. Moll, *Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution*, 1999 U. ILL. L. REV. 517, 529-30 (same) [hereinafter Moll, *The Investment Model Solution*]; Bailey H. Kuklin, *The Justification for Protecting Reasonable Expectations*, 29 HOFSTRA L. REV. 863, 884-905 (2001) (suggesting refinement of the reasonable expectations doctrine); Moll, *Shareholder Oppression*, *supra* note 22, at 789-97 (proposing an "investment model" for analyzing reasonable expectations); Moll, *Investment Model Solution*, *supra*, at 556-68 (same). *See generally* Sandra K. Miller, *Should the Definition of Oppressive Conduct by Majority Shareholders Exclude a Consideration of Ethical Conduct and Business Purpose?*, 97 DICK. L. REV. 227 (1993) [hereinafter Miller, *Definition of Oppression*].

25. Polikoff v. Dole & Clark Bldg. Corp., 184 N.E.2d 792, 795 (Ill. App. Ct. 1962).

26. *See* O'NEAL & THOMPSON, *supra* note 13, §§ 7.19-7.20; Moll, *Investment Model Solution*, *supra* note 24, at 546-47. *See generally* J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977) (arguing that minority stockholders in close corporations should have the right to force a buyout).

27. *See* Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1715-22 (1990) (arguing that the dissolution for oppression remedy is really a tort remedy, not the imposition of a fiduciary standard, because it is based on bad faith and wrongful conduct rather than on a failure to act in the minority's best interest).

28. This is, generally, the understanding. *See* O'NEAL & THOMPSON, *supra* note 13, § 7.20.

29. 626 A.2d 1366 (Del. 1993).

founder's heirs and legatees to a financial interest only.[30] In such cases, a majority stockholder should not be held to any higher standard than that to which it implicitly or explicitly agreed at the time it organized the corporation. If, on the other hand, courts adopt the reasoning of some of the commentators and conclude that minority investors in closely held corporations are incapable of appreciating the implications of their actions, they may define reasonable expectations in a way that imposes a heightened burden on controlling stockholders akin to that imposed by the partnership fiduciary duty model.

B. General Corporate Law, Including Publicly Held Corporations

In publicly held corporations, where there is no argument that partnership rules should apply, controlling stockholders are nevertheless subject to fiduciary duties to the corporation and, perhaps, to the minority stockholders.[31] In general, transactions in which the duty is implicated will be subject to scrutiny for entire fairness, unless some ratification or curing mechanism has occurred, such as approval by disinterested directors or by a majority of the disinterested stockholders.

The parameters of controlling stockholders' duties are somewhat unclear in publicly held companies. A leading Delaware case, for example, held that the duty is only implicated where the controlling stockholder "has received a benefit *to the exclusion and at the expense of* the subsidiary."[32] Later Delaware cases have suggested, however, that the duty is implicated whenever the controlling stockholder is on both sides of the transaction, even if it has not used its control to "dictate[] the terms of the transaction."[33] Other sources suggest that the heightened

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30. *See id.* at 1379-80. Delaware does not have a dissolution-for-oppression statute and thus does not apply the reasonable expectations test. Nevertheless, the court's analysis in *Nixon* provides a nice example of a court using expectations to rule against a minority stockholder plaintiff. *Id.*

31. *See* HARRY G. HENN, LAWS OF CORPORATIONS § 240 (3d ed. 1983). For an excellent discussion of the problems of controlling shareholders in public corporations and the methods of controlling those problems, see Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines & Markets: Controlling Controlling Shareholders*, 152 U. PENN. L. REV. 785 (2003).

32. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (emphasis added); *see also* Summa Corp. v. Trans World Airlines, Inc., 540 A.2d 403, 407 (Del. 1988); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594-95 (Del. Ch. 1986); Heil v. Standard Gas & Elec. Co., 151 A. 303, 304 (Del. Ch. 1930) (controlling stockholder may vote in accordance with own interests "so long as no advantage is obtained *at the expense of* their fellow stockholders") (emphasis added).

33. *See* Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 500 n.13 (Del. Ch. 1990) (basing its observation on Weinberger v. UOP, Inc., 457 A.2d. 701, 710 (Del. 1983) and other cases). *Weinberger*, however, dealt with the actions of directors. *See Citron*, 584 A.2d at 501.

scrutiny arising from the presence of a fiduciary duty applies only in matters involving ownership of the corporate assets, and not in matters involving the corporation's ordinary business operations.[34]

Additionally, a leading California case has held that "[m]ajority shareholders may not use their power to control corporate activities to benefit themselves alone *or* in a manner detrimental to the minority."[35] In that case, it was held to be a breach of duty for a majority holder to, in effect, sell its majority position to the public without permitting the minority holders to do the same.[36] It was unclear in what way, if at all, the minority holders were made worse off by the majority's actions.[37] This appears to be a different fiduciary standard than that articulated by the courts in Delaware, which requires only that controlling stockholders avoid benefiting themselves *at the expense of* the minority. The California court also articulated a variety of concerns indicating it might have been treating the corporation as closely held, which leaves the applicability of the standard somewhat in doubt.[38]

Additionally, all the cases cited dealt with parent-subsidiary mergers, in which the parent is clearly receiving a benefit to the exclusion of the minority. *See id.* at 502.

34. *See* Tanzer v. Int'l Gen. Inds., Inc., 379 A.2d 1121, 1124 (Del. 1977) (holding that the business judgment rule applies to "intra-corporate affairs" but the cntire fairness test applies to a parent's "responsibility to minority shareholders in its subsidiary... at least when control over corporate assets and processes for merger purposes is at issue"), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701, 704, 715 (Del. 1983); *see also* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after* Van Gorkom, 41 BUS. LAW. 1, 5-6 (1985) (describing the types of transactions in each category to include mergers, other organic changes, and everyday transactions); Siegel, *supra* note 1, at 43; *id.* at 32 (describing the types of transactions in each category). *Cf.* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 5.10(c) (providing that with respect to transactions with controlling stockholders that are in the ordinary course of business, the plaintiff has the initial burden of coming forward with evidence that the transaction was unfair).

35. *See* Jones v. H. F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) (emphasis added).

36. *See id.* at 473-74. As discussed *infra*, the case can be seen as merely the realization of a control premium, which is not a violation of fiduciary duty. *See infra* Part V.C. (discussing control premia).

37. *H. F. Ahmanson & Co.*, 460 P.2d at 475-76. The court suggested that as a result of the majority's actions there could never be a public market for the minority's stock. This seems to ignore the fact that the majority was in control of the corporation and could not have been forced to take the company public; thus, the existence (or lack thereof) of a public market for the minority's stock was always at the will of the majority. On the other hand, there was a suggestion that the majority had used corporate assets to effectuate their plan, which would have been a violation of duty under the Delaware standard. *Id.* at 476.

38. *See id.* at 473-74; *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 5.11 cmt. c(1) (noting that section applies even if the shareholder's use of corporate property is not harmful to the corporation, its shareholders, or both).

Further complicating matters, the courts rarely articulate to whom a controlling stockholder's fiduciary duty is owed.[39] As a general rule, the duty is owed to the corporation, not to the stockholders directly.[40] The *H. F. Ahmanson* case clearly enunciated a duty owed directly to the minority stockholders.[41] Most courts, however, describe the duty as owed to the corporation and the other stockholders without providing further guidance or analysis.[42] In cases where minority stockholders are permitted to recover for injuries suffered directly, such as termination of employment,[43] denial of a repurchase opportunity,[44] or inadequate compensation in a buyout,[45] the courts must be recognizing a duty owed to the minority stockholders directly.[46]

Although controlling stockholders owe fiduciary duties whenever they are dealing with the corporation, in public companies those duties are most frequently litigated in the "squeeze-out" merger context.[47] A

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39. *See* HENN & ALEXANDER, *supra* note 5, § 240 n.10.

40. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971) ("By reason of Sinclair's domination, it is clear that Sinclair owed [its subsidiary] a fiduciary duty."). *See generally* Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 523-27 (2001). *Cf.* ALI, PRINCIPLES OF CORPORATE GOVERNANCE, Introductory Note, Part V, para. b. (1994 ed.) ("The duty of fair dealing normally extends only to the corporation. However, there are also circumstances when the duty of fair dealing requires director[s], senior executive[s], or controlling shareholder[s] to . . . avoid using [their] positions to obtain improperly a benefit for [themselves] as shareholder[s] to the exclusion of other shareholders similarly situated.").

41. *See H. F. Ahmanson*, 460 P.2d at 472-74; *see also* Recent Cases, *Corporations—Rights and Powers of Minority Stockholders—Controlling Stockholders Who Exclude Minority Stockholders from Plan to Create New Market for Stock Violate Fiduciary Duty Owed to Minority* (Jones v. H.F. Ahmanson & Co., Cal. 1969), 83 HARV. L. REV. 1904, 1906 (1970) (noting that *H.F. Ahmanson* changed the law regarding to whom the fiduciary duty was owed).

42. *See, e.g.*, Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1388 (Del. 1995); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

43. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 659 (Mass. 1976).

44. *See* Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505, 508 (Mass. 1975).

45. *See infra* notes 47-49 and accompanying text (discussing parent/subsidiary mergers).

46. *Donahue* was originally brought as a derivative action, but the court treated it as personal to the plaintiff in light of the claimed injury. *Donahue*, 328 N.E.2d at 508 n.3.

47. Chancellor Chandler, in *Orman v. Cullman*, opined that the *only* situation in which the entire fairness standard applies automatically is where there is a controlling stockholder on both sides of a challenged merger. Orman v. Cullman, 794 A.2d 5, 21 n.36 (Del. Ch. 2002). He supported this proposition with a number of cases, including Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001) [hereinafter *Emerald III*], that ruled that the entire fairness standard applied in such cases, but that did not limit the automatic application of the entire fairness to such a case. It seems unlikely that the entire fairness standard would apply "automatically" to a parent-subsidiary merger but not to, say, the sale of a corporate asset to a company in which a majority of the board of directors have a material financial interest. In fact, the Delaware Supreme Court appeared to suggest as much when it applied the entire fairness standard in *Emerald III*, a case in which the majority

squeeze-out merger[48] occurs when the subsidiary merges with either the parent or another subsidiary so as to eliminate the minority's interest in the subsidiary. The minority holders usually receive cash in exchange for their stock in the subsidiary. The parent, who by definition controls a majority of the voting power, can always force a merger, and the minority holders will always have appraisal or dissenters' rights to challenge the consideration received in the merger, as stockholders do in almost all mergers.[49] Nevertheless, the conflict of interest is extreme: each additional dollar of consideration to the minority comes from the parent and its own stockholders. Although the analysis is rarely explicit, the rule regarding squeeze-out mergers is a clear application of the Delaware rule originating in *Sinclair*.[50] A parent proposing to merge with a subsidiary is clearly realizing a benefit (100% ownership of the subsidiary or its assets) to the exclusion or detriment of the minority. Thus, the entire fairness standard applies.

In a squeeze-out merger, the board of directors of the subsidiary is required to approve the merger.[51] Thus, the board of the subsidiary,

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stockholder (Hall) reduced his ownership to twenty-five percent prior to approval of the challenged transaction. *See id.* at 88, 98. The court there held that the entire fairness standard nevertheless applied because Hall was also Chairman and CEO of the corporations on both sides of the transaction. *See id.* at 94. In *Orman*, the Chancellor argued that the Supreme Court's application of the entire fairness standard had to be viewed in light of Hall's *prior* ownership of a majority interest. *Orman*, 794 A.2d at 21-22 n.36. The implication here is that had Hall never been a majority stockholder the entire fairness standard would not have applied, despite his extraordinary conflict of interest as CEO of both companies. That simply cannot be the case. Also, it is not clear what it means to say that the entire fairness standard applies "automatically." Chandler stated that "the business judgment presumption is rebutted and entire fairness is the standard" when a plaintiff alleges "facts demonstrating a squeeze out merger or a merger between two corporations under the control of a controlling shareholder." *Id.* at 20. Later, he states that "the business judgment rule presumption . . . can be rebutted by alleging facts which . . . establish that the *board* was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders." *Id.* at 22 (emphasis in original). Thus, the entire fairness standard appears to apply in both cases when the plaintiff alleges the relevant facts with the required particularity. However, even if Chandler's distinction is meaningless in practice, the distinction he advocates tends to confuse an already complex doctrine.

48. This term should not be confused with the so-called freeze-out of minority stockholders in close corporations, which occurs when the majority, by refusing to pay dividends, provide employment opportunities, or approve a sale of the company or a public offering, leaves the minority no way to realize cash on its investment other than by selling to the majority at whatever price the majority offers. *See Donahue*, 328 N.E.2d at 513.

49. *See, e.g.*, DEL. GEN. CORP. LAW § 262 (2001); REV. MODEL BUS. CORP. ACT § 13.02 (1994).

50. *See generally* Gilson & Gordon, *supra* note 31, at 817-27.

51. *See, e.g.*, DEL. GEN. CORP. LAW. § 251(b) (2001); REV. MODEL BUS. CORP. ACT § 11.04(a) (1994).

which will almost always have been chosen by the parent, also faces a very real conflict. In Delaware, the courts have recognized the special concerns applicable to squeeze-outs by creating a special rule: approval by a committee of disinterested directors and by a majority of the minority holders will not, as is usually the case, result in application of the business judgment rule. Rather, such approval will only result in a shifting of the burden of proof of entire fairness (or lack thereof) to the plaintiff.[52] The courts reasoned that the influence of the controlling stockholder in those cases is so great that it may affect even disinterested directors and a seemingly disinterested stockholder vote.[53]

The uncertain origin and nature of stockholder fiduciary duties has created an anomaly in the Delaware law regarding a parent's elimination of the minority in a subsidiary. While a controlling stockholder in a squeeze-out merger is subject to the entire fairness standard even if the merger is approved by independent directors or a majority of the minority holders, where the stockholder instead offers to purchase the minority holders' stock directly, courts have held that there is no heightened duty.[54] The effect of these rules is to apply different standards to transactions that look very similar to the minority stockholders: in each case, the majority holder is eliminating the minority's interest in the corporation. As discussed further below, there are explanations, albeit perhaps not satisfactory ones, for this difference in treatment based on the form of the transaction.[55] In any event, the

52. *See Lynch I*, 638 A.2d at 1116; Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d at 501-02.

53. *See Lynch I*, 638 A.2d at 1116; *Citron*, 584 A.2d at 502. *Cf.* Zapata Corp. v. Maldonado, 430 A.2d 779, 787, 789 (Del. 1981) (holding that a court considering a motion to dismiss a derivative suit brought at the request of a special committee of the board must apply its own independent discretion, rather than the business judgment rule, in light of the "sufficient risk in the realities of the situation" in which board members are "passing judgment on fellow directors in the same corporation" who selected them to act as directors in the first place). *But see* Siegel, *supra* note 1, at 41-42 (rejecting this rationale); William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1308-09 (2001) (same).

54. *See In re* Pure Resources, Inc. S'holders Litig., 808 A.2d 421, 444 (Del. Ch. 2002); *In re* Aquila, Inc. S'holders Litig., 805 A.2d 184, 187 (Del. Ch. 2002). Furthermore, once the majority stockholder has acquired ninety percent of the subsidiary's stoek, it can enter into a short-form merger under DEL. GEN. CORP. LAW § 253 (2001). In that case, the minority's only remedy against the majority is to pursue appraisal rights. *See In re* Unocal Exploration S'holders Litig., 793 A.2d 329, 338 (Del. Ch. 2000). For an in-depth analysis of this point, see Gilson & Gordon, *supra* note 31, at 817-27.

55. For a thorough discussion of this issue, see Vice-Chancellor Strine's opinion in *Pure Resources*, 808 A.2d at 433-47.

inconsistency in the law provides an example of the consequences of a lack of a clear explanation for stockholder fiduciary duties.

III. JUSTIFICATIONS FOR CONTROLLING STOCKHOLDER FIDUCIARY DUTIES

Courts imposing fiduciary duties on controlling stockholders cite a variety of legal and equitable justifications for their holdings. In close corporations, duties are said to arise from the partnership-like nature of the closely held business and from the economic realities facing investors therein. In other contexts, duties are attributed to the need to protect minority stockholders, to "settled" legal principles, and to the fact of control. Each of these justifications, however, has serious weaknesses.

A. Close Corporations Are Like Partnerships

Courts and commentators frequently argue that the relationship between investors, in a closely held corporation, more closely resembles that of partners than that of traditional shareholder-investors.[56] Close corporation stockholders are said to depend upon a "relation of trust and confidence."[57] They rely upon the "fidelity and abilities" of their fellow stockholders, and disloyalty can lead to "bickering, corporate stalemates, and, perhaps, efforts to achieve dissolution."[58] Similarly, close corporation stockholders are said to have an identity of interest,[59] an expectation of group decision-making,[60] and an expectation of proportionate sharing of benefits such as salaries and management rights.[61] Such circumstances are said to require that stockholders in close corporations be held to the "more rigorous" fiduciary standards of partners.[62]

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56. *See* James M. Van Vliet, Jr., & Mark D. Snider, *The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap*, 18 N. ILL. U. L. REV. 239, 249 (1998); Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 CARDOZO L. REV. 51, 52 (2000) (quoting Chief Justice Cardozo's standard offered in Meinhard v. Salmon, 164 N.E. 545, 545-46 (N.Y. 1928)); Hetherington & Dooley, *supra* note 26, at 2.

57. *See* Hetherington & Dooley, *supra* note 26, at 2-3; *see also Donahue*, 328 N.E.2d at 512.

58. *Donahue*, 328 N.E.2d at 512.

59. *See* Hetherington & Dooley, *supra* note 26, at 2-3.

60. *See id* at 2.

61. *See* Van Vliet & Snider, *supra* note 56, at 253; *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 7.25 cmt. a.

62. *Donahue*, 328 N.E.2d at 516.

There are a number of problems with this line of reasoning. First, it is not true that closely held corporations are essentially like partnerships. Unlike stockholders, even those in closely held corporations, partners are fully liable for all obligations of the partnership.[63] Every partner (unlike a stockholder) by law has broad apparent authority to bind the partnership. That authority subjects the other partners to full personal liability for a wide variety of acts of their partners. Differences between the legal rules applicable to corporations and those applicable to partnerships are largely attributable to that difference in management power and liability.[64] For example, partners have the power to withdraw from the partnership, and thereby terminate their liability for their partners' future acts, at any time. That power, which is akin to the power of a principal to terminate the agency relationship, is necessary to permit the partner to cut off her potentially unlimited liability, not to provide an investor with a guaranteed exit right. Similarly, any change in the identity of the partners traditionally resulted in a dissolution of the partnership.[65] If one views the partnership as the pool of assets available to satisfy its obligations, then it makes sense to consider the partnership to be fundamentally changed when a partner, whose personal assets are part of that pool, enters or leaves the partnership or goes bankrupt.[66] Even minor technical rules, such as rules requiring a public filing and a designation of an agent for the service of process for limited liability

63. *See* Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 876-77 (2000) (discussing the importance of asset partitioning as a function of business organization). *Cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 41 (1991) (arguing that the separation of ownership and control, not limited liability, is the key feature of the corporation, and that limited liability came about because it *allows* that separation); Daniel S. Kleinberger, *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 WM. MITCHELL L. REV. 1143, 1150 (1990) (arguing that the only resemblance close corporations bear to other corporations is limited liability, and that they are fundamentally different from other corporations because there is no role differentiation between shareholders and managers).

64. *See* John Armour & Michael J. Whincop, *An Economic Analysis of Shared Property in Partnership and Close Corporations Law*, 26 J. CORP. L. 983, 994 (2001). It is worth noting that limited liability, unlike almost every other corporate attribute, cannot be achieved by contract alone. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 431 (2000).

65. To enhance stability in partnerships, this rule has been changed in the revised version of the Uniform Partnership Act. Under the revised act, a change in the identity of the partners causes a "dissociation." *See* U.P.A. § 18, 6 U.L.A. 104, 107 (2001).

66. *Cf.* Larry E. Ribstein & Mark A. Sargent, eds., *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 645-47 (1997) (discussing bankruptcy issues in LLCs).

entities but not for partnerships, make sense if one remembers the different position of creditors of partnerships.[67]

Partnership fiduciary duties similarly derive from the intertwined obligations and management rights that arise from each partner's status as both an agent and a principal.[68] As a principal, each partner has certain rights of control over the business and liability for the acts of her agents (the other partners). As an agent, each partner has the power to create liabilities of the partnership and the other partners (the other principals) and consequently owes fiduciary duties to the principal. Partners have both the right to demand information from the other partners (which, as principals, they need to protect their interests) and the obligation to supply information to the other partners (which is part of their fiduciary duties).[69]

Stockholders (as opposed to officers and directors) in corporations and non-manager members of limited liability companies are neither principals nor agents.[70] This is true even in closely held corporations.[71] Although limited liability did not originate as a theoretical correlative to the idea of the corporate entity, it coincides with it perfectly as a practical matter: stockholders are not principals, and thus should not be ultimately liable for the entity's debts. More importantly, because they are not agents they do not have the power to bind the corporation or LLC and, consequently, there is no need for anyone to have the power to cut off a stockholder's ownership interest (and thus her legal authority to bind the company) at will. On the contrary, a stockholder's only rights as

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67. *Cf.* S.J. Naude, *The South African Close Corporation*, 9 J. JURID. SCI. 117, 126 (1984) (quoting *In re* Exchange Bank Co. (Flitcroft's Case), 21 Ch. 519 (Eng. C.A. 1882)):

> The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore . . . gives credit to that capital, gives credit to the company on the faith of the implied representation that the capital shall be applied only for the purpose of the business.

Id.

68. *See* Hillman, *supra* note 56, at 51-52 (noting that partners' fiduciary duties arise from their unlimited liability).

69. *See* J. William Callison & Allan W. Vestal, *"They've Created a Lamb with Mandibles of Death": Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L.J. 271, 307 (2001) (arguing that fiduciary duties and information rights go with management power, but failing to make the connection to liability). *Cf. id.* at 279-80 (arguing that a person with the right to obtain information must owe a fiduciary duty).

70. *See* RESTATEMENT (SECOND) OF AGENCY § 1.01 (1958) (defining agent and principal); REV. MODEL BUS. CORP. ACT § 1.40(22) (1984) (defining shareholder).

71. *Cf.* RESTATEMENT (THIRD) OF AGENCY § 1.03 (Tentative Draft No. 2, 2001) (asserting that an ownership interest in a corporation does not create any capacity to act on behalf of the corporation, and a closely held corporation may only be created if the corporation's organizational documents eliminate a board of directors).

a stockholder are property rights, which generally cannot be extinguished without the consent of the propertyholder. Similarly, stockholders are not entitled to withdraw at will because they are not subject to personal liability.[72] They have little management authority, and their informational rights are limited to the information necessary to engage in their minimal ownership activities, such as electing directors or managers and voting on fundamental changes. Because they are not agents, they owe no fiduciary duties to the corporation or LLC or to the other stockholders or members. In short, their position is very different from that of corporate officers, directors, or LLC managers, who are agents and who, consequently, are held to fiduciary duties.

By ignoring the practical and fundamental link between liability, management power, and fiduciary duties, commentators who suggest that close corporations are like partnerships are misunderstanding completely the nature of partnership law. The differences in the law between corporations and partnerships have important purposes related to the nature of liability, and should distinguish partnerships not only from publicly held corporations, but also from close corporations, limited liability companies, and even, to some degree, limited partnerships.[73]

The variation in legal regime between corporations and partnerships makes further sense when one considers the position of creditors of limited liability entities. An agent who owes her duties solely and directly to her principal is indirectly protecting the creditors of the business because the creditors have a claim on the principal's assets. In contrast, if corporate management prefers the interests of the stockholders over the interests of the corporate enterprise (or, to use the common shorthand, the entity), the creditors of the enterprise are permanently disadvantaged. The usual rule that a corporate fiduciary owes his or her duties to the corporation, and not to the stockholders

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72. A variety of commentators, apparently misunderstanding the basis of partnership withdrawal rights, have argued that the power to withdraw should be extended to holders of interests in limited liability entities. *See* Sandra K. Miller, *What Remedies Should be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 522 (1994) (arguing that members of LLCs should have the right to withdraw); Hetherington & Dooley, *supra* note 26, at 46-47 (arguing that partners are protected from overreaching by the majority by their power to withdraw); Hillman, *supra* note 56, at 64-65 (same).

73. Unlike those commentators who seek to extend partnership law to close corporations, Easterbrook and Fischel argue that the similarity in management structure between closely held corporations and partnerships suggests that limited liability is less appropriate in closely held corporations. *See* EASTERBROOK & FISCHEL, *supra* note 63, at 41.

directly,[74] is consistent with this reality. A partnership is directly analogous to the principal-agent paradigm, because benefits to the partners individually also benefit the creditors of the partnership. Creditors of a close corporation, on the other hand, must rely solely on the financial health of the corporation.[75] Thus, corporate law reflects the fact that the corporation—the business—may have interests of its own separate from those of its stockholders.[76] If those in control of closely held corporations are required to consider the direct interests of the minority stockholders, they may be required to make decisions that adversely affect the corporation, its other stockholders, and its creditors.[77]

Furthermore, participants in a corporate venture have always, by definition, elected to incorporate. They have chosen the benefits of limited liability and in exchange the law subjects them to a variety of rules intended to protect creditors, among other things. A stockholder, even a stockholder in a closely held corporation who expects to have some management participation, can relax her vigilance in the knowledge that all she can lose is her investment. There is no reason to believe that the stockholders of close corporations uniformly, or even usually, desire to have the intensive management powers and other rights and obligations that characterize partners.[78] In *Donahue*, the classic close-corporation-as-partnership case, the dispute appeared to originate from (or be aggravated by) the fact that the minority stockholders (a former employee's widow and son) did not want and were not qualified to have employment positions with the corporation.[79] Had the court really treated the Rodd Electrotype Company as a partnership, it would have completely disturbed the operation of the

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74. *See* Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganziations*, 71 CAL. L. REV. 1072, 1074 n.4 (1983) (noting that officers and directors are "said to owe their obligations to the corporation, and not, at least at the expense of the corporation, to particular stockholders, or to one group of stockholders rather than another").

75. Contract creditors can and often do seek guarantees from stockholders of close corporations. Tort creditors, of course, cannot do so.

76. *See* Clements v. Rogers, 790 A.2d 1222, 1242-44 (Del. Ch. 2001) (ruling that the obligation of directors of a subsidiary is to the subsidiary only, not to the parent). *But see* Mitchell, *supra* note 27, at 1690-91, 1707 (arguing that in a closely held corporation, the corporation may not have interests of its own).

77. *See* Mitchell, *supra* note 27, at 1710-12; Moll, *Shareholder Oppression*, *supra* note 22, at 774, 783-788.

78. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 298-300 (1986) [hereinafter Easterbrook & Fischel, *Close Corporations*].

79. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 510 n.8, 519-20 (Mass. 1975).

company and the expectations of the parties and quite possibly have made Mrs. Donahue and her son worse off than they would have been under standard corporate law.

Second, even if close corporations were more similar to partnerships than to publicly held corporations, the fiduciary duties owed in partnerships would be no more protective than the ordinary duties owed by corporate actors to the corporation and its stockholders. In both cases, the duties are owed to the business organization, not to the partners or stockholders directly. The fiduciary duties owed by partners, which derive from the partners' status as agents (and principals) of each other,[80] are essentially the same as those of corporate officers and directors, which similarly derive from the agency relationship.[81] While courts and commentators criticize the "less stringent" nature of corporate fiduciary duties,[82] rarely do they actually describe the difference.[83] Presumably, they are referring to the protections of the business judgment rule,[84] the legal rules allowing conflicts of interest to be partially cured by obtaining the approval of disinterested directors or stockholders,[85] and the fact that corporate duties are generally owed to the corporation and its stockholders as a whole rather than to the stockholders individually.[86] Thus, if a board decided to have the corporation repurchase the shares of a board member, the transaction would be protected from judicial scrutiny under the business judgment rule if there was disinterested director or stockholder approval, and if the board acted in good faith and in a fully informed manner. Furthermore, when the board of a public company fires an employee-stockholder, no fiduciary duties are implicated because no duties are owed to the stockholder individually.

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80. *See* Paula J. Dalley, *The Law of Partner Expulsions: Fiduciary Duty and Good Faith*, 21 CARDOZO L. REV. 181, 189-92 (1999) [hereinafter Dalley, *The Law of Partner Expulsions*].

81. *See* HENN & ALEXANDER, *supra* note 5, § 207.

82. *Donahue*, 328 N.E.2d at 515-16.

83. For a rare discussion of the "somewhat more relaxed fiduciary duties" facing corporate managers, *see* Eric Talley, *Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001, 1008-09 (1999).

84. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *Compare* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976), in which the same court that decided *Donahue* ruled, one year later, that a controlling stockholder "must have some room to maneuver in establishing the business policy of the corporation," and therefore does not violate a fiduciary duty to the minority when it can establish a "legitimate business purpose" for its action.

85. *See, e.g.*, DEL. GEN. CORP. LAW § 144 (Rev. 1974).

86. *See* Kleinberger, *supra* note 63, at 1145; *see also* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 243-46 (1999).

What results would obtain in similar circumstances in a partnership? First, fiduciary duties generally are not owed when individual partners purchase each other's interests.[87] Partnership governance is by majority rule, and a majority of the partners can cash-out a partner over the objections of a minority without fiduciary implications.[88] Second, while all partners are entitled to management rights,[89] they are not entitled to remuneration for services performed.[90] Furthermore, courts have repeatedly held not only that a partner may be removed from his or her partnership position, but also that his or her interest may be cashed out against his or her will, without in either case breaching a fiduciary duty directly to the affected partner.[91] Thus, a partner who runs afoul of his or her partners is in no better position than a stockholder. While it is true that partners are protected by their right to withdraw and cause a dissolution at any time, an option not usually available to stockholders, it is not true that partnership fiduciary duties are more protective than corporate duties. More importantly, partners do not owe broad fiduciary duties directly to each of the other partners, but rather only to the group of partners embodied in the partnership. Thus, the partnership analogy cannot be the basis for fiduciary duties owed by controlling stockholders directly to minority stockholders individually.

Third, even if the controlling stockholders' fiduciary duty arises from the similarity between partnerships and closely held corporations, that explanation fails to account for the imposition of fiduciary duties on controlling stockholders where there is a publicly traded minority. Such minority stockholders bear little resemblance either to partners or to the paradigm "vulnerable" minority stockholder in a closely held corporation: they can freely cash out their interests on the open market, they generally do not expect to receive salaries or participate in management, they do not have a personal relationship with the

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87. *See* Dalley, *The Law of Partner Expulsions*, *supra* note 80, at 188 n.41; *see also* Walter v. Holiday Inns, Inc., 985 F.2d 1232, 1238 (3d Cir. 1993) (discussing "adverse interest exception" to fiduciary duty).

88. *See* Dalley, *The Law of Partner Expulsions*, *supra* note 80, at 191-92.

89. *See* U.P.A. § 18, 6 U.L.A. 18(e) (2001).

90. *See* U.P.A. § 18, 6 U.L.A. 18(f) (2001).

91. *See* Dalley, *The Law of Partner Expulsions*, *supra* note 80, at 191-92, 206 n.153. Thus, those who argue that fiduciary duties in closely held corporations are, or should be, owed to the stockholders *directly*, *see* Mitchell, *supra* note 27, at 1700; *see also* Jones v. H. F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) (arguing that stockholders in closely held corporations should receive greater fiduciary protections than partners).

controlling stockholder, and they are not usually any less diversified than other public stockholders.[92]

Jurists discussing controlling stockholders' fiduciary duties generally ignore the wide diversity among corporations.[93] At best, such jurists assume that all corporations are either public or closely held. In fact, many of the leading cases involve corporations that do not fit into these categories. *Donahue* involved a closely held corporation with a dominant stockholder group. *Wilkes,* on the other hand, involved a closely held corporation in which each stockholder held a one-third interest. The plaintiff was a "minority" holder only because the other two stockholders ultimately banded against him. *Sinclair* involved a corporation in which the minority interest was publicly traded. *Ahmanson* involved a corporation in which the minority interest was widely dispersed, although there was no organized market for the stock. The minority holders had no management or other non-economic interest in the corporation. If there is a reason to impose fiduciary duties on controlling stockholders in all these cases, it cannot be because the corporations resemble partnerships. Publicly traded minority stockholders suffer certain disadvantages not endured by investors in fully public companies. The market price for their stock will reflect a minority discount and may be depressed as a result of known or suspected wrongdoing by the controlling stockholder, and the market for corporate control does not provide a check on ineffective or dishonest management.[94] To the extent controlling stockholder duties arise from those facts, however, they are based on the economic position of the minority holders, not on any superficial resemblance between a publicly held company and a partnership.

B. Controlling Stockholder Fiduciary Duties Reflect Economic Realities

The second argument used to justify imposing fiduciary duties on controlling stockholders is that the economic realities of closely held

92. *See* Moll, *Reasonable Expectations, supra* note 24, at 996-99 (describing the characteristics of stockholders in closely held corporations); Moll, *The Investment Model Solution, supra* note 24, at 539-44 (same).

93. *Cf.* Easterbrook & Fischel, *Close Corporations, supra* note 77, at 271 n.3 (recognizing the spectrum of forms existing).

94. *See generally* Sally Wheeler, *The Business Enterprise: A Socio-legal Introduction, in* A READER ON THE LAW OF THE BUSINESS ENTERPRISE 1, 33 (Sally Wheeler ed., 1994).

corporations[95] require a different set of legal rules than those applicable to public corporations.[96] Stockholders in closely held corporations are said to differ from the classical model of the stockholder as a diversified, wealth-maximizing passive investor,[97] and therefore the governance rules usually applicable to corporations are inappropriate for closely held corporations.[98] The most obvious difference between stockholders in public and private companies is the lack of an organized market for shares in closely held corporations. The lack of an "exit" is said to lead to opportunities for the majority to exploit the minority,[99] and commentators have argued that the business judgment rule should not apply in closely held corporations because of the lack of market constraints on management behavior.[100] In fact, minority stockholders usually have a readily available exit: they can sell out to the majority. The problem is the price they will be able to negotiate. The lack of an organized market increases the transaction costs of selling one's stock, creates the potential for market failures as a result of bilateral monopoly conditions, and requires minority sellers to bargain with the majority directly, rather than through the intermediary of the market. It is assumed that the price that a majority stockholder in a closely held corporation will offer will always be less than the price the shares would bring in a public market. However, if market prices are efficient, publicly traded minority shares should trade at a discount reflecting all the risks of the minority position. Unsophisticated investors may not appreciate this fact, and may believe the market price is somehow

95. *See generally* Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 273-77.

96. Again, commentators seem to assume that all corporations fit into one of these two categories, which fails to recognize not only the variation among corporations, but also the variations in needs and expectations among participants in corporations of similar size. *See supra* note 93 and accompanying text.

97. *See* Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMPLE L.Q. 47, 63-78 (1987) (criticizing the neoclassical model of corporate stockholders and arguing that stockholders in closely held corporations are not diversified or wealth maximizing).

98. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975); Ribstein & Sargent, *supra* note 66, at 610-11 (comments of Gordon Smith) (arguing that a state needs only two forms of business association, one for public companies and one for private companies, because "the difference in governance [issues] between closely held entities and publicly held entities is enormous and not comfortably accommodated in one statute").

99. *See* Donahue, 328 N.E.2d at 514-15; Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 275; Hetherington & Dooley, *supra* note 26, at 3-4, 6.

100. *See* Moll, *Shareholder Oppression*, *supra* note 22, at 823-25; Hetherington & Dooley, *supra* note 26, at 39-43.

"better," but they will, in most cases, be wrong. In some cases, a majority holder, who has better information about the company and faces no minority risks, may be willing to pay more for minority shares than an open market purchaser. The real problem is neither the lack of an exit nor the "depressed" price that majority holders in closely held corporations are presumed to offer for minority shares. Rather, it is the increased transaction costs that always exist in the absence of organized markets, and a minority stockholder is in no worse a position than an individual selling a used car. While this may be a legitimate concern, it is by no means clear that imposing general fiduciary duties on majority stockholders is an effective or appropriate solution.

The lack of a market for stock in closely held corporations also means that stockholders in closely held corporations lack the protections provided by the market for corporate control. In public companies, mismanagement results in a decline in the stock price, which in turn provides opportunities for those who think they would do a better job managing the company to purchase control.[101] The threat of a change in control thus disciplines existing management.[102] A number of commentators have challenged the assertion that a lively market in corporate control benefits investors,[103] but even if it is true, the same rationale should apply, to a lesser extent,[104] to privately held corporations. If a controlling stockholder is merely mismanaging the business, she is injuring herself as well as the other stockholders; if a better manager offers her a premium for control, she should take it. The controlling stockholder will reject the offer only if the benefit to herself from her mismanagement outweighs the injury to the corporation—in other words, if she is engaging in looting. But the market for corporate control cannot prevent looting, because it depends upon someone purchasing control and therefore having the continuing ability to loot the

101. *See* Cox, *supra* note 97, at 60-61.

102. *See* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 698 (1982) [hereinafter Easterbrook & Fischel, *Corporate Control*].

103. *See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1420-27 (1985) [hereinafter Brudney, *Corporate Governance*]; James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 265-84 (2001); Wheeler, *supra* note 94, at 17-18; William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, *in* A READER ON THE LAW OF THE BUSINESS ENTERPRISE 117, 153-58 (Sally Wheeler ed., 1994); Caroline Bradley, *Corporate Control: Markets and Rules*, *in* A READER ON THE LAW OF THE BUSINESS ENTERPRISE, 180, 181-87 (Sally Wheeler ed., 1994).

104. It will be more difficult for a potential acquiror to identify poorly managed closely held corporations. Thus, the information costs of such acquisitions would be substantially higher.

company. In fact, one of the challenges to the argument that the market for corporate control protects investors is that it also rewards looting.[105]

However, even if it is true that the market for corporate control will impose more discipline on managers of public corporations than on managers of closely held corporations, it may be the case that other factors provide protection for stockholders in close corporations. First, the monitoring costs should be lower for stockholders in closely held corporations. They often have closer relationships with management and greater access to information and knowledge about the business. Second, the collective action problems which discourage monitoring in publicly held corporations do not exist for stockholders in close corporations. A minority investment in a closely held corporation is usually not diversified, which provides an increased incentive for the minority holder to monitor management. In other words, stockholders in closely held corporations may not need the market for corporate control to protect them from mismanagement.[106]

Furthermore, investors in closely held corporations are said to have interests that differ substantially from those of investors in public companies. They invest because they want jobs and management control, and their financial investments tend to be a large proportion of their wealth. Their investments are not diversified,[107] and as a result they are more vulnerable to risk and investment loss. One way to address that vulnerability is to impose fiduciary duties on majority stockholders.[108] As discussed above, this analysis ignores the fact that courts impose fiduciary duties on controlling stockholders even when the minority position is widely traded. It also ignores the fact that controlling stockholders are equally undiversified and perhaps even more vulnerable as a result of their greater investment.[109] If it justifies anything, the lack of diversification justifies imposing broad duties on everyone involved

105. *See* Brudney, *Corporate Governance*, *supra* note 103, at 1425-26. *But see* John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1153-54 (1984).

106. *See infra* Part V (discussing the remedies for a stockholder who detects mismanagement).

107. *See* Cox, *supra* note 97, at 60.

108. *See* Moll, *Reasonable Expectations*, *supra* note 24, at 1071-73; Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L. Q. 1099, 1108-18 (1999); Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 416-17 (2001) (discussing need for protections of LLC members) [hereinafter Miller, *What Buy-Out Rights*].

109. *See* Shannon Wells Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1144 (2002).

in a company with undiversified investors. Furthermore, the analysis does not explain why fiduciary duties are the appropriate protection for undiversified investors in closely held corporations. Public companies also have undiversified stockholders: employees who have invested human capital, executives with substantial stockholdings acquired through stock option programs, employees with retirement funds invested in company-dominated plans, and some institutional holders.[110] There are, however, no special duties owed to any of such investors. Rather, such investors are expected to protect themselves by contract.

The most difficult point for those who argue that the special circumstances faced by minority holders justify imposing duties on the majority is that the usual way in which the corporate law provides exceptions for people in special circumstances is by permitting them to alter the applicable legal rules by contract. Minority holders could completely protect themselves if they entered into agreements with the controlling stockholders prior to investment[111] or opted into close corporation statutory schemes.[112] Commentators advocating stockholder fiduciary duties argue that minority stockholders are essentially incapable of protecting their own interests, and that the law must therefore do so. Minority stockholders are said to lack the sophistication necessary to bargain for the protections they need.[113] Heuristic biases and bounded rationality contribute to the failure of contract.[114] Furthermore, because minority stockholders are investing with people they know, they depend upon trust, rather than contract, to secure their expectations.[115] Additionally, minority stockholders often acquire their

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110. *See* Shelly Branch et al., *Sweet Deal: Hershey Foods Is Considering A Plan to Put Itself Up for Sale*, WALL ST. J., July 25, 2002, at A1 (discussing position of charitable trusts and foundations that own large, undiversified blocks of stock); David Bank, *Loading Up: Should Foundations Rely on One Stock, or Diversify?*, WALL ST. J., Feb. 14, 2002, at C1 (same); David Bank, *H-P Paints Foundation Opposing Merger as Risk-Averse Due to Grant Obligations*, WALL ST. J., Dec. 11, 2001, at A4 (quoting the President of the David and Lucille Packard Foundation as saying: "Our particular risk profile may not be the same as other shareholders.").

111. *See* Stevenson, *supra* note 109, at 1154-64 (describing the contracts usually entered into by venture capitalists in connection with their investments).

112. *See* Nixon v. Blackwell, 626 A.2d 1366, 1380-81 (Del. 1993).

113. *See* Miller, *What Buy-Out Rights*, *supra* note 108, at 437-39; Brudney, *Corporate Governance*, *supra* note 102, at 1411-20; Hetherington & Dooley, *supra* note 26, at 36-39.

114. *See* Brudney, *Corporate Governance*, *supra* note 103, at 1418 n.35; Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 213-25, 251-53 (1995) [hereinafter Eisenberg, *Limits of Cognition*].

115. *See* Stevenson, *supra* note 109, at 1143, 1144-46, 1149; Hetherington & Dooley, *supra* note 26, at 36-39.

shares through gift or inheritance, and therefore have never been in a position to protect themselves through contractual arrangements.[116]

Even if all these arguments are correct,[117] they do not explain why the solution is to impose fiduciary duties on *all* controlling stockholders.[118] Stockholder fiduciary duties are the appropriate remedy for the failure of contract only if the stockholders would have bargained for such duties in the absence of such failure.[119] Experience suggests that that is not the case: sophisticated investors bargain for a variety of protections, but they do not bargain for fiduciary duties.[120] There are several solutions to the problem of unsophisticated investors failing to make contracts: the law could be designed to make such investors aware of the risks they face and the availability of contractual alternatives;[121] the law might contain default rules similar to those selected by sophisticated investors;[122] or the law of contracts might be rewritten to take account of the insights of behavioral economics.[123] The imposition of fiduciary duties, with their broad applicability and stringent standards,

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116. *See* Miller, *What Buy-Out Rights*, *supra* note 108, at 437-39. Miller also argues that minority stockholders often lack the bargaining power to impose restrictions on controlling stockholders. *See id.*

117. Such arguments can be challenged on a number of grounds. *See* Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 284-86.

118. One commentator has suggested that stockholder fiduciary duties protect minority stockholders by creating "corporate cohesion." Mitchell, *supra* note 27, at 1715. Perhaps such cohesion would enable stockholders to reach amicable resolutions to disputes.

119. *See* Brudney, *Corporate Governance*, *supra* note 103, 1407-08 n.15 (arguing for fiduciary duties as a gap-filling provision in the absence of stockholder agreements); Moll, *Shareholder Oppression*, *supra* note 22, at 799-809 (seeking to give content to the terms of stockholders hypothetical bargains); *see also* J. Mark Meinhardt, Note, *Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited-Liability Business Organizations: Delaware Law and its Adherents*, 40 WASHBURN L.J. 288, 308 n.157 (2001) (citing commentators advocating fiduciary duties as a default rule). *But see* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1271-76 (1999) (rejecting fiduciary duty as a hypothetical contract term); Hillman, *supra* note 56, at 57-58 (criticizing hypothetical bargain analysis). On the use of hypothetical bargain analysis in corporate law generally, *see* EASTERBROOK & FISCHEL, *supra* note 62, at 228-52.

120. *See* Stevenson, *supra* note 109, at 1154-64 (describing terms used in typical venture capital agreements); *see also* Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 294-95.

121. For example, corporations with fewer than twenty-five stockholders might be required to "Mirandize" investors before issuing stock to them. Requiring disclosure is, of course, the approach taken to protect investors in public companies.

122. For example, commentators have advocated granting minority stockholders a "put," that is, a right to require the corporation or the majority to repurchase their stock. This is a crude version of the exit rights that sophisticated investors bargain for.

123. *But see* Jennifer Arlen et al., *Endowment Effects Within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1, 5, 33 (2002) (noting that there is reason to suspect that the "endowment effect" may not be as powerful in corporate and financial contexts).

on all controlling stockholders without any examination into the actual economic realities of the particular business relationships involved seems ill-suited to addressing the specific concerns the commentators identify.[124]

A further fundamental difficulty with the argument that economic circumstances require the imposition of fiduciary duties on controlling stockholders is that it ignores the economic circumstances of the controlling stockholder. By definition, the controlling stockholder has more invested in the enterprise than the minority holder. The controlling stockholder paid for hcr favored position. The creation of stockholder fiduciary duties, which are likely to interfere with the controlling stockholder's ability to act in what she perceives to be the best interests of the business (including, for example, firing a minority stockholder-employee),[125] will deprive the majority stockholdcr of the benefit of her investment.[126] Why is the controlling stockholder's investment not as worthy of protection as the minority's?

C. Controlling Stockholder Fiduciary Duties Are a "Settled Rule of Law"

Commentators further arguc that controlling stockholder fiduciary duties are a "settled rule of law."[127] That settled rule of law in Dclaware

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124. At least one commentator has made reasoned arguments that fiduciary duties can address the minority stockholder's problem of lack of marketability. *See* Mark Blair Barta, *Is the Imposition of Fiduciary Responsibilities Running From Managers, Directors, and Majority Shareholders to Minority Shareholders Economically Efficient?*, 38 CLEV. ST. L. REV. 559, 568-71 (1990) (arguing that fiduciary duties reduce the size of control premia and reduce risk to stockholders and therefore make minority stock more marketable).

125. *See In re* Topper, 433 N.Y.S.2d 359, 366 (N.Y. Sup. Ct. 1980) (allowing fired stockholder-employee to recover for "oppression"). In the seminal *Donahue* case, the controlling stockholder group sought to have the corporation buy out the interest of the aging family patriarch in order to induce him to retire. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 510 (Mass. 1975). The remedy created by the court required the corporation to repurchase the minority's interest in its entirety at the same price, thereby doubling the cost to the corporation of ensuring a smooth generational transition. *See id.* at 521. Even if breaches of fiduciary duty are not strictly enforced or heavily litigated, the mere threat would have a chilling effect on controlling stockholders' actions. *See* Hillman, *supra* note 56, at 60-61.

126. The controlling stockholder will also require stability of capital, so that providing minority holders with a "put" (effectively converting an equity interest into a demand note) will be harmful to the controlling stockholder's investment expectation. *See* Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 288-90; Rock & Wachter, *supra* note 6, at 919.

127. *See* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109-10 (Del. 1952).

is often attributed, directly or indirectly,[128] to *Sterling v. Mayflower Hotel Corp.*[129] The court in *Sterling*, after stating the "settled rule of law" that majority shareholders occupy a fiduciary position in relation to the minority,[130] cited *Keenan v. Eshleman*[131] and *Gottlieb v. Heyden Chemical Corp.*[132] Both of those cases, however, deal with the duties of directors and do not involve controlling shareholders at all.[133] Similarly, courts often cite *Weinberger v. UOP Inc.*[134] for the proposition that controlling shareholders owe a duty to the minority. While *Weinberger* did in fact involve a controlling shareholder, the court's entire discussion was about the duties owed by the directors of the subsidiary.[135] Thus, there is no full discussion anywhere in the Delaware cases about the origin or purpose of the "settled rule."[136]

The Delaware courts implicitly draw a link between the duties-of-directors cases and the duties-of-shareholders cases through language appearing in many cases that "where one stands on both sides of a transaction, he has the burden of establishing its entire fairness."[137] This statement is too broad, however. First, the Delaware courts have repeatedly held that in some cases the entire fairness test does not apply to transactions between majority shareholders and either the corporation

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128. For other cases often cited for this proposition, see, e.g., Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (citing *Sterling*); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (citing *Sterling*); Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (Del. 1994) (citing *Weinberger*); Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985) (citing *Weinberger*).

129. 93 A.2d at 109-10.

130. *Id.* at 109-10.

131. 2 A.2d 904 (Del. 1938).

132. 90 A.2d 660 (Del. 1952).

133. *Cf.* Gilson & Gordon, *supra* note 31, at 826-27 (describing courts' confusion regarding differences between duties of controlling shareholders and duties of directors).

134. 457 A.2d 701 (Del. 1983).

135. *See id.* at 710-11.

136. Interestingly, the settled rule is often supported by a citation to Pepper v. Litton, 308 U.S. 295, 306 (1939). *See, e.g.*, Ragazzo, *supra* note 107, at 1135; LARRY D. SODERQUIST ET AL., CORPORATE LAW AND PRACTICE § 10:3.2 (2d ed. 1999). *Pepper* supported its statement of the rule with Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919), which states that a person with control is deemed to be fiduciary but says nothing about stockholders. *Pepper* involved a bankruptcy proceeding in which the court sought to disallow a fraudulent salary claim by the "dominant" stockholder. Because the bankruptcy court is a court of equity, equitable doctrines such as the fiduciary duties of directors or stockholders apply. Of course, such doctrines are a matter of state law, and by 1939, when *Pepper v. Litton* was decided, the Supreme Court was no longer the supreme arbiter of state law. *See* Ruhlin v. New York Life Ins. Co., 304 U.S. 202 (1938) (extending doctrine of Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938), to cases in equity); Guaranty Trust Co. v. York, 326 U.S. 99, 107 (1945) (same).

137. *Weinberger*, 457 A.2d at 710 (citing Sterling v. Mayflower Hotels, 93 A.2d 107, 110 (Del. 1952)).

or its minority shareholders.[138] Second, one who stands on both sides of a transaction has the burden of establishing its entire fairness only when he already has a fiduciary duty to other parties to the transaction. A minority shareholder on both sides of a transaction does not have to prove entire fairness, for example.[139] Third, a majority shareholder does not always stand on both sides of the challenged transaction. Where the majority shareholder is purchasing shares from minority shareholders, for example, either directly or through a tender offer, the parties to the transaction are clearly acting at arm's length. In fact, even in the extreme conflict of interest scenario in which the majority causes a cash-out merger of the minority, the majority shareholder only stands on both sides of the challenged transaction because the court is equating the acts of the corporation (acting, as always, through its board of directors) with the acts of the majority shareholder. Thus, it is the identification of the corporation's board with the majority shareholder that creates the need for enhanced scrutiny. Unfortunately, that step of the analysis is invariably omitted from the discussion. The "settled rule of law" is therefore based largely on sloppy analysis.

D. Fiduciary Duties Accompany Control

Courts and commentators also argue that stockholders owe fiduciary duties because they control the corporate enterprise, and one exercising control over the property of another owes that person a fiduciary duty.[140] This premise is relatively unobjectionable, although it overstates the case. In fact, fiduciary duties arise from a relationship of dependence, not control.[141] Often, the dependent relationship includes an element of control by the fiduciary over the affairs of the beneficiary, as in the case where a principal hires an agent to serve as general manager in the absence of the principal, or in the case of a trustee. However, not all fiduciary relationships take this form. Attorneys, for example, often do not have sufficient authority to constitute "control" over the affairs of

138. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Thorpe v. CERBCO, Inc., 676 A.2d 436, 442-43 (Del. 1996); *see also* Siegel, *supra* note 1, at 30 (noting that a rule in which all transactions, between the parent and subsidiary, were subject to the entire fairness standard would be unworkable and would result in eourts' evaluating the substance of business decisions).

139. *See* Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002).

140. *See* Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947); Southern Pac. Co. v. Bogert, 250 U.S. 483, 492 (1918); HENN & ALEXANDER, *supra* note 5, § 240 at 654.

141. *See infra* notes 142-44 and accompanying text.

their clients; rather, it is the attorney's superior knowledge of the law, and the client's relatively vulnerable position, that creates the dependence.

Furthermore, although many situations in which one party "controls" the property of another are fiduciary in nature, not all are. A bailee, for example, by definition controls the property of the bailor, but does not owe fiduciary duties.[142] Similarly, a tenant does not owe fiduciary duties to his or her landlord. Those parties are expected to protect their interests by contract, or the law protects them by application of specific default rules from the substantive law.[143] Thus, it cannot be the mere existence of control over the property of another that creates the fiduciary duty.[144]

IV. CONFLICT WITH BASIC PRINCIPLES OF AMERICAN LAW

Even if one accepts that there are reasons to impose fiduciary duties on stockholders, those reasons must be weighed against the fact that imposing such duties violates several basic principles of American law.

A. Contract Law

As a general rule, courts enforce contracts as they are written.[145] In the absence of agreement, courts apply default rules. In the absence of relevant default rules, courts may seek to determine what the parties would have agreed to in the event they had considered the issue. It is generally accepted that in no event should a court rewrite the agreement for the parties based on what the court thinks the parties *should* have agreed to.[146] The judicial imposition of stockholder fiduciary duties violates all of these principles.

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142. The bailee is held to a negligence standard with respect to damage to the property, and is strictly liable for misdelivery. *See generally* ARMISTEAD M. DOBIE, ILLUSTRATIVE CASES ON BAILMENTS AND CARRIERS 32-34, 41 (1914). The bailee is not held to a fiduciary standard. *See, e.g., id.* at 39.

143. Both landlord/tenant and bailment are subject to rich common law and statutory legal regimes, but those regimes do not include fiduciary duties.

144. Furthermore, as I argue at greater length below, controlling stockholders do not ordinarily control either the corporation's business or its assets. *See infra* Part V.

145. *See* Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 742 (1982) [hereinafter Eisenberg, *Bargain Principle*].

146. *See* Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993) ("It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.").

People invest in corporations, including close corporations, against the background of a clear set of default rules governing their relationships.[147] Contractual silence does not create ambiguity in a contract if the silence relates to a matter on which the law is settled.[148] As further explained below, one of those default rules in corporate law is that stockholders do not owe fiduciary duties to each other or to the corporation. Thus, the fact that the investors have not articulated an understanding about their fiduciary obligations to each other may indicate that they considered the default no-duty rule to be acceptable, rather than that they failed to reach agreement on the issue.[149] In other words, there may not be a gap in the stockholders' agreement for the court to fill.

If there is a gap in the contract, and if there is a sufficiently compelling reason not to apply the default rule, one might ask what the parties would have agreed to, had they addressed the question.[150] Commentators generally assume that the minority holder would have demanded that the controlling stockholder agree to be subject to fiduciary duties.[151] But would the majority holders have agreed to give up their right to prefer the interests of the business over those of the minority holder? Would they have done so without demanding a larger financial investment from the minority holder in exchange for that agreement?[152] What about a case such as *Wilkes* in which there are several equal investors? At the time of the litigation, Wilkes took the position that his colleagues could not force him out of the business. But

147. *Cf.* Metro. Life Ins. Co., v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1520 (S.D.N.Y. 1989) (noting that "this Court, like the parties to these contracts, cannot ignore or disavow the marketplace in which the contract is performed").

148. *See* New Jersey v. New York, 523 U.S. 767, 783 (1998).

149. *Cf. Metro. Life Ins. Co.*, 716 F. Supp. at 1520 (noting that there was "no reason to believe that the market... did not discount for the possibility" arising in the case). *But see* Charles Rogers O'Kelley, Jr., *Opting In and Out of Fiduciary Duties in Cooperative Ventures: Refining the So-Called Coasean Contract Theory*, 70 WASH. U. L. Q. 353, 357 (1992) (arguing that choice of form may not indicate agreement with the associated default rules).

150. *Cf.* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1550-51 (1989) (noting that the nexus-of-contracts approach to corporate law includes an assumption that the law should reflect what typical parties would have agreed to if contracting was costless).

151. *See* Moll, *Shareholder Oppression*, *supra* note 22, at 784 (arguing that investors probably would not consider in advance whether a controlling stockholder should have the right to prefer the corporation's interests to the other stockholders).

152. *See* Eisenberg, *Bargain Principle*, *supra* note 145, at 746 (noting that the bargain principle is based, in part, on the recognition that a court cannot know what price the parties *would have* agreed to if the terms had been different).

would he have taken that position at the time he formed the business, when it might have seemed likely that he would be in the majority, not the minority, when push came to shove? In fact, minority investors generally do not bargain for fiduciary duties,[153] and at least some majority investors might balk at being asked to undertake fiduciary responsibilities for the minority.[154]

One of the reasons that *ex ante* agreements are preferred is that, at the time the agreement is made, the parties do not know which side they will be on; therefore, they are more likely to be reasonable in the negotiation.[155] The parties can determine for themselves the risks of loss from bad acts by the other parties and determine the price they are willing to pay to reduce that risk. It is at best overly simplistic to assume that close corporation stockholders would always have bargained for fiduciary duties without any change in the investment price. It is particularly questionable whether investors would demand a regime in which the stockholders must prefer the other stockholders' individual interests to the corporation's. Rather, the parties might reasonably agree to forego certain individual protections if doing so resulted in greater gains to all parties.[156] For example, the stock repurchase in *Donahue* that the court held to be a breach of fiduciary duty may in fact have greatly benefited the business (and ultimately all stockholders) by permitting an orderly change of management.[157]

Similarly, in *Wilkes*, the dissension originated when the plaintiff negotiated too hard on behalf of the company in a transaction with another stockholder.[158] Wilkes himself clearly thought the corporation should come first; the other stockholders apparently disagreed. Thus, there was express disagreement between the parties on the fiduciary

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153. *See* Stevenson, *supra* note 109, at 1155-64 (describing the terms usually included in contracts governing venture capital investments); David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 368-73 (noting that investors in venture capital limited partnerships often waive the general partner's fiduciary duties, and instead rely on other constraints to reduce the risk of exploitation while preserving the manager's freedom to operate).

154. The author has personally experienced this phenomenon in a number of cases involving investments by sophisticated investors.

155. *Cf.* JOHN RAWLS, A THEORY OF JUSTICE 11 (rev. ed. 1999) (noting that the veil of ignorance ensures that choices of principles are made without regard to circumstances; since "no one is able to design principles to favor his particular condition, the principles of justice are the result of a fair agreement or bargain"). The same observation operates in the old solution to the one-piece-of-cake problem: one person cuts the cake, and the other selects the first piece.

156. *See* Easterbrook & Fischel, *Corporate Control*, *supra* note 102, at 703-704.

157. *See* Easterbrook & Fischel, *Close Corporations*, *supra* note 78, at 295.

158. Wilkes v. Springside Nursing Home, Inc. 353 N.E.2d 657, 660 (Mass. 1976).

duties issue. At the time of the negotiation, Wilkes was acting to protect the corporation against an individual stockholder. Only latcr, when he was on the losing side, did he change his tune about where the investors' duties lay. This illustrates perfectly why parties should be held to their *ex ante* agreements.

The stockholder fiduciary duty cases generally arise from a situation in which a stockholder finds that things have not turned out as well as expected, and that he or she has struck a bad bargain. Should the court relieve that party of the consequences of that bargain? The usual answer in the American legal system is no,[159] unless the complaining party can prove fraud, duress, or unconscionability.[160] The law assumes that parties know their own interests best,[161] and that they rationally make tradeoffs between price and other contract terms.[162] The insights of behavioral economics challenge some of these underlying assumptions in some contexts,[163] but investors in business ventures, unlike consumers, are presumptively acting in economically rational ways.[164] It is hard to argue, in any event, that business investors should be held to a lower standard of rational behavior than other contracting parties.[165]

159. *See, e.g.*, *Metro. Life Ins. Co.*, 716 F. Supp. 1504, 1520; Miller, *Definition of Oppression*, *supra* note 24, at 257-58; Eisenberg, *Bargain Principle*, *supra* note 145, at 745.

160. *See generally* Eisenberg, *Bargain Principle*, *supra* note 145, at 742. Consumer law protects parties who are in a disproportionately weak bargaining position, but such inroads into the general principles of contract law were generally made by statute, not by courts, and are subject to carefully crafted limitations; *see also infra* notes 253-55 and accompanying text (discussing purpose of fiduciary duties); *Cf.* Miller, *What Buy-Out Rights*, *supra* note 108, at 438-39 (arguing that fiduciary duties should be imposed upon controlling stockholders because there is not a level playing field between majority and minority investors).

161. *See* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1463 (1989); *see also* JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 950 (W. Ashley ed. 1961).

162. *See* Eisenbcrg, *Limits of Cognition*, *supra* note 114, at 211-12; Easterbrook & Fischel, *Corporate Control*, *supra* note 102, at 713 (arguing that an investor's failure to diversify may indicate that he or she is not risk averse); *see also* Barta, *supra* note 124, at 566-67 (arguing that the risk of bad acts by the controlling stockholder should be treated like other risks that the parties rationally allocate between them).

163. *See* Eisenberg, *Limits of Cognition*, *supra* note 114, at 212-25.

164. *See* Arlen et al., *supra* note 123, at 5, 33 (noting that the "endowment effect," which leads to seemingly irrational decision-making, appears to be less important in corporate contracts); *see also In re* Staples, Inc. S'holders Litig., 792 A.2d 934, 952 (Del. Ch. 2001) (noting that eourts are reluctant to pre-empt the stockholders' own judgment of fairness); *In re* IXC Communications, Inc. S'holders Litig., No. C.A. 17324, C.A. 17334, 1999 WL 1009174, at *10 (Del. Ch. Oct. 27, 1999) (stating that stockholders have the right to decide their own best interest).

165. *See* Timothy J. Storm, *Remedies for Oppression of Non-Controlling Shareholders in Illinois Closely-Held Corporations: An Idea Whose Time has Gone*, 33 LOY. U. CHI. L.J. 379, 431-32 (2002). *Cf.* Cox, *supra* notc 97, at 92 (arguing that stockholders do not consent to harm just

B. Corporate Law

Stockholder fiduciary duties also violate the basic premise of corporate law that stockholders are entitled, as owners of property, to protect their own interests. Stockholders are permitted to act in their own interests, even when doing so injures the corporation or other stockholders.[166] A controlling stockholder can refuse to agree to a sale of the corporation that would greatly benefit the stockholders,[167] and can liquidate the corporation for any reason.[168] Similarly, a controlling stockholder is permitted to bargain for and receive a premium for a controlling block of shares.[169]

The stockholder's right to selfish action is vividly illustrated in *Thorpe v. CERBCO, Inc.*[170] In that case, the Eriksons, who had a controlling block of stock and served as half the board of directors, received an offer for the purchase of one of the company's subsidiaries.[171] The Eriksons countered with a proposal that the buyer instead purchase the Eriksons' share in the parent, and intimated that they would use their voting control to prevent a sale of the subsidiary.[172] The Eriksons did not inform the other board members of the original offer[173] and eventually negotiated a sale of their stock at a premium.[174] The court held that the Eriksons had violated their fiduciary duties *as directors* by competing with the corporation when the buyer first approached them about purchasing a corporate asset and by failing to inform the rest of the board about the offer.[175] However, since the Eriksons had the right *as stockholders* to vote against the sale of the subsidiary, there was no real loss of a corporate opportunity.[176]

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because they paid a lower price for their shares); Stevenson, *supra* note 109, at 1175-76 (arguing that legislatures should enact protections because minority investors do not have the bargaining power to buy them).

166. *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 598 (Del. Ch. 1986); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, at § 5.11 cmt. c(1).

167. *See* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987).

168. *See* Siegel, *supra* note 1, at 76 n.248.

169. *See In re* Sea-Land Corp. S'holders Litig., 642 A.2d 792, 802 (Del. Ch. 1993); Citron v. Steego Corp., Civ. A. No. 10171, 1988 WL 94738, at *8 (Del. Ch. Sept. 9, 1988).

170. 676 A.2d 436 (Del. 1996); *see also In re* Digex, Inc. S'holders Litig., 789 A.2d 1176, 1190-92 (Del. Ch. 2000) (reaching same conclusion on similar facts).

171. *Thorpe*, 676 A.2d at 438.

172. *See id.*

173. In fact, they lied when asked about it. *Id.* at 439.

174. The sale was never consummated. *Id.* at 439-40.

175. *See id.* at 442.

176. *See id.* at 443-44. The plaintiffs were permitted to recover certain expenses incurred by the corporation in connection with the negotiations. *Id.* at 445.

The stockholder's right to act in his or her own best interest is particularly clear in the case of voting.[177] The statement of this principle invariably includes the proviso "so long as he violates no duty owed his fellow shareholders."[178] The meaning of this proviso is somewhat obscure. If intentionally preventing a sale, for the benefit of the corporation as a whole, in order to benefit the controlling stockholder personally does not constitute such a violation,[179] what could? In fact, no Delaware court has ever held that a stockholder acting as a stockholder (that is, voting or selling) breached a duty to the corporation or other stockholders.

Additionally, to the extent stockholder fiduciary duties are based on the stockholder's control of the corporate enterprise, they violate the basic premise of corporate law that stockholders do not manage the corporation. A stockholder's power to "control" corporate affairs begins and ends with the right to elect directors and to vote on fundamental corporate changes. Any further attempted exercise of control is void as an incursion into the board's authority and an interference with the board's ability to act in accordance with its own fiduciary duties.[180] Even in closely held corporations, a stockholder's attempted exercise of control will be upheld only if *all* the stockholders agree and the creditors are protected, or if the certificate of incorporation expressly provides for stockholder management.[181] This rule is not mere formalism. Rather, it is designed to protect creditors. Corporate creditors ordinarily have no recourse against a stockholder's assets. Because corporate debts will be paid only from corporate assets, corporate managers are required to act in the best interests of the *corporation*. Stockholder control permits stockholders, in effect, to act as principals without incurring a principal's liability. It thus violates an important rule of corporate and agency law.

C. *Fiduciary Law*

Stockholder fiduciary duties are also inconsistent with the basic principles of the law of fiduciary duties generally. Fiduciary duties apply

177. *See* Tanzer v. Int'l Gen. Indus., Inc., 379 A.2d 1121, 1123 (Del. 1977) (collecting cases).

178. *Id.* (quoting Ringling Bros. Barnum & Bailey Com. Shows v. Ringling, 53 A.2d 441, 447 (Del. 1947)). *Cf.* Heil v. Standard Gas & Elec. Co., 151 A. 303, 304 (Del. Ch. 1930) ("so long as no advantage is obtained at the expense of their fellow stockholders").

179. *See supra*, text accompanying notes 170-76 (discussing *Thorpe v. CERBCO, Inc.*).

180. *See* Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85, 86-87 (N.H. 1880).

181. *See* Galler v. Galler, 203 N.E.2d 577, 585 (Ill. 1964); McQuade v. Stoneham, 189 N.E. 234, 238 (N.Y. 1934).

to people sueh as agents or trustees, who have discretion that puts them in a position of power with respect to the principal or beneficiary.[182] Although the nature of fiduciary relationships is largely undertheorized, fiduciary duties tend to arise where someone is acting on another's behalf and has been given power or authority in order to accomplish the purpose of the relationship.[183] That situation does not generally exist *between stockholders* in a normally functioning corporation. A stockholder is not expected to act on behalf of either the corporation or the other stockholders; in fact, stockholders lack the power to do so.[184] Similarly, there is no delegation of power to stockholders. Stockholders' limited powers, which involve only voting, are their own; they are incidents of the ownership of shares and are not delegated by anyone.[185] The other stockholders retain their own, identical, powers.

As discussed above, in a corporation officers and directors, not stockholders, meet the criteria for fiduciaries.[186] Their management power requires them to act on behalf of the corporation, and their powers are created to enable them to accomplish the goals of the relationship (that is, the operation of a profitable business).[187] Thus, corporate law imposes fiduciary duties on officers and directors. Stockholders, even controlling stockholders, who do not act on behalf of anyone other than themselves and do not have delegated powers, are not subject to fiduciary duties.[188]

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182. *See* Mitchell, *supra* note 27, at 1684-85.

183. *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 808-09 (1983) (identifying "substitution" and delegation of power as the common fcatures of fiduciary relationships); *see also* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002) (arguing that a fiduciary is one who acts on behalf of another while exercising discretion with respect to a critical resource belonging to the other); Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 922 (1993) (identifying dependence, conference of power, inability to protect oneself by contract, and the fiduciary's acceptance of the "entrustment" as the common features).

184. *See supra* text accompanying notes 180-81.

185. *See* Jay H. Knight, *Merger Agreements Post-*Omnicare, Inc. v. NCS Healthcare, Inc.*: How the Delaware Supreme Court Pulled the Plug on "Mathematical Lock-Ups,"* 31 N. KY. L. REV. 29, 45 (2004); Ronald A. Brown, Jr., *Claims of Aiding and Abetting a Director's Breach of Fiduciary Duty—Does Everybody Who Deals With a Delaware Director Owe Fiduciary Duties to That Director's Shareholders?*, 15 DEL. J. CORP. L. 943, 960 n.95 (1990).

186. *See* DEL. GEN. CORP. LAW § 141(a) (2001); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

187. The power of the board of directors is created by law, not delegated, because the beneficiary of the relationship (the corporation) cannot act independently. *See* HENN & ALEXANDER, *supra* note 5, § 207.

188. *See* Siegel, *supra* note 1, at 36 (stockholders owe duties only when they act as managers).

Courts and commentators occasionally reject the idea that directors, not stockholders, manage the corporation, especially in closely held corporations.[189] In many cases, the controlling stockholder, one of the directors, and the president of the company will be the same person, and the parties themselves rarely distinguish acts taken in one capacity from acts taken in another. For the law to treat different acts of this single person differently seems formalistic and against common sense. There are two responses to this argument. First, the law *consistently* makes and requires the parties to make such distinctions, absurd or not. Tax law, criminal law,[190] and other areas of the corporate law[191] place great weight on the formalistic distinction between stockholders and directors.

Second, in many, if not most, corporations the distinction has practical value both descriptively and normatively. In publicly traded corporations, for instance, the roles of director and controlling stockholder are kept separate because the market for the minority shares will require formal acts by directors.[192] The following excerpt from the *Wall Street Journal* illustrates the extent to which a controlling stockholder's supposed powers can be limited by market forces:

> Viacom Chairman and Chief Executive Sumner Redstone emerged from . . . [a recent management] accord, announced yesterday, with enhanced powers to run the company, in which he is the controlling shareholder. Mel Karmazin, the company's president and chief operating officer, has the right to quit if Mr. Redstone uses the most important of those powers. Mr. Karmazin has a loyal following among investors, so his departure likely would hurt the stock price of

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189. Although stockholders indirectly control corporate policy through the election of directors, the law treats the election of directors, like other stockholder votes, as an incident of the ownership of stock. When voting, stockholders are acting *on their own behalf*, and therefore they are not subject to fiduciary duties. *See supra* notes 1 & 34. Even those who would otherwise be in a fiduciary relationship are held to a different standard when they are acting adversely to one another (as, for example, in a negotiation over salary). *See* RESTATEMENT (SECOND) OF AGENCY § 390, 392 (1958). The rules in such eases generally require full disclosure of all material facts. *See also* Amanda K. Esquibel, *The Finality of Buyout Agreements in the Close Corporation Context: What Recourse Remains for Aggrieved Sellers?*, 53 RUTGERS L. REV. 865, 905-906 (2001) (arguing that fiduciary duties should not apply where one stockholder is buying the shares of another because they are acting adversely rather than in a relationship of trust and confidence).

190. *See* Cedric Kushner Promotions, Ltd., v. King, 553 U.S. 158, 163-64 (2001) (ruling that sole shareholder is different person from corporation for purposes of RICO liability).

191. *See* JAMES D. COX ET AL., CORPORATIONS §§ 7.4-7.5 (1997) (noting that a stockholder's disregard of corporate formalities and dominating corporate affairs are factors leading to piercing the corporate veil).

192. *See* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 618 (1997).

> Viacom. . . . Mr. Redstone [as CEO] has full authority over corporate policy and strategy, including acquisitions. But he also can overrule Mr. Karmazin on operating matters after consulting with the board, or fire him with board approval at any time.[193]

In closely held corporations, the behavior of the parties may or may not respect formal distinctions. Where some minority stockholders are passive investors, either by original plan or because the original shares have been passed on to heirs or other family members, actions by stockholders will often be clearly distinguishable from actions by managers. In *Donahue*, for example, the decision to buy back the controlling stockholder's shares was made by his son, who was *not*, in his own right, a controlling stockholder.[194] That act had to be taken as a director, whether formally or not. It is only in those limited number of cases where all the stockholders are engaged in management, as in *Wilkes*, that distinctions between acts taken as stockholders and acts taken as managers will be difficult. Nor is it necessarily the case that unsophisticated parties will fail to distinguish between actions taken *as management on behalf of the business* or as part of the operation of the business, and actions taken *as owners*, in light of the fact that a stockholder's ownership rights are so limited.

The feature of fiduciary relationships that leads to the imposition of fiduciary duties is the danger of abuse of power that arises from the combination of substitution and delegation of power. No such danger exists in the case of controlling stockholders because there is no substitution and delegation. The alleged vulnerability of minority investors arises from unequal wealth, unequal bargaining power, or lack of sophistication. The law addresses those vulnerabilities, in strictly limited ways, with doctrines such as unconscionability, fraud or duress.[195] Often, however, the law leaves such vulnerabilities unaddressed, especially in the business context, because rewards for superiority of skill or investment are a necessary feature of functioning markets. Fiduciary duties, on the other hand, are designed to address a potential for abuse of power that arises from the *structure* of the relationship, in which power must be delegated to the fiduciary in order

193. Martin Peers, *Viacom Managers Make a Tense Peace*, WALL ST. J., Mar. 21, 2003, at B4. The article also reported that Mr. Redstone agreed, as part of Viacom's acquisition of CBS, Inc., in 2000, not to change the composition of the board for three years. *Id.*

194. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 510 (Mass. 1975).

195. *See* Brudney, *supra* note 192, at 628 n.84. *See generally*, Jordan v. Duff, Inc., 815 F.2d 429 (7th Cir. 1987).

for the fiduciary to carry out the business of the principal.[196] No amount of sophistication, wealth or bargaining power can eliminate that potential for abuse.[197] This feature, too, is absent from the relationship between stockholders. A minority stockholder is fully capable of protecting his or her rights (to employment, to a seat on the board, to a regular dividend or other return on investment, or otherwise) by contract.

The stockholders of a closely held corporation can elect to manage the corporation directly, but if they do so they are subject to the same liabilities as directors.[198] In other cases, the law expressly prevents stockholders, even controlling stockholders, from directly managing the corporation in their capacity as stockholders.[199] It is therefore not only incoherent, but also unjust, to subject them to fiduciary duties in that capacity.

V. THE REAL BASES FOR CONTROLLING STOCKHOLDER LIABILITY

A. *Direct Liability as Officers or Directors*

The established law of agency and corporations provides a sufficient basis for holding controlling stockholders liable for injuries to the corporation in appropriate circumstances.[200] In a public company without a controlling stockholder, business decisions are made by the board and the authorized officers. If the decision-makers do not have a conflict of interest, and if they act in an informed manner, their decisions are protected by the business judgment rule.[201] If, on the other hand, the decision-makers have an interest in the transaction, the transaction will be scrutinized by the court for "entire fairness" to the corporation, and

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196. *See* Frankel, *supra* note 183, at 810.

197. *See* Scallen, *supra* note 183, at 922 (noting that the inability of the entrustor to protect himself by contract is a required feature of a fiduciary relationship).

198. *See* DEL. GEN. CORP. LAW § 351 (2001).

199. Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporation*, 46 AM. J. COMP. L. SUPP. 317, 327 (1998).

200. Commentators have also suggested that the law of contracts may provide some protection for unhappy minority stockholders. *See* Barta, *supra* note 124, at 573-74 (frustration of purpose or unconscionability doctrine); *see also In re* Sunstates Corp. S'holder Litig., 788 A.2d 530, 533 (Del. Ch. 2001) (noting that a stockholders' rights under the certificate of incorporation are contract rights). *But see* Moll, *Reasonable Expectations*, *supra* note 24, at 1027-39 (noting that contract law will not enforce stockholders' reasonable expectations because they are insufficiently definite); *id.* at 1039-43 (noting that the employment at-will doctrine prevents recognition of an implied contract between stockholders for employment).

201. *See* Pinto, *supra* note 199, at 331-32.

the burden will usually be on the directors to establish fairness.[202] The stockholders' role is limited to electing directors and voting on fundamental changes to the corporate structure, and they are not subject to fiduciary duties in doing so. Rather, the law assumes that each stockholder will act in his or her own best interest, and that the entire body of stockholders will be protected by that mechanism.[203] Why should a corporation with a controlling stockholder be treated any differently? Controlling stockholders who are actually exercising control will invariably serve, or have employees who serve, as directors and officers of the company.[204] As directors and officers, they will be subject to the usual fiduciary duties in acting on behalf of the corporation. There is no need to impose duties on the stockholder *qua* stockholder as well.[205]

Controlling stockholders have been held liable for the following actions:

(1) denying employment opportunities to minority stockholders,[206]

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202. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, at § 5.02 (fairness standard applies to transactions between a director or officer and the corporation).

203. *See, e.g.*, Schreiber v. Carney, 447 A.2d 17, 24 (Del. Ch. 1982) (quoting Cone v. Russell, 21 A. 847, 849 (N.J. 1891)).

204. A majority stockholder who does not elect directors or officers is generally not considered "controlling" and so would not be subject to fiduciary duties in any event. Courts and commentators dealing with controlling stockholder cases frequently ignore the fact that the wrongdoers in the cases are usually acting as directors, not stockholders. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 349-351 (2002); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, Introductory Note, Part V, para. b. ("When a director or senior executive is also a controlling shareholder, whether the governing rules are those applicable to a director or senior executive on the one hand, or to a controlling shareholder on the other, will depend on the context."). *Cf.* HENN & ALEXANDER, *supra* note 5, at § 240 (noting difference between acts of director and acts of stockholder). For an example of this confusion, *See* Stevenson, *supra* note 108, at 1158 (discussing contracts between "management and venture capitalists" as an example of agreements protecting minority stockholders from the majority). *But see* Mitchell, *supra* note 27, at 1700 n.101 (noting that the cases do not distinguish between stockholders and directors in determining who owes the duty, but arguing that in close corporations the distinction does not matter). Nevertheless, hints of the true nature of the claim for breach of fiduciary duty by a controlling shareholder arise in a few cases where the claim is brought against the directors of the corporation, in addition to the controlling stockholder. *See In re* Student Loan Corp. Derivative Litig., No. C.A. 17799, 2002 WL 75479 at *1 (Del. Ch. Jan. 8, 2002); Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983) (focusing on the conflict of interest and breach of duty by the directors of the subsidiary).

205. *See* Siegel, *supra* note 1, at 33-34, 36.

206. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663-64 (Mass. 1976).

(2) causing the corporation to repurchase shares from the controlling stockholder but not the minority,[207]

(3) causing the corporation to purchase the minority's shares at an inadequate price,[208]

(4) causing the corporation to pursue business policies that benefit the controlling stockholder,[209]

(5) creating a market for the controlling stockholders' shares but not the minority's,[210] and

(6) purchasing the minority's shares at an inadequate price.[211]

Of these allegedly wrongful acts, the first four must, as a matter of corporate law, be undertaken by the board of directors or officers of the corporation. If the law of director fiduciary duties were applied to these acts, the first question would be whether the directors were "interested" in the transaction. Interest is generally defined as a personal financial interest not shared by the other stockholders.[212] The test for independence is a subjective test based on the actual director and on whether she was likely to be affected by the interest.[213] A director who is "dominated and controlled" by an interested director will also be considcred interested.[214] The test for domination and control asks whether "through personal or other relationships the directors are beholden to the controlling person."[215] Based on this analysis, if a

207. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 518 (Mass. 1975).

208. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115-17 (Del. 1994).

209. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971). *See generally* Summa Corp. v. Trans World Airlines Inc., 540 A.2d 403 (Del. 1988).

210. *See* Jones v. H. F. Ahmanson & Co., 460 P.2d 464, 477-78 (Cal. 1969).

211. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951); Wilkes, 353 N.E.2d at 664.

212. *See* 1 RODMAN WARD JR. ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2.3 (4th ed. 2004) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

213. *See* Cinerama, Inc., v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995) [hereinafter *Cede III*].

214. *Id.* at 1168.

215. *Aronson*, 473 A.2d at 815; *see also* Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002).

> A director may be also be deemed 'controlled' if he or she is beholden to the allegedly controlling entity, as when the entity has the direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so

controlling stockholder places her family or close personal advisors on the board, the board as a whole will be interested when the controlling stockholder (as director) is interested. Similarly, the Delaware court's definition of "self-dealing" in *Sinclair Oil*[216] is, in essence, a test for independence: when the controlling stockholder is receiving a benefit to the exclusion of the minority, the controlled directors who approve the transaction are "interested."[217]

Consider, then, the results if the wrongful acts enumerated above are analyzed under the usual director fiduciary standards. First, the board's denial of employment to a minority stockholder would ordinarily not create a conflict of interest, and therefore the transaction would ordinarily be protected by the business judgment rule.[218] This result reflects the fact that ordinarily one person does not derive a benefit from the failure to employ another person. Where, however, the profits

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> dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.

Id. (citing Orman v. Cullman, 794 A.2d 5, 25 n.50 (Del. Ch. 2002).

216. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

217. The ALI *Principles of Corporate Governance* provide that a transaction between two corporations (such as the transactions in *Sinclair Oil*) is not subject to the entire fairness standard *solely* because someone is an officer or director of both corporations, *unless*:

> (1) The director or senior executive participates personally and substantially in negotiating the transaction for either of the corporations; or (2) The transaction is approved by the board of either corporation, and a director on that board who is also a director or senior executive of the other corporation casts a vote that is necessary to approve the transaction.

PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 5.07(a). Furthermore, under Section 1.03(b), a corporation is not an "associate" of a person solely because the person is a director or principal manager of the corporation, despite the fact that the general definition of "associate" is "a person with respect to whom [one] . . . has a business, financial, or similar relationship that would reasonably be expected to affect the person's judgment . . . in a manner adverse to the corporation." *Id.* § 1.03(a)(2). The comment states, however, that if a person is a director or a principal manager of two corporations, he may be interested in a transaction between the two under Section 1.03(a)(2). *Id.* § 1.03 cmt. Thus, the definition appears to be intended to apply only where the transaction in question does not involve the individual, but only the corporations (e.g., a routine contract between the two firms). Section 5.08 states that an officer or director who knowingly advances the pecuniary interests of an associate is subject to the same standard as if he had advanced his own interest. *Id.* § 5.08. Elsewhere, however, the *Principles* notes that "there are . . . circumstances when the duty of fair dealing requires a director, senior executive, or controlling shareholder . . . to avoid using their positions to obtain improperly a benefit for himself as shareholders to the exclusion of other shareholders similarly situated." *Id.* Introductory Note, Part V, para. b.

218. Without that protection, the board's acts should be subject to the reasonableness standard that ordinarily applies to acts not involving a conflict of interest: a director "must exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances." ROBERT C. CLARK, CORPORATE LAW § 3.4 (1986).

of the corporation are divided into salaries, the ordinary rule would not hold. If the failure to employ a stockholder resulted in larger salaries for the directors, they would be interested and the transaction would be subject to the entire fairness standard.

Second, the purchase by the corporation of shares from a stockholder/director directly benefits the director and is clearly an interested director transaction. When, in *Donahue*, the Rodds agreed to have the corporation repurchase their father's stock, they were acting as officers and directors; only the board would have that authority.[219] Because the transaction involved a family member to whom they were "beholden," they would have been "interested directors," and they would, under ordinary corporate law principles, be required to prove that the transaction was fair to the corporation.[220] Mrs. Donahue's lawyer presumably understood this when he filed the claim as a derivative suit. Unfortunately for Mrs. Donahue, the transaction may, in fact, have been fair to the corporation, if old Mr. Rodd's continued participation in management was detrimental to the orderly operation of the business, or if the price was commensurate with the value of the shares. But fairness to the corporation was not Mrs. Donahue's concern: Her real complaint was the lack of liquidity of her own position, a situation which did not stem from any action by the directors or other stockholders.[221] Nevertheless, the Supreme Judicial Court could have ruled that providing a buyback of some shares, but not others, was not "entirely fair" in these circumstances. That ruling would have led to the same result without doing damage to the basic rules of corporate law.

Compare *Levco Alternative Fund Ltd. v. The Reader's Digest Association, Inc.*,[222] in which Reader's Digest decided, as part of a recapitalization, to repurchase shares from trusts established by the founders of the company.[223] The court ruled that the directors of Reader's Digest initially bore the burden to prove that the repurchase was entirely fair, because the directors were "subject to the control" of the stockholder and were therefore interested.[224] Because the special committee negotiating on behalf of the minority stockholders had not

219. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 510 (Mass. 1975); CLARK, *supra* note 218, at § 3.2.1.

220. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 1.03(a).

221. *See Donahue*, 328 N.E.2d at 511.

222. 803 A.2d 428 (table), No. 466,2002, 467,2002, 2002 WL 1859064 at *1 (Del. Aug. 13, 2002).

223. *See id.*

224. *See id.* at *2.

appropriately balanced the minority's interests with those of the majority and the corporation, the court held that the plaintiffs stood a reasonable chance of success on the merits and granted a preliminary injunction.[225] Thus, in a situation exactly analogous to *Donahue*, the minority was protected without the court's resorting to the creation of specious stockholder fiduciary duties.

Third, the purchase of the minority's interest by the corporation will directly benefit the remaining stockholders/directors if it is at less than full value, and the transaction will therefore be subject to the entire fairness test unless the board can demonstrate that the repurchase was made for a legitimate business purpose, such as protecting the corporation from a threat[226] or cashing out a disruptive holder.[227] This established rule of director liability effectively duplicates the Massachusetts court's innovative approach to stockholder duties in *Wilkes*.[228]

Fourth, under *Sinclair Oil*, the corporation's pursuit of business policies that benefit the controlling stockholder/director does not create "interest" unless the benefit causes injury to the corporation.[229] There are a number of reasons for this rule. First, the corporation's business is supposed to benefit the stockholders, and as long as that benefit is shared by all the stockholders proportionately, it is, in essence, only a dividend.[230] Stockholders will often prefer different outcomes with respect to dividends; they have different investment time horizons, tax positions, and cash needs. The board is supposed to consider what is best for the corporation as a whole, but there are innumerable policy choices that a board makes, most of which will benefit one stockholder more than another.[231] To subject all such decisions to scrutiny for entire fairness would make it impossible for a board to do its job.

Lastly, to the extent the board considers the preferences of any stockholder in choosing one of several courses of action (all of which benefit the corporation), it is entirely appropriate for the board to place more weight on the preferences of the majority, whether that is one

225. *See id.* at **2-3.

226. *See* Cheff v. Mathes, 199 A.2d 548, 554-55 (Del. 1964)

227. *See* Kaplan v. Goldsamt, 380 A.2d 556, 568-69 (Del. Ch. 1977).

228. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (modifying *Donahue* to create an affirmative defense for controlling stockholders who can show a "legitimate business purpose" for their acts).

229. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

230. *See id.* at 721-22.

231. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

stockholder or an unaffiliated mass. When directors consider a dividend policy, they are not "interested" because their interest is no different from that of the other stockholders, even if some or all of the directors have personal situations that lead them to prefer one policy over another.[232] The same rule applies when the director is also a controlling stockholder. If, on the other hand, the policy results in harm to the corporation and a disproportionate benefit to a stockholder, as where the corporation fails to purchase needed equipment and instead leases inferior equipment from a stockholder/director, the director is interested because she receives a benefit to the detriment of the corporation.[233]

The last two allegedly wrongful acts in the list above present different issues. The majority's acts with respect to its own stock or in a transaction with the minority are carried out without the participation of the board of the corporation and, therefore, should not give rise to claims against the directors for breach of fiduciary duty. In fact, those acts should not give rise to claims of breach of fiduciary duty against anyone. To say that a stockholder "created a market" for her shares is another way of saying the stockholder found a purchaser for her shares, and a stockholder is free to sell her shares to anyone, at any time, unless she has reason to believe the buyer will engage in wrongful conduct.[234] Any other rule would deny the stockholder the right to alienate her property. Similarly, a stockholder's purchase of another stockholder's shares usually involves an arm's length transaction. The parties clearly understand that they are in a win-lose negotiation. If one of the parties is also a director, her informational advantage may require that she fully disclose all material facts to the other party.[235] Otherwise, however, there is no relationship of dependence or even inequality that can justify imposition of a fiduciary duty.[236]

B. *Indirect Liability for Acts of Directors*

Even where the challenged transaction is taken by directors other than the controlling stockholder (for example, where the controlling stockholder is a corporation), the controlling stockholder itself may be

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232. *See Sinclair Oil Corp.*, 280 A.2d at 721-22.

233. *See* Summa Corp. v. Trans World Airlines, Inc., 540 A.2d 403, 407-09 (Del. 1988).

234. *See* Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387 (N.Y. 1979).

235. *See* Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1331-35 (1998).

236. Needless to say, mere inequality of wealth between parties does not create a fiduciary duty.

vicariously liable for the acts of the directors of the corporation if they can be shown to be acting as agents of the controlling stockholder.[237] In general, a principal is liable for the acts of its agent, if the agent was authorized to so act, or if the agent was acting in the scope of employment.[238] With respect to controlling stockholders, the predicates for vicarious liability will usually exist if the corporate officers or directors can be shown to be agents. In the usual case, the directors will be acting within the scope of their employment with the controlling stockholder in preferring the stockholder's interest over the corporation. First, the director's act would not be effective if she were acting completely outside the scope of employment. Second, if her act is advancing the controlling stockholder's interest, she will meet the "actuated . . . by a purpose to serve" standard, which is the principal test used to define the scope of employment in many states.[239] A principal is also liable if she actually authorizes or directs the agent to commit the breach.[240] Thus, the controlling stockholder would be directly liable if it caused its agents on the corporation's board to engage in the wrongful transaction.[241] Thus, when the controlling stockholder *actually* exercises control over the management of the corporation, she will be liable irrespective of any fiduciary duty she might (or might not) owe as a stockholder.

The difficult question in establishing a controlling stockholder's vicarious liability for the acts of the directors is determining whether the director is an agent of the controlling stockholder. Agency is defined as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject

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237. There is little case law addressing whether a shareholder can be held liable for the acts (including the breaches of fiduciary duty) of the shareholder's designates on thc board of directors. Where the shareholder is a *minority* shareholder, some federal courts applying state law have held that the shareholder cannot be held liable on a respondeat superior theory. *See* CCBN.com v. Thompson Financial, Inc., 270 F. Supp. 2d 146, 151 (D. Mass. 2003); Medical Self Care, Inc. v. Nat'l Broadcasting Co, Inc., 01-CV-4191, 2003 WL1622181, *7 (S.D.N.Y. Mar. 28, 2003); U.S. Airways Group Inc. v. British Airways PLC, 989 F. Supp. 482, 494 (S.D.N.Y. 1997). *But see In re* Papercraft Corp., 165 B.R. 980, 981 (Bankr. W.D. Pa. 1994).

238. *See generally* Paula J. Dalley, *All in a Day's Work: Employers' Vicarious Liability for Sexual Harassment*, 104 W. VA. L. REV. 517, 527-28, 543-50 (2002).

239. *See id.* at 544-45.

240. *See id.* at 528.

241. *See In re* Unocal Exploration Corp. S'holders Litig., 793 A.2d 329 (Del. Ch. 2000), in which Vice Chancellor Lamb noted that, "By exereising control over the corporation's board of directors, the 50.1% stockholder may, *in breach of its fiduciary duties to the minority stockholders*, cause the board, *in breach of their respective fiduciary duties*, to approve a merger that is not fair to the minority stockholders." *Id.* at 338 (emphasis in original).

to his control, and consent by the other so to act."[242] Applying this definition to the relation between a controlling stockholder and her nominees on the board raises several issues.[243] First, the director is not supposed to be the stockholder's agent in acting as a director;[244] rather, she is supposed to be acting on behalf of the corporation and its stockholders as a whole.[245] Except in rare cases,[246] the director is not supposed to consider the interests of any one stockholder or individual group of stockholders.[247] If, however, a director can be shown to be acting on behalf of a stockholder, as will often be the case where the director approves a transaction that confers a special benefit on the controlling stockholder, then the director may be acting as an agent. A good example of this is provided in *Weinberger v. UOP, Inc.*,[248] where two directors of UOP used their position to prepare financial analyses "solely for the use of" the parent corporation.[249]

The second prong of the test for agency asks whether the agent was subject to the control of the principal. In fact, an agent is under a duty to obey the principal.[250] This principle clearly conflicts with a director's

242. RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

243. Although this potential agency relationship is frequently ignored, courts have recognized it occasionally. *See* Comac Partners, L.P., v. Ghaznavi, 793 A.2d 372, 382 (Del. Ch. 2001). In *Comac Partners, L.P.*, the defendants argned that the plaintiff stockholders' claims were barred because the directors elected by that class of stockholders had acquiesced in the challenged transaction. The court rejected that argument because the defendant "has made no attempt to show that *all* the plaintiff stockholders havc such a strong relationship (e.g., principal-agent, employer-employee) to the [directors elected by their class] that none of them may press the claim now before me." *Id.*

244. *See* Cochran v. Stifel Fin. Corp., No. Civ. A. 17350, 2000 WL 286722 at *16 (Del. Ch. Mar. 8, 2000) (noting that the mere fact that a stockholder elects a director does not make the director an agent of thc stockholder); Brudney, *Corporate Governance*, *supra* note 103, at 1428-30 (noting that the stockholder-management relationship is not usually an agency one because there is usually no control and no information rights, among other things, between them).

245. *See In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 465 n.3 (Del. Ch. 2000) (citing Citron v. Fairchild Camera & Instruments Corp., 569 A.2d 53, 65-66 (Del. 1989)) ("[T]hc mere fact that a controlling stockholder elects a director does not render that director non-independent.").

246. *See, e.g.*, Levco Alternative Fund Ltd. v. The Rcader's Digest Ass'n, Inc., 803 A.2d 428 (table), No. 466,2002, 467,2002, 2002 WL 1859064 at *1 (Del. Aug. 13, 2002) (noting that directors were required to consider the specific interests of the class of stockholders that would be advcrsely affected by thc transaction).

247. *See* HENN & ALEXANDER, *supra* note 5, § 240.

248. 457 A.2d 701, 708-09 (Del. 1983).

249. *Id.* at 708.

250. RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

duty to act in the best interest of the corporation.[251] Thus, the controlling stockholder cannot force a director to obey the controlling stockholder, but where a director does in fact follow the directions of the controlling stockholder, the director is probably acting as an agent. Thus, the controlling stockholder will be vicariously liable for the director's acts if the director breaches a fiduciary duty to the corporation or its stockholders in general.[252]

Subjecting controlling stockholders to liability for the acts of their agents is not only consistent with corporate law, but also with analogous doctrines of debtor-creditor law. Lenders will not only be liable for corporate debts, but also subject to fiduciary duties, if they exercise control by electing the board, controlling management, and otherwise engaging in "financial domination."[253]

C. Policy Considerations

If controlling stockholders are likely to be liable under corporate or agency law principles anyway, what harm does it do to create stockholder fiduciary duties? There are two answers to this question. First, imposing fiduciary duties on stockholders creates an unworkable legal rule. To whom are those duties owed, and in what contexts? As discussed above, stockholders have certain rights as property owners, such as the right to sell their stock and the right to vote on fundamental corporate matters, that courts have been unwilling to restrict. The exercise of those rights may in some cases disadvantage the minority. Imposing duties with respect to some acts, but not others, will require careful line-drawing. More fundamentally, controlling stockholders have presumably paid for the right to control corporate decision-making.

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251. A contract limiting a director's discretion on matters with respect to which he owes a fiduciary duty is invalid. *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 104-05 (Del. Ch. 1999); McQuade v. Stoneham, 189 N.E. 234, 236-37 (N.Y. 1934); RESTATEMENT (SECOND) OF CONTRACTS § 193 (1981). The Restatement (Second) of Agency expressly provides that an agent does not have a duty to obey with respect to acts that are illegal, unethical, or unreasonable. RESTATEMENT (SECOND) OF AGENCY § 411 (1958).

252. *See* BAINBRIDGE, *supra* note 204, at 336 (2002).

253. *See* Margaret Hambrecht Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343, 343-45, 348-49 (1975); *see also* Jeffrey John Hass, Comment, *Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321, 1341-42, 1356 (1987) (proposing as a standard for creditors that "[a]ny control exerted over the board must work for the corporation's best interests and not solely for those of the controlling creditor").

Courts will also have to distinguish legitimate exercises of bargained-for control from those that are, for some reason, illegitimate.

The situation becomes more difficult when there are more than two stockholders. If "control" is calculated on a transaction-by-transaction basis, any majority block—even, possibly, a public majority—can become subject to fiduciary duties. Unless "control" is carefully defined, such a rule would undercut the basic premise of corporate democracy. Similarly, even if stockholder duties are applied only in closely held corporations, the definition of such corporations is not without difficulty. Is a non-publicly traded corporation with fifty stockholders "closely held"? Is a publicly traded corporation with a single controlling stockholder? Finally, the imposition of stockholder fiduciary duties must include an analysis of the particular contract underlying each investment. Where a controlling stockholder bargains for control, the courts should not rewrite the contract and provide a windfall to the minority. Although careful analysis might lead to the creation of workable parameters for stockholder duties, courts imposing such duties have been unwilling or unable to engage in such analysis, perhaps because they focus on inappropriate analogies to partnership law or succumb to unthinking urges to "protect" minority stockholders.

Second, the imposition of stockholder fiduciary duties fundamentally alters the nature of business investment. Investors purchase controlling interests because they believe that their management ability will justify the price of a control premium. Restricting their freedom to manage the business will adversely affect the business of those corporations with controlling stockholders.[254] Future investors will reduce the control premia they are willing to pay,[255] and may be discouraged from making investments at all.[256]

254. *Cf.* Frankel, *supra* note 183, at 835 (arguing that one of the goals of fiduciary law is to reduce the costs of the relationship and avoid restricting the fiduciary's ability to carry out the purposes for which she was hired); *id.* at 814 (noting that restricting the right of the principal to interfere with the fiduciary's freedom to act may increase the benefits of the relationship to the principal).

255. *See In re* Pure Resources Inc. S'holders Litig., 808 A.2d 421, 434-35 (Del. Ch. 2002).

256. To the extent the payment of a control premium represents the desire to loot the company, existing officers' and directors' fiduciary duties address the problem. Ordinary corporate fiduciary duties serve, among other things, to reduce agency costs, but there is no reason to extend that reasoning to stockholders, who do not pose agency problems. Furthermore, the fact that sophisticated investors do not bargain for such duties indicates that they do not serve an important economic function. Instead, sophisticated minority investors rely on the majority's need for future capital inputs and on reputational constraints to reduce the risk of exploitation. *See* Rosenberg, *supra* note 153 at 368-73.

Alternatively, the imposition of duties may discourage sole stockholders from selling interests in their businesses to minority investors, raising the cost of capital and eliminating investment opportunities.

Furthermore, a fiduciary relationship includes a moral dimension. Fiduciaries are expected to be altruistic[257] and behave with "the punctilio of an honor the most sensitive."[258] While it is appropriate to hold directors and other corporate agents to such a standard because they are supposed to be acting on behalf of others, it is not only inappropriate, but counterproductive, to expect an investor to adhere to such a standard. A market economy operates on the assumption that individuals will produce social goods in pursuit of their own self-interest. Expecting altruism from business owners, or encouraging some business owners to rely on the altruism of others, threatens the very nature of the market for business investments.

VI. CONCLUSION

Controlling stockholders' fiduciary duties are a judicial invention stimulated by a desire to provide relief to minority stockholders who later regretted their own or their decedent's bargains and encouraged by scholars advocating a neo-marxist view of investing. Although such duties have been enforced in some jurisdictions for a quarter-century, they continue to be poorly understood and undertheorized. Even a cursory examination of the offered justifications for such duties reveals the weaknesses of such justifications. More importantly, a reasoned understanding of fiduciary duties reveals that they are both unnecessary and inappropriate restrictions on a stockholder's freedom to act.

257. *See* Frankel, *supra* note 183, at 829-39.
258. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).