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Is the Imposition of Fiduciary Responsibilities Running from Managers, Directors, and Majority Shareholders to Minority Shareholders Economically Efficient

Mark Blair Barta

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IS THE IMPOSITION OF FIDUCIARY RESPONSIBILITIES RUNNING FROM MANAGERS, DIRECTORS, AND MAJORITY SHAREHOLDERS TO MINORITY SHAREHOLDERS ECONOMICALLY EFFICIENT?

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I. INTRODUCTION

The tension between the desires of managers of a corporation to maximize corporate "returns" in the manner they see fit and the desires of minority (i.e. non-controlling) shareholders to obtain the best possible return on their investment has been a continuing theme in the evolution of the corporate law. This tension is part of a larger paradox in the relationship between the corporate investor and the corporate manager. This paradox arises because the interests of the investor and the manager are not identical: The manager is left with the "duty" to increase investor wealth and the desire to increase his own.

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This paradox was recognized by an early commentator who stated:

The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear. Size alone tends to give these giant corporations a social significance not attached to smaller units of private enterprise. By the use of the open market for securities, each of these corporations assumes obligations towards the investing public which transform it from a legal method clothing the rule of a few individuals into an institution at least nominally serving investors who have embarked funds in its enterprise. New responsibilities towards the owners, the workers, the consumers, and the State thus rest upon the shoulders of those in control.¹

The following article will address the issue of the extent to which minority shareholders should be recognized to have a legal right which reflects the responsibilities of the management to the shareholders as a group.² It will then address the issue of whether the imposition of "fiduciary duties" as traditionally defined furthers the goal of protecting minority shareholders.³ It concludes that while minority shareholders need more protection than the corporate structure (absent the imposition of extrinsic duties) can give them, the imposition of "fiduciary duties" is not a proper response.

In order to explore these issues, the article will analyze the behavior of the controlling shareholder(s) in a close corporation; it will then analyze the behavior which the minority shareholder(s) would try to impose upon the controlling corporation; these behaviors will then be compared in terms of economic efficiency; finally the economic efficiency of allowing minority shareholders an enforceable right to change corporate policy will be discussed.

II. THE ACTIVITY OF THE CONTROLLING SHAREHOLDERS

Controversies between minority shareholders and controlling shareholders can be placed into two categories. The first type of controversy arises when the minority shareholders do not believe that the controlling

¹ A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1935). *But see* Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977) which argues that the increased pace of information flow and market reaction has mitigated the problem that Berle and Means described.

² In 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 TEMP. L. Q. 47 (1987), the author concluded that market forces would mitigate the necessity for the imposition of such rights and responsibilities.

³ See DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879 (1988).

shareholders are capable of maximizing the total return to the corporation. This type of controversy could manifest itself in the minority shareholders' attempt to force the corporation to pursue a certain course of action which the minority shareholder deems advantageous. This type of controversy has not proven susceptible to remedy by the courts. The courts generally will not substitute their business judgment for that of the directors and the managers.⁴

The second type of controversy arises when the minority shareholders claim that the controlling shareholders are not primarily attempting to maximize corporate returns, but are attempting primarily to maximize returns to the controlling shareholders. This activity may or may not involve also trying to maximize total corporate returns.

Maximization of returns to the controlling shareholders can be attempted through the use of "amenities."⁵ "Amenities" are defined as those attributes of a corporation which allow a manager to withdraw value without declaring a dividend.⁶ An "amenity" can be as innocuous as free executive travel or as crucial as the publicity that results from owning a sports franchise.⁷

The minority shareholders object to the maximizing of the corporate "amenities" to the detriment of present or future dividends. The minority shareholders therefore contend that management has breached its fiduciary relationship to the corporation.⁸ This contention brings us to the crux of the issue: Which "persons" are entitled to enforce the fiduciary duty owed to the corporation by the managers of the corporation? This issue is critical because the "corporation" itself is a legal fiction reflecting the legal rights and obligations of some of the parties with an interest in the corporation.⁹

In order to test the economic efficiency of management's decision to maximize the returns to the controlling shareholders, we will make the following assumptions:

⁴ See generally Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157 (1970). But see *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) in which the court determined that the corporate managers acted in an uninformed manner and were not entitled to the presumption of care accorded by the business judgment rule. *Smith v. Van Gorkom*, it should be noted, did not involve the issue of whether a minority shareholder would be able to sue for the same abuse.

⁵ Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. OF POL. ECON. 1155, 1161 (1985).

⁶ *Id.*

⁷ *Id.*

⁸ In *Commodities Futures Trading Commission v. Weintraub*, 471 U.S. 343, 348-349 (1985), the court stated: "The managers of course, must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation and not of themselves as individuals" (quoting *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919)).

⁹ "A corporation is an ideal body, subsisting only in the contemplation of the law, which may be comprised of members constantly changing." *Pratt v. Bacon*, 27 Mass. (10 Pick.) 123, 125-26 (1830).

1. That the management's decision to maximize the controlling shareholders' return does not affect the overall economic return of the corporation, but merely transfers some of the returns from the minority shareholders to the controlling ones.
2. That the management's decision to maximize the controlling shareholders' return also maximizes the overall return to the corporation, but the controlling shareholders benefit disproportionately from the gain.
3. That the management's decision to maximize the controlling shareholder's return has a negative impact upon the corporation's total return. It not only works to transfer some of the gain from the minority shareholders to the controlling shareholders, it also works to lower the overall return.

A. Cases in Which the Management's Decision to Maximize Return to the Controlling Shareholders has no Apparent Effect on Total Corporate Return

Often, controlling shareholders will attempt to withdraw value from a corporation in a manner which does not lower the total returns from the corporation, but which shifts returns from minority shareholders to controlling shareholders. The most obvious example of this type of behavior is the misdirection, or theft, of corporate funds. Although controlling shareholders rarely actually "steal" corporate funds, arguably behavior that is similar morally is the granting of larger salaries to insiders in lieu of larger corporate dividends, when it is clear that the larger salaries are not justified in an arm's length transaction.¹⁰

The misdirection, or theft, scenario presents a compelling argument for the imposition of some form of minority shareholder protection. While it could be, and has been, argued that shareholders take the risk of economic setback into account when they invest in corporations,¹¹ this argument is more attractive when the subject is management "shirking" rather than management "theft".¹² When theft is involved, the minority shareholders' right to relief seems almost irrebuttable.

¹⁰ See *Aronson v. Lewis*, 466 A.2d 375 (Del. Ch. 1983), *rev'd*, 473 A.2d 805 (Del. 1984).

¹¹ *Cox*, *supra* note 2.

¹² *Id.* at 59. In part this distinction stems from the fact that the fiduciary's duty, when imposed, is not absolute. The fiduciary does not act as the guarantor of the investment, but only agrees to use reasonable care in his management. *Harvard College v. Armory*, 9 Pick. (Mass.) 446 (1830). See Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L. J. 491 (1951).

A complex system has been developed to vindicate the minority shareholders' claim in this type of situation.¹³ In short the following steps are taken: 1) The dissenting shareholder must request that the corporation take steps to vindicate the rights of the corporation; 2) if the corporation does not act within a reasonable time, the dissenting shareholder may file suit against the directors and any other offending parties; 3) the corporation may appoint an independent board to weigh the plaintiffs' claims; 4) if the independent board decides that there is no merit to the plaintiffs' claims, it will seek to dismiss the plaintiffs' suit; 5) if the court determines that the independent board set up by the corporation is truly not independent or did not fairly consider the claims of the plaintiffs, the court will at that time litigate the merits of the plaintiffs' claims.¹⁴

The claim can be very expensive to litigate.¹⁵ There is no guarantee that the suit has been filed in good faith; and because the question of whether the board and management have violated their fiduciary relationships to the corporation is fact-intensive, the findings of fact will often be extensive and expensive to present to the court.¹⁶

The expense of the litigation not only extends to the plaintiffs and the defendant corporation; the time spent in court places a burden upon taxpayers in general. This ability to go to court to enforce the rights of the corporation is in marked contrast to other holders of interests in the corporation, who have no such right.¹⁷ Other holders of corporate interests may be protected by the "morals of the marketplace" rather than by any fiduciary responsibility running to them.¹⁸

The potential for abuse of the positions of corporate management is high. When corporate management is an alter ego of the controlling shareholders, the potential for abuse is increased markedly. The "transfer" of wealth from the minority shareholders to the controlling shareholders can make the interests of the minority shareholders almost worthless. Under these circumstances, the issue is not whether the shareholder has been harmed, but whether he has sustained what should be recognized as a legally cognizable harm.

¹³ Technically, the minority shareholders are vindicating the claim of the corporation as a whole. The corporation and not the complaining shareholder receives the benefit of any recovery. Because, however, the corporation is a legal fiction reflecting the rights and duties of the various parties involved in the corporation, and because the controlling shareholders are losing value and the minority shareholders are gaining it, claims of the minority shareholders are in fact being vindicated, regardless of the legal niceties.

There are still situations in which the minority shareholder can seek relief on his own behalf rather than that of the corporation. *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

¹⁴ *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). See also *Youngman v. Tahmoud*, 457 A.2d 376 (Del. Ch. 1983).

¹⁵ See *Kaplan v. Wyatt*, 484 A.2d 501 (Del. Ch. 1984), *aff'd* 499 A.2d 1184 (Del. 1985).

¹⁶ *Id.*

¹⁷ *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (the court would not impute a fiduciary obligation upon the management of a corporation towards bondholders absent a specific agreement).

¹⁸ *Id.* at 1525.

B. Cases in Which the Management's Decision to Maximize the Controlling Shareholders' Return also has the Effect of Maximizing the Total Return to the Corporation

It has been theorized that the tendency of the controlling shareholders to take advantage of corporate "amenities" tends to maximize ownership utility, if not ownership profit.¹⁹ It has been further theorized that a large shareholder is profit-maximizing to a firm because he has the initiative to do the necessary research to discover firm value-increasing improvements.²⁰ Another possible source of wealth-maximizing selfish behavior on the part of corporate insiders is when the attributes of the corporation and the attributes of the corporate insiders produce a synergistic effect. When the attributes of the corporation are combined with the attributes of the corporate insiders the total is greater than the sum of the parts: One plus one is equal to three.²¹

An example of this type of combination is a sports franchise controlled by a television station,²² or a sports franchise controlled by the manufacturer of a commodity.²³ The "free" use of the sports franchise for television or the "free" advertising and publicity which the commodity receives might be worth more to the controlling shareholder than the franchise would be worth operating in an arm's-length manner.

In practice, it would be unusual to find a case where this synergistic effect could be proven with any certainty. The closest example would be *Dodge v. Ford Motor Co.*²⁴ In *Dodge*, the controlling shareholder attempted to maximize the returns from a closely-held corporation by producing many cars at an inexpensive price. This strategy required the shareholder to retain large amounts of cash in the corporation.²⁵ The controlling shareholder received an amenity by: 1) Being able to perform charitable acts; and 2) being able to manage a larger corporation. The returns were maximized because almost surely the money would be more efficient in the hands of Ford Motor Co. than in the hands of the shareholders.

These amenities were purchased in part by the involuntary contributions of the minority shareholders. Even though the controlling shareholder used his management position to maximize corporate profits, the result of these transactions was to lower the return on the minority shareholders' shares. The issue to be addressed later is the extent to which courts should take into consideration the fact that the synergistic effect of the transaction results in a net increase in societal assets.

¹⁹ Demsetz & Lehn, *supra* note 5, at 1161.

²⁰ Shleifer & Vishny, *Large Shareholders and Corporate Control* 94 J. OF POL. ECON. 461, 465 (1986).

²¹ The term "synergism" is borrowed from the patent law. It describes the situation where two or more obvious objects are combined in a nonobvious way with unforeseeable results. Fenton, *Combination Patents and Synergism: Must 2 + 2 = 5?*, 37 WASH. & LEE L. REV. 1206 (1980).

²² For instance, WTBS and the Atlanta Hawks and the Atlanta Braves.

²³ For instance, Anheuser-Busch, Inc. and the Saint Louis Cardinals.

²⁴ 204 Mich. 459, 170 N.W. 668 (1919).

²⁵ 170 N.W. at 682.

C. Cases in Which the Management's Decision to Maximize the Returns to the Controlling Shareholder Results in Lower Returns to the Corporation as a Whole

The third type of transaction which the controlling shareholders could enter into in order to maximize their returns are transactions which fail to maximize corporate returns but by their nature increase the amenities to the controlling shareholders. An example of this type of transaction is the granting of "perks" to the officers of the corporation.

The granting of perks fails to maximize corporate returns because management might, absent the constraints of the corporate and tax laws, prefer cash to non-pecuniary awards. It is the structure of the organization or the effects of the tax laws, which in many cases makes the awarding and receipt of non-pecuniary awards attractive. Only in relatively rare circumstances does the provision of non-pecuniary benefits by the corporation have positive economic utility aside from these legally created distortions.²⁶

Judicial review of these types of transactions is difficult because the extent to which the perks represent a distribution of assets to management and the extent to which the perks represent a benefit to the corporation is difficult to ascertain. Although this type of transaction is clearly a form of self-dealing and the business judgment standard might not apply,²⁷ the courts are reluctant to lightly dismiss the claims of management which was responsible for the decision.²⁸ The extent to which this failure to maximize returns represents a major factor in corporate decisions is discussed *infra*.

²⁶ These circumstances include structures which give rise to economies of scale that the corporation can invoke, which its employees cannot (i.e. group health insurance). They might also include circumstances in which the corporation desires to direct its employees' expenditures (i.e. exercise club memberships), where the expenditures at least arguably benefit both the employer and the employee.

²⁷ *New York Trust Co. v. American Realty Co.*, 244 N.Y. 209, 155 N.E. 102 (1926).

²⁸ Although the standard under which the managers' activities are judged is different in the case of self-dealing than the standard in the usual case, the intricate fact issues remain. The court must determine the consequences of the deal and the facts as they were presented to management at the time the deal was consummated. The court (and the minority shareholder) is disadvantaged in that it can only judge the transaction retrospectively while the manager could judge the transaction prospectively.

Under these circumstances, it is clear that the corporate manager is best *able* to determine whether impermissible self-dealing has occurred. The issue facing the court is whether the manager is willing to honestly make this determination. Under these circumstances the courts are understandably unwilling, to in effect, accuse the manager of being untruthful.

III. THE BEHAVIOR WHICH THE MINORITY SHAREHOLDERS SEEK TO IMPOSE

The behavior that the minority shareholders would seek to impose upon the closely-held corporation is that the closely-held corporation act like a publicly-held corporation. The attributes would include:

1. That the corporation seek to maximize "profits" to the greatest extent possible.
2. That the corporation and the corporation's management/controlling shareholders act at arm's length as though they were unrelated parties.
3. To the extent that there are profits arising from the operation of the corporation, these profits should be distributed to the shareholders in the form of dividends.

To early commentators, these attributes were apparently inseparable from the concept of the corporation.²⁹ Because the form of the corporation was dictated by the state of incorporation as consideration for the privilege of doing business,³⁰ and not created as a result of bargaining between the parties to the venture, the issue of whether deviations from this form would be efficient did not arise. The courts were not interested in maximizing corporate returns, they were interested in determining the scope of the corporate charter granted by the state.

Proponents have attempted to justify the imposition of a duty to minority shareholders by noting that this duty reflects the parties' expectations; this duty would have been made express if the parties had contracted completely.³¹ This assumption about the parties' expectations is not entirely convincing: The consequences of being a minority shareholder in a closely held corporation can be so disastrous that rather than seek to mitigate the effects contractually, the investor would avoid the investment³² or rely upon the character of the board of directors. Under this view, the risk of being a minority shareholder in a controlled corporation is an economic risk that is borne by the investor like any other economic risk.³³ The purchase price of the shares reflects any perception

²⁹ Cf. Note, *The Effect of Depreciation, Depletion, and Appreciation of Assets on the Payment of Dividends*, 28 COLUM. L. REV. 231, 236 (1928) ("[t]here are but two logical points for the stockholders to reap their benefit: (i) When the appreciation accrues; (ii) On dissolution.").

³⁰ *Schumann-Heink v. Folsom*, 328 Ill. 321, 159 N.E. 250, 253 (1927) ("A corporation is an artificial body composed of individuals who own its capital stock and whose rights and liabilities are *fixed by statute*."). (Emphasis added).

³¹ Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1451 (1989).

³² I.e., by refusing to buy shares in corporations where the likelihood appears high that the corporation would go private.

³³ Cox, *supra* note 2, at 51:

[t]he neoclassical model perceives the shareholder as an investor in a diversified portfolio of securities whose interest in and relationship to any particular firm in the portfolio is extremely tenuous. Shareholder utility is a function of the wealth generated for the investor by the investor's portfolio. It is independent of conduct or events affecting any particular firm, except to the extent that the conduct or the events affect the portfolio's value.

of risk that the contingency may occur. The parties do not attempt to mitigate or allocate the risk because of the practical impossibility of doing so.³⁴ As explained earlier, it is nearly impossible in many instances to separate bona fide corporate transactions from the forbidden transfer of amenities.

The attempt to gauge the intentions of the parties, had they considered the problem of the role of the minority shareholder in the closely held corporation, is inconclusive. Even if the intentions were clear, it is not apparent that they should be controlling. The imposition of rights and duties has ramifications beyond the contract between the shareholder and the corporation. In order to determine whether the imposition of rights and duties would be justified, one must look at the content of the rights and duties and their economic consequences. The next section of this article will discuss the fiduciary duties applied and why they are appropriate or not for the corporate area.

IV. THE ECONOMIC EFFICIENCY OF THE IMPOSITION OF FIDUCIARY RESPONSIBILITIES FROM THE CORPORATION TO MINORITY SHAREHOLDERS

It is unclear whether the rule allowing minority shareholders to maintain actions against corporate managers is a default rule, a strong default rule, or an immutable rule.³⁵ A law is a "default rule" if it operates only in the absence of express agreement of the parties. A law is a "strong default rule" if the parties can change the rule only through a clear and unambiguous manifestation of intent to do so. A law is an immutable rule if the parties can not avoid the rule through express agreement.³⁶ The issue, reduced to its simplest terms, is whether a corporation could be organized with a provision disallowing the right of a minority shareholder to maintain a derivative action and whether this provision would be enforced because it is not inconsistent with public policy.³⁷

³⁴ A legislative reaction to this problem is to allow shareholders to force dissolution of closely held corporations, regardless of whether the board of directors or management has acted in an improper manner. See, DEL. CODE ANN. tit. § 355 (1953). The problem then becomes: What constitutes a closely held corporation for this purpose?

³⁵ For a more detailed discussion of these different types of laws, see Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L. J. 87 (1989).

³⁶ *Id.*

³⁷ The provision might be against public policy because it leaves the shareholder with a right (the right to a dividend equal to that of other shareholders), but no remedy. In *Penington v. Commonwealth Hotel Constr. Co.*, 17 Del. Ch. 394, 155 A. 514, 517 (1931), the court defined "dividend" as "a sum of money or portion of a divisible thing to be distributed according to some fixed scheme." The diversion of corporate funds in the form of amenities violates this "fixed scheme" requirement.

In *Ellingwood v. Wolf's Head Oil Refining Co.*, 27 Del. Ch. 356, 38 A.2d 743 (1944) the court held that articles of incorporation contrary to public policy would not be enforced.

The determination of which type of law encompasses the imposition of the fiduciary responsibility is important because that will effect the law's economic significance. If the circumstances are such that the law will be imposed, the law will have identical consequences regardless of its underlying nature. If, however, the law is merely a default rule, the economic effect can be changed and even eliminated through the bargaining process.

The economic effect of the imposition of fiduciary responsibility can be felt in several areas: 1) It may facilitate the sale of stock in the marketplace because the legal rights of minority shareholders in controlled corporations will be uniform; 2) it may induce the sale of stock in the marketplace because prospective non-controlling shareholders value the protection that it gives; 3) it may reduce the disparity in value between large blocks of stock owned by the same person and small blocks with diffuse ownership; 4) it may force management to fail to maximize economic benefits because of fear of a derivative suit; and 5) it may impose costs on the public at large to litigate minority shareholder claims. The following sections of this article will focus upon these possible economic effects.

A. The Facilitation of the Sale of Stock in the Marketplace

The imposition of a fixed fiduciary duty on the part of the corporation to individual shareholders and the delineation of a fixed manner of enforcing that right provides stability in financial markets. The transaction costs of trying to determine the effect of particular provisions upon the investor's potential returns are avoided.³⁸ In this sense, the imposition of a certain rule is an important event independent of the content of the rule.³⁹

This imposition of a uniform rule has a temporal as well as a geographical function. Prospective shareholders are not only concerned with the transaction costs of determining the impact of present non-conforming articles of incorporation on their possible returns; they are also concerned about the possibility that non-conforming rules that might have a negative impact will be imposed in the future. In order to quantify the future possibility of negative amendments to the articles of incorporation, the prospective shareholder will have to gauge the honesty and ability of the board of directors⁴⁰ and other shareholders. Because of the myriad factors

³⁸ See Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1567 (1989). In this article, the author advances the thesis that non-uniform corporate articles impose costs on both investors and on other corporations. They do this by increasing the perceived risks associated with investing in corporations whose articles *might* contain terms potentially harmful to the shareholders' returns.

³⁹ There is a constant tension in the law between applying a rigid rule in every case and providing just relief in the case at hand. Shauer, *Formalism*, 91 YALE L. J. 509, 537 (1988). The application of rigid rules might be more important in the corporate law where large numbers of transactions are essential than in other areas of the law.

⁴⁰ The Securities Exchange Commission has promulgated regulations requiring companies which register stocks to disclose legal activities taken against insiders which might reflect on their honesty. The regulations also require the companies to disclose the insiders' business experience. 17 C.F.R. §§ 229.401(e) and (f).

involved, these determinations are clearly more difficult than determining the impact of a uniform law.

If the policies which favor the application of a uniform rule are determined to be important, the choosing of the uniform rule will be correspondingly more important. While the determination of whether a uniform rule is needed is to some degree independent of what the rule should be, to some degree the determinations are interdependent. A case can be made that a "default rule"⁴¹ should tend to benefit those parties with the least ability to avoid its application.⁴² If, on the other hand, a rule is "immutable" (i.e. uniform) there should be greater pressures for the rule to achieve efficient results when applied. The next sections of this article will explore this "efficiency" issue in greater depth.

B. Inducing the Sale of Stock in the Marketplace

The imposition of a duty on the part of the corporation to individual shareholders may aid the sale of stock in the marketplace because prospective shareholders might be reluctant to buy stocks without the protection that the imposition provides. Absent the imposition of a duty, the prospective shareholders may be purchasing a "right" that has little legal significance in the traditional concept of the word.⁴³ This lack of legal protection might deter the small investor from investing in equity stocks and force them into investments where the legal protections are more traditional.

If the removal of the "protections" granted to minority shareholders at this time⁴⁴ were to prevent small investors from investing in equity stocks, the economic effects would probably be very significant. It is perhaps the fear of these possible adverse economic effects which have led the courts to impose this duty of fiduciary responsibility.

Upon reading investment literature, it appears that investors place little confidence in the ability of the courts to enforce the fiduciary responsibility of the corporation. Typical of the comments is: "The minority stockholder has little power to stop or change company procedures unless

⁴¹ See Ayres & Gertner, *supra* note 34.

⁴² Under the same rationale, contracts are construed against the parties who construct them.

⁴³ This view of stock ownership apparently violates the common law maxim, "every right has a remedy." *Ashby v. White*, 2 Ld. Raym. 938, 953, 92 Eng. Rep. 126, 136 (1703). This apparent violation is reconciled if one accepts the fact that shareholders are not protected by contractual obligation, but through their power to elect the board of directors. See Williamson, *Corporate Governance*, 93 YALE L. J. 1197, 1210 (1983). A recurring theme in corporate law is the attempt to reconcile the rights created by the corporation with those created by the trust and the contract. It is not clear whether this reconciliation is proper or desirable.

⁴⁴ These include the right to sue derivatively and the right to sue for breach of fiduciary duty.

the majority stockholders make a major management error."⁴⁵ This theme has been repeated endlessly and the market value of minority shareholdings reflects this perception of the plight of minority shareholders.⁴⁶

While it might be argued that investors have already discounted the "security" given to them by the right to sue and the right to sue derivatively, generalizations of this type are of uncertain utility. The elimination of these rights would in some degree affect the risk and uncertainty attached to stock ownership. To a large extent, the science of investment is the science of risk management.⁴⁷ The reaction of capital markets to even a small change in perceived risk is difficult to predict.⁴⁸

The difficulty with the imposition of a workable fiduciary duty is the articulation of a standard under which compliance with the duty will be measured. There are two values competing in this area. First, the corporation's insiders must have the ability to carry out their task with relatively unfettered discretion.⁴⁹ Second, the interests of the outsiders must be protected from overreaching on the part of insiders.⁵⁰

The imposition of a fiduciary duty running from majority shareholders, directors, and managers to minority shareholders might be perceived to have some value because it limits the ability of corporate insiders to engage in egregious acts of corporate waste.⁵¹ This perceived value may aid the sale of stock in the marketplace. It appears that the fiduciary duty, to the extent that it exists, is not highly valued within the parameters of actual corporate transactions. Because the duty is not highly valued, it is doubtful that it plays a major role in aiding the sale of stocks.

⁴⁵ Trieschman, Leverett, & Shedd, *Valuating Common Stock for Minority Stock and ESOPs in Closely Held Corporations*, 31 BUS. HORIZONS Feb. 1988, at 63, 66. Along the same lines is Snyder, *The Woes of Investors in Private Corporations*, FORTUNE, (Aug. 14, 1978, at 189) ("Often there is a tendency among the majority shareholders to regard the company's assets as belonging to the family rather than to the shareholders.") (quoting F. Hodge O'Neal, Madill Prof. of Law at Wash. Univ.).

⁴⁶ See Morck, Shleifer, & Vishny, *Management Ownership and Market Valuation* 20 J. OF FIN. ECON. 293 (1988); DeAngelo, DeAngelo, & Rice, *Going Private: Minority Freezeouts and Shareholder Wealth*, 27 J. OF L. AND ECON. 367 (1984).

⁴⁷ See Collins, Ledolfer, & Rayburn, *Some Further Evidence on the Stochastic Properties of Systemic Risk*, 60 J. OF BUS. 425 (1987), and sources therein cited. See also Wagner, *The Many Dimensions of Risk*, 14 J. OF PORTFOLIO MGMT. Winter 1988, at 35.

⁴⁸ The extent to which investors attempt to avoid and quantify risk is reflected in the popularity of J. GLEICK, CHAOS: MAKING A NEW SCIENCE (1987) and its application to investments in general and the stock markets in particular. This book tried to find fundamental patterns in even purportedly "random" events.

⁴⁹ As stated by a court, "I think the matter lies so appropriately in the field of management, that a shareholder has no right to the aid of a court of equity to assist him in overcoming the judgment of the directors." *Mercantile Trading Co. v. Rosenbaum Grain Corp.*, 17 Del. Ch. 325, 154 A. 457, 461 (1931).

⁵⁰ See *Donahue v. Rodd Electrotypes Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

⁵¹ These egregious acts are to some extent accepted practices which are taken to illegal extremes. See Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961).

If the imposition of a fiduciary duty running from controlling shareholders, directors, and managers to minority shareholders is helping to induce the sale of stock in the marketplace, it is possible that small investors are being systematically misled about the scope of protections that the duty offers. Shareholders have been the major beneficiaries of the corporate takeovers as structured in the past.⁵² Would the fiduciary standards for corporate insiders protect minority shareholders from transactions which lower the value of their interest? It seems unlikely that it would give them any true protection.

C. The Reduction in the Disparity in Value Between Shares Held by Large Shareholders and those Held by Small Shareholders

To some extent, the imposition of a duty might act as a mechanism to equalize the value of shares owned by large shareholders and those owned by small shareholders. This result could be derived from the minimization of any quasi-control premium: The benefits to be derived from controlling the corporation would be lowered in comparison to the benefits to be derived from being a passive owner. This stressing of the benefits of passive ownership of stock at the expense of the benefits of operating the corporation would have two primary results: 1) The "efficiency" of the market would be enhanced; and 2) small shareholders could more easily participate in equity ownership.

The extent to which financial markets are "efficient" and the extent to which movements in financial markets represent a "random walk" have been debated for decades.⁵³ Studies have implied that these markets are not absolutely efficient: Intrinsic factors, such as disparities in access to information between the parties, can cause the markets to behave inefficiently.⁵⁴ The degree to which these deviations from the efficient market hypothesis can be viewed as aberrations or as part of an overall pattern is debatable or perhaps merely a matter of semantics.

Regardless of whether the market reacts with precise efficiency, it behaves efficiently enough that many investors proceed as if the market were efficient.⁵⁵ This efficiency is the basis upon which small, unsophis-

⁵² See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (the owner of a debt interest in a corporation contended that the corporate transaction worked a transfer of value from the debt holders to the equity holders).

⁵³ Forma, *Efficient Capital Markets: A Review of Theory and Empirical Work* 25 J. FINANCE 383 (1970).

⁵⁴ Sanger & McConnell, *Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ*, 21 J. Fin. and Quantitative Anal. 1 (1986); Barry & Brown, *Differential Information and Security Market Equilibrium*, 20 J. FIN. AND QUANTITATIVE ANAL. 407 (1985).

⁵⁵ This behavior includes diversifying one's portfolio in order to avoid risk. Evans & Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FINANCE 761 (1968) (investing in mutual funds and hedging with index futures); Nordhauser, *Using Stock Index Futures to Reduce Market Risk* 10 J. OF PORTFOLIO MGMT. Spring 1984, at 56.

ticated, and unmanaged investors are able to invest in securities. Even if they are not knowledgeable in the dynamics driving the price of the security they are buying or selling, the price is established by those who are.⁵⁶ The efficient market hypothesis has been at least implicitly accepted by the courts.⁵⁷

This efficient market hypothesis pre-supposes that shares from the same class of stock from the same corporation are equally fungible.⁵⁸ If a share that is part of a ten percent block of stock is more valuable than a share that is part of a one percent block, the ability of the market to efficiently value a generic share of stock is impaired. This state of affairs could substantially compromise the orderly operation of financial markets.

A related concern is the welfare of minority shareholders without regard to any contractual or voluntary fiduciary duties on the part of the parties. This concern is reflected in the "insider trading" rules.⁵⁹ The "insider trading" rules are generally applied without regard to any fiduciary responsibility on the part of the insider to the non-insider; they reflect a policy that small investors should be protected.⁶⁰

⁵⁶ This observation explains the time-honored advice to non-professional investors: buy diversified securities, and never trade them unless you want to consume the value.

⁵⁷ *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986) held that victims of insider trading need not prove actual reliance on a misrepresentation or omission of fact, but could rely on a "fraud on the market" theory. The court stated: "The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Id.* at 1160. *See, Note, The Fraud-on-the-Market Theory* 95 HARV. L. REV. 1143, 1154-56 (1982). *Accord, In re Phillips Petroleum Securities Litigation*, 881 F.2d 1236, 1249-1250 (3d Cir. 1989).

⁵⁸ An efficient market in which shares of the same class of stock were not fungible could be imagined. In practice, however, it would be difficult to facilitate the free flow of information necessary to keep the market equilibrium stable for all buyers.

⁵⁹ 17 C.F.R. § 240.10b-5 (1990). *See* remarks of Rep. Rosenthal, 128 CONG. REC. 29021 (1982) ("People with inside information benefit to the detriment of innocent people who lose money on these fixed situations. For every insider who profits, another investor without inside information is the loser.")

⁶⁰ The problem of the precise fiduciary duty, if any, required to impose Rule 10b-5 liability has proved troublesome to the courts. In *Chiarella v. United States*, 445 U.S. 222 (1980), the court held that some breach of an existing fiduciary relationship by an "insider" was a prerequisite to derivative "insider trading" liability. This holding was amplified by *Dirks v. Securities Exchange Commission*, 463 U.S. 646 (1983). Although the concept of fiduciary responsibility plays a critical role in the determination of Rule 10b-5 analysis, it is clear that the concept is broader in the Rule 10b-5 analysis than in the common law analysis.

The requirement of fiduciary duty as a prerequisite for Rule 10b-5 liability has been heavily criticized. *See The Supreme Court, 1982 Term* 97, HARV. L. REV. 1, 286-94 (1983).

This goal of protecting small investors is a constant theme in the corporate and securities laws.⁶¹ It is based upon the fact that small shareholders have little ability to protect themselves in the securities markets. The justification for the goal is therefore very similar to the justification for the doctrine of unconscionability in contract.⁶² The weakness of the corporate remedy when compared to the contractual remedy is that the contractual remedy is not primarily concerned with the finding of "fault" on the part of the stronger party,⁶³ while the corporate remedy is.⁶⁴

The nexus between the goal of protecting small shareholders and the determination of insider wrongdoing seems tenuous at best. If the goal of the corporate law is to protect the small shareholder from losses, it would seem that the courts could use either the doctrine of unconscionability or the doctrine of frustration of purpose⁶⁵ to avoid the contract, or a modification of these doctrines adopted to the corporate law area. The application of both of these doctrines is more or less independent of wrongdoing on the part of the party against whom the doctrine is sought to be used.⁶⁶

There are two major interrelated problems with the application of these doctrines in the corporate law context: 1) The corporation, unlike the contract, is deemed to be a permanent arrangement; and 2) neither the doctrine of unconscionability nor the doctrine of frustration of purpose is

⁶¹ See remarks of Rep. LaGuardia, 75 CONG. REC. 8399 (1932): "So that the American investor, on the representation made by the New York Stock Exchange, thinking he was investing in something that was sound, now finds himself entirely wiped out with bonds, the security and collateral for which have been entirely removed."

See also a message from President Roosevelt, 78 CONG. REC. 2264 (1934):

There remains the fact, however, that outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pay envelope or his meager savings on a margin transaction involving stock with those whose true value he was wholly unfamiliar . . .

⁶² See U.C.C. § 2-302; *Jones v. Star Credit Co.*, 59 Misc. 2d 189, 298 N.Y.S.2d 264 (1969); Eddy, *On the "Essential" Purpose of Limited Remedies: The Metaphysics of U.C.C. Section 2-219(2)*, 65 CAL. L. REV. 28, 40-58 (1977). Under the unconscionability doctrine, a contract whose terms are grossly unfair ("unconscionable") will not be enforced to the extent that it is unfair unless some reason can be advanced why it should be enforced.

⁶³ *Id.*

⁶⁴ "[The directors] may not act out of avarice, expediency, or self-interest in derogation of their duty of loyalty to the other shareholders and to the corporation." *Donahue v. Rodd Electrotypes Co.*, 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975).

⁶⁵ *Krell v. Henry*, 2 K.B. 740 (1903); *Lloyd v. Murphy*, 25 Cal.2d 48, 153 P.2d 47 (1944).

⁶⁶ Some of the early unconscionability cases seem to imply that the application of the doctrine was based on the fact that there was a presumption that the stronger party engaged in prohibited behavior. The modern trend is to deny enforcement of egregiously one-sided contracts even when the stronger party can show good faith dealing.

designed to compensate a party to the contract for foreseeable occurrences which affect the value of the contract. Both of these problems are the result of the unique nature of stock ownership as an investment contract.

All of the investors in a corporation envision that their ownership represents an investment in an ongoing enterprise. This vision is reflected in accounting principles used to illustrate the condition of the corporation. The principles are meant to reflect "the expectations a person has that his decision about the use of certain resources will be effective."⁶⁷ If one party is permitted to withdraw from the corporation, the expectations of the investors will be substantially affected.

The application of the doctrine of frustration of purpose requires that the occurrence which frustrates the purpose was not foreseeable by the party claiming relief.⁶⁸ It further requires that, in light of all the facts and circumstances, public policy would be furthered by shifting the risk of such occurrence from one party to the other.⁶⁹ In this regard, application of the doctrine could be viewed as essentially equitable in nature: The party seeking relief must show that it would be "fair" to grant him (or her) the relief.

The occurrence of a corporation "going private" is foreseeable, even if the probability of any given company going private is considered remote.⁷⁰ On the other hand, the decision of the corporation to go private is not outside of the control of all of the parties to the corporate contract. If the corporation were a simple bilateral contract between the majority shareholder and the minority shareholder, a strong argument could be made that the doctrine of frustration of purpose should be applied because it would not be "unfair" to prejudice the rights of the majority shareholder.⁷¹ In a more complex corporate situation, for example a corporation with a large amount of debt, this argument would lose force because the rights of "innocent" parties would also be prejudiced.⁷²

⁶⁷ Gamble, *Property Rights and the Formulation of Accounting Statements*, 1 (N.S.) J. ACCT. AUD. AND FIN. No. 2, 102 (1986) (quoting, Furubotn & Pejovich, *Property Rights and Economic Theory—Survey and Recent Literature*, 63 J. ECON. LIT. 1137, 1139 (1973)).

⁶⁸ 153 P.2d at 50.

⁶⁹ *Id.*

⁷⁰ Some relief to shareholders that own stock in a corporation that is going private may be afforded by the "tender offer" rules. See, Prentice, *The Role of States in Tender Offers: An Analysis of CTS*, 1988 COLUM. BUS. L. REV. 1 (1988). This relief is arguably more procedural than substantive.

⁷¹ This is apparently the rationale that the court was willing to adopt in *Donahue v. Rodd Electrottye Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

⁷² The holders of debt would be advancing an argument similar to the one that was unsuccessful in *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989). The argument would in this case have more force because the corporation (or the minority shareholders) could not argue that the debt holders should have foreseen the elimination of part of the equity in this type of transaction.

The application of "fiduciary duties" as opposed to contractual duties is limited by the corporate environment, in which both the person who owes the fiduciary responsibility and the person who is the recipient of the fiduciary responsibilities expect to maximize their profits. This is in stark contrast to other areas in which a fiduciary responsibility has been applied. In a trustee/beneficiary relationship, for example, the trustee is expected to be a disinterested caretaker.⁷³ Any self-dealing will be subject to strict scrutiny.⁷⁴ In practice this additional scrutiny given self-dealing transactions probably acts to restrain the consummation of economically beneficial deals between the trust and the trustee.⁷⁵

A similar personal disinterest on the part of the party upon whom the duty of fiduciary loyalty is placed is a hallmark of all traditional fiduciary relationships. In the employee/employer relationship or principal/agent relationship, the amount that the person owing the duty of loyalty can benefit from the transaction is limited by the employment or agency contract: the person has no direct interest in the outcome of the transaction.

Imposing the same standards of loyalty on a person who has an interest in the transactions, such as a corporate insider, can result in placing the insider in an untenable position. In the case of *In re Hubbell's Will*⁷⁶ the court placed a duty of fiduciary responsibility on a corporate officer who was also the trustee of a testamentary trust. The court held that the duty of fiduciary responsibility included responsibility for acts taken in his personal capacity as a director/shareholder.⁷⁷ This imposition of fiduciary responsibility had a substantial probability of creating a conflict between the duties of the director/trustee and the rights of the director/shareholder.

The court resolved this possible conflict in the following manner: "[i]f an irreconcilable conflict between self-interest and fiduciary responsibility develops, the choice of the fiduciary is either to subordinate the former or resign."⁷⁸ This mode of avoiding fiduciary responsibilities is not avail-

⁷³ *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928).

⁷⁴ *See*, *Munson v. Syracuse, Geneva & Corning R.R.*, 103 N.Y. 59, 8 N.E. 355, 358 (1886), which stated: "[The trustee] stood in the attitude of selling as owner and purchasing as trustee. The law permits no one to act in such inconsistent relations. It does not stop to inquire whether the contract or the transaction was fair or unfair."

Most states probably would not follow the per se rule adopted in the above case, but would place the burden on the trustee to prove that the transaction was fair.

In most states, the trustee's duty to refrain from self-dealing transactions cannot be avoided contractually. *See* Comment, *Directory Trusts and the Exculpatory Clause*, 65 COLUM. L. REV. 138, 140 (1965), and cases therein cited.

⁷⁵ The risk to the trustee of failing to meet his (or her) burden of proof that the transaction was mutually beneficial is great when the transaction becomes uneconomical to the trust after the fact.

⁷⁶ 302 N.Y. 246, 97 N.E.2d 888 (1951).

⁷⁷ *Id.* at ___, 97 N.E.2d at 891.

⁷⁸ *Id.* at ___, 97 N.E.2d at 894.

able to the director who is given fiduciary responsibilities because of his position as director. Unless the legislatures or the courts are willing to in effect mandate that all directors must be "outside" directors, and thus forego the savings in agency costs resulting from interested directors, conflicts of interest are unavoidable.

The goal of reducing the disparity in price between large blocks of shares and smaller blocks of shares is an important justification for the imposition of duties running from majority shareholders, directors, and managers to minority shareholders. The imposition of the duty is, however, ill-suited to this purpose. The traditional contract remedies are similarly ill-suited to this purpose. While the duty might prevent egregious examples of corporate waste, it is doubtful that it protects in any real manner the economic well-being of minority shareholders.

D. The Imposition of Inefficient Economic Behavior on the Corporation

Recent economic literature has attempted to discern the effect of centralized stock ownership on the value of the corporation. One study indicates that the value of a firm tends to rise as the centralized ownership increases up to five percent; the value of a firm tends to decrease as the centralized ownership increases from five percent to twenty-five percent; the value of a firm again rises as the ownership increases over twenty-five percent.⁷⁹ This phenomenon has been explained in the following terms:

A greater level of ownership concentration increases firm value if the stockholder uses his votes to see that corporate resources are managed more efficiently, or if the existence of the block increases the probability of a value-increasing takeover. Greater ownership concentration decreases firm value if the block entrenches managers, insulating them from market discipline or reducing the possibility of a takeover.⁸⁰

The value of common stock is in this view the reflection of the value of the firm, any reallocation of "firm" assets from the common shareholders reduces the value of the "firm".

⁷⁹ Morck, Shleifer, & Vishny, *supra* note 46, at 301. The increasing and decreasing values of the firm were tracked using the following formula:

$$\frac{\text{The Firm's Market Value}}{\text{Replacement Cost of its Physical Assets}}$$

This formula attempts to determine the value that the market places on the non-tangible assets of the firm, including the ability and desire of the management to compete with other firms in the marketplace. The important factor for the terms of this paper is that the firm's market value is determined entirely by the value of its common stock.

⁸⁰ Wruck, *Equity Ownership Concentration and Private Equity Sales*, 23 J. OF FIN. ECON. 3, 12 (1989).

The "firm" however is not necessarily limited to the people who are traditionally considered the owners of the firm.⁸¹ Commentators have proposed the use of the term "coalition" to replace the term "firm". A "coalition" is defined as a set of resource owners bound by contractual relations.⁸² This "coalition" would include employees, managers, bondholders, and other persons who are interested in the corporation but who are not necessarily part of the traditional term "firm".

This expanded view of the definition of the firm would allow for a broader calculation of its value. The firm would be more "efficient" if it were able to generate more value for all persons with an interest in the firm, from shareholders to the general public. Morck, Shleifer, and Vishny⁸³ speculate that the value of the corporation increases because the interests of management and shareholders converge. It is not clear whether this increase in value is due to a real increase in efficiency or merely a shift of returns from other persons with an interest (i.e. employees or the general public) to shareholders.

The determination of the total return to all interested persons in the corporation is not susceptible of precise measurement. In this sense, the use of the value of outstanding shares as a shorthand measurement of the value of a corporation may reflect the unavailability of more general information rather than theoretical limitations on the scope of the firm.⁸⁴ The measurement of firm efficiency in the general sense must be extrapolated from the known values of firm efficiency with regard to shareholders.

It can be speculated with virtual certainty that the decline in value of the corporation associated with the entrenchment of management is not the result of a loss in efficiency (broadly defined), but a result of the shifting of value from minority shareholders to majority shareholders/management.⁸⁵ The interests of management and shareholders would continue to converge in the maximization of the overall value of the firm; the divergence would occur in the proper allocation of the value between shareholders and the minority shareholders' ability to enforce their will.

The management would only continue to divert corporate amenities to the extent that the expected value of these amenities exceeds the expected cost to the management. This equilibrium can be expressed in the following manner:

⁸¹ O. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985).

⁸² Alchian & Woodward, *The Firm is Dead; Long Live the Firm*, 26 J. ECON. LIT. 65, 76 (1988).

⁸³ See *In re Hubbell's Will*, 302 N.Y. 246, 97 N.E.2d 888, 894 (1951); Morck, Schleifer & Vishny, *supra* note 46, at 301.

⁸⁴ In Morck, Shleifer & Vishny, *supra* note 46, at 301, the authors explain their methodology of arriving at the value of the corporation. Implicit in their explanation is that their method is imprecise, limited by the availability of published information.

⁸⁵ A possible caveat to this statement is the type of inefficiency imposed by the imposition of a duty running from the corporation to minority shareholders. This source of inefficiency will be discussed *infra*.

$$(1) \quad V' = C' K(R)$$

Where V' represents the expected value of the diverted amenities, C' represents the expected cost of obtaining the amenities, and $K(R)$ represents some constant reflecting the fact that very few managers are risk-neutral (at some point they are going to opt for the less than optimal choice merely because the risks associated with the other choice are too great).

The expected cost of obtaining the amenities can be divided into three categories. These three are the possible cost of losing an election and being replaced, the possible cost of being the subject of a shareholder derivative suit or suit for violation of fiduciary obligation, and the possible cost of being criminally prosecuted for embezzlement. Because the probability of criminal prosecution is so low and is not really relevant to the type of activity that is the subject of this article, we will ignore this factor.

The expected cost of obtaining the desired amenities can be expressed in the following manner:

$$(2) \quad C' = (PL)(CL) + (PE)(CE)$$

Where PL equals the probability of a lawsuit, CL equals the cost of a lawsuit to management,⁸⁶ PE equals the probability of losing an election for directors and CE equals the cost to management of losing the election.

Ideally, the probability of a lawsuit and the probability of losing an election for the board of directors would be a function of the extent to which: 1) The directors and management have failed to maximize corporate returns to the shareholders, and 2) the directors and management have diverged from the shareholders' best interests to advance their own. Analyzing the probability and cost of a lawsuit, we can ignore the failure to maximize the corporation's returns since failure to do so is protected in most cases by application of the business judgment rule.⁸⁷ Even in those cases where the business judgment rule does not apply, the effect of this type of activity because that failure to maximize corporate returns is unaccompanied by any benefit to management, is rarely a conscious decision.

The probability of a lawsuit and the cost of a lawsuit are directly related to the extent to which the complaining shareholder is able to prove a divergence between the management's actions and the shareholders' best interests. Management which is seeking to avoid the costs of a lawsuit will act in accordance with the following formula:

$$(3) \quad T = V' - \frac{CL}{AR}$$

⁸⁶ The cost of a lawsuit to management will not be the same as the cost of the lawsuit to the corporation or the overall cost of the lawsuit. The corporation will ordinarily bear what are generally thought of as the "costs" of the lawsuit (i.e. legal expenses and the payment of any judgments). Nevertheless, the cost to management can be significant in terms of adverse publicity, effect on future actions, and expenditure of time.

⁸⁷ See *supra* note 4.

Where T is the transaction under consideration and AR represents the ability of the corporation to re-characterize the transaction as one for the corporation's own good (i.e. that there has been no divergence between the management's interest and the shareholders' interest).

The ability to recharacterize the transaction as being in the best interest of shareholders is in general terms a function of the returns to the management as compared to the claimed returns to the shareholders. It is this tension which creates incentive on the part of the management to fail to optimize corporate efficiency.⁸⁸ The management desires to maximize its own returns, but can not except at the risk of harming its ability to re-characterize the transaction as one in the corporation's own interest. The management is only interested in maximizing the returns of the corporation to the extent that this maximization is reflected in the management's own returns.

The end result of this tension is the "perk" (or perquisite), which is a subset of the term amenity. The definition of the word "perk" is somewhat nebulous. At least two definitions are possible. The first definition includes all non-salary transfers of wealth from the corporation to managers that are traditionally treated as compensation, but perhaps not taxed as such.⁸⁹ The transfers included in this definition are health benefits, pension plans, and paid vacations. Both management and shareholders are aware that these transfers are compensation to the management.

The second type of perk, and the one that results in inefficiencies in the corporate system, is the perk that arguably contains both a business purpose and a benefit to management. This type of perk includes a myriad of examples. It includes corporate travel for "business purposes", stock option plans for "incentive purposes",⁹⁰ work conditions (such as luxurious

⁸⁸ "Corporate efficiency" as used for purposes of this article is the ability of the corporation to generate value for all members of the corporate coalition. To the extent that value is maximized, the corporation is said to be more efficient.

⁸⁹ I.R.C. § 89. This sort of behavior is justifiable if the United States government is not considered part of the corporate coalition. A discussion of this point is beyond the scope of the present work.

⁹⁰ The stock option granted to insiders has, of course, utility to the insiders as well as to the corporation. In Mason, *Four Ways to Overpay Yourself Enough*, 66 HARVARD BUS. REV. 69, 71 (1988), the author explained:

A familiar example of the KCR [Keep Compensation Rising] at work is the underwater stock option. What better executive incentive than the stock option for a corporation whose objective is to augment shareholder value? The executive doesn't benefit unless the shareholder does. No tickee, no washee, right? Wrong, says KCR. No tickee, we give you new tickee. Within days after 1987's Black Monday stock market crash, the business press was reporting that several major corporations planned to replace their executive's newly drowned options.

While disguised compensation in the form of stock options might be evidence of excessive compensation, it does not increase corporate inefficiency. The perk is ultimately paid in cash and not in some other commodity with less value to the corporate coalition. See also Bohan, *Measuring the Compensation Element in Employee Stock Option Plans*, 2 J. OF ACCT. AUD. AND FIN. 261 (1979).

offices), executive education, and corporate charities.⁹¹ The dual purpose of this type of perk simplifies the task of re-characterizing the benefits received through it.

Under this mode of reasoning, the ability to find an unassailable business purpose for these perks is much more important than the value to be received by the management, as long as the value is greater than zero. As long as there is an unassailable business purpose, the transaction will have a zero probability of engendering litigation and under Formula 3, proposed earlier, management will enter into the transaction. In order to have an unassailable business purpose, the transaction should have a positive marginal utility. Courts have given great deference to managerial decision-making in this area. It would be very difficult to determine whether the renovation of a corporate headquarters, for instance, would have a positive marginal utility.

In light of this theoretical momentum towards entering into transactions which contain both returns to the corporation and returns to the management, one would expect some type of empirical validation. The empirical validation might be limited by the natural reluctance of corporate officials to disclose such transactions. The facts brought to light in two recent hostile takeovers perhaps shed some light on the extent of this activity.

The New York Times⁹² contained an article that described the perks available to the executives of the J. Walter Thompson Co. prior to its takeover. This article revealed that the advertising agency spent \$4,000,000 a year keeping up the two executive floors in its headquarters. It further revealed that the company spent \$80,000 a year providing one executive with a single peeled orange every day. The article also revealed that Shearson Lehman Hutton, Inc. spent \$25,000,000 on a lodge in Beaver Creek, Colorado and that Time-Warner, Inc. owns a luxury house in Acapulco used mostly by corporate executives.

In the best seller *Barbarians at the Gate: The Fall of RJR Nabisco*,⁹³ the authors outline the activities of Ross Johnson. These activities include the maintenance of a large private aircraft fleet and the habit of flying his dog with him around the country in a separate aircraft.

⁹¹ In *A.P. Smith Manufacturing Co. v. Barlow*, 13 N.J. 145, 98 A.2d 581 (1953) the court held that a gift to Princeton University served a useful corporate end, that it did not constitute a distribution to the executive who favored the distribution, and that the gift was a legal exercise of the corporate power. Would the result in this case have been different if the plaintiff could have shown that the executive was an alumnus of Princeton, that he sat on the board of trustees of Princeton, and that Princeton had voted him an award for corporate charity? Obviously at some point the "corporate" charitable acts begin to have substantial personal benefit to the executive.

⁹² N. Y. Times, Feb. 4, 1990, § 3 at 29, col. 1.

⁹³ B. BURROUGH & J. HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990).

Perhaps more reflective of the tension between the personal return to the management and the objective of maximizing shareholder wealth is the growing investment by corporations in art.⁹⁴ This art has an element of personal return to corporate management/executives: They like to be around nice things. Arguably, the purchase and display of the art maximizes shareholder returns: Art has been a good investment traditionally and it can be used by the corporation to increase employee morale. It is difficult to separate the elements of investment for the sake of shareholders and investment for the sake of the management.

These incidences are not advanced in this article as examples of corporate "greed" or "abuse": They are advanced as examples by corporate managers of failing to maximize corporate efficiency. The most ardent supporters of high executive compensation would not argue that Ross Johnson would have flown his dog around the country, or that the management of J. Walter Thompson Co. would have spent \$80,000 a year for an orange a day if they had been spending their own money. By spending the corporation's money in such a manner they not only fail to maximize the returns to the shareholders, they fail to maximize the returns to the entire corporate coalition.

This result is troublesome both from a theoretical and societal perspective. Under Coase's theorem, parties to a contract normally will reach an agreement that maximizes production to the unit as a whole.⁹⁵ This mechanism is apparently not operating in the case of corporate perks. A commentator has theorized that the free exchange of information is a necessary prerequisite to the operation of the theorem.⁹⁶ In the case of public companies, this prerequisite is not met because management has no duty to disclose behavior which they contend is in the shareholders' best interest and only tangentially in their own.

In the closely held corporation,⁹⁷ the failure to disclose information is not the critical driving force behind the failure to maximize the efficiency of the corporation. The driving force stems from the relative, but not absolute, failure of minority shareholders to obtain redress for their grievances. A requirement that the management reveal corporate "perks" would mitigate the potential for abuse in the publically-owned corporations; in order to mitigate the potential for abuse in privately-held corporations, the process by which minority rights are vindicated would have to be totally overhauled.

⁹⁴ N. Y. Times, Feb. 12, 1989, § 3, at 13, col. 1; Cassullo, *The Fine Art of Corporate Collecting*, 66 HARV. BUS. REV. 137 (1988).

⁹⁵ Coase, *The Problem of Social Cost*, 3 J. OF L. AND ECON. 1, 8 (1960).

⁹⁶ Farrell, *Information and the Coase Theorem*, 1 J. OF ECON. PERSP. 113 (1987).

⁹⁷ For this purpose, a closely held corporation is a corporation where there is a substantial unity of interests between a group of shareholders who are able to maintain control of the corporation and the management. This definition is somewhat broader than the traditional definition which includes both centralized shareholder control and the lack of a market for the shares. *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

While the press has revealed disparagingly the excesses of corporate America,⁹⁸ it has failed to consider that these excesses are the rationale if cynical, response to the application of corporate law. A point worth noting is that these corporations are publicly held and the threat of shareholder disapproval at the shareholders' meetings, however remote, is at least a possibility.⁹⁹ In a privately-held corporation the momentum toward disguising compensation as expenditures for the independent good of the corporation would be even greater.

*E. The Costs Imposed Upon Society to Litigate Claims
of Insider Wrongdoing*

The courts have been given two models to review actions by corporate insiders to the detriment of minority shareholders. The first is the deferential, or traditional corporate, model;¹⁰⁰ the second is the strict review, or trust, model.¹⁰¹ As has been explained in this article, the courts and legislatures have chosen a deferential approach to review corporate management's behavior in dealing with minority shareholders.¹⁰² In part, this decision is possibly the result of the courts' unwillingness to imply any form of fiduciary responsibility on corporate insiders.

An additional reason for the implication of a deferential as imposed to a strict review of the actions of corporate insiders is that the corporate environment continually places insiders in a position where fiduciary requirements in a strict sense could not possibly be met.¹⁰³ The deferential model of review of the actions of insiders has been adopted because it is workable compared to the strict review (or trust) model and not because of any intrinsic value in the concept.

A third alternative open to the courts and the legislatures is the adoption of an intermediate standard for review of corporate transactions. An intermediate standard could vindicate the claims of minority shareholders without placing the insiders in the position of violating their fiduciary responsibilities in every situation. The standard could be flexible enough to effectively prohibit forms of diversion which only facially have a valid corporate purpose.

⁹⁸ Greenwald, *Bashing Greed for Fun and Profit*, TIME, February 19, 1990, at 71.

⁹⁹ See E. ARONOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (1968); Bartlett, *Life in the Executive Suite After Drexel*, N.Y. Times Feb. 18, 1990, § 3, at 1, col. 2, which argues that since hostile takeovers will be less likely to occur, management will be less likely to be responsive to the needs of shareholders.

¹⁰⁰ See *supra* note 4.

¹⁰¹ See *supra* note 12.

¹⁰² See *Mercantile Trading Co. v. Rosenbaum Grain Corp.*, 17 Del. Ch. 325, 154 A. 457, 461 (1931).

¹⁰³ See *In re Hubbel's Will*, 302 N.Y. 246, 97 N.E.2d 888, 894 (1951).

The courts have at times applied an intermediate standard of scrutiny of the actions of corporate insiders. In *Smith v. Van Gorkom*,¹⁰⁴ the Delaware Supreme Court stated that the standard to be used to judge insiders' actions is whether the actions constituted "gross negligence".¹⁰⁵ This intermediate standard, designed to prohibit careless acts, is easily avoided ex ante and is taken into consideration by insiders while corporate action is being considered.¹⁰⁶

The flexibility of this standard, which is its greatest strength, is also its greatest weakness. Many corporate transactions could become the subject of debate and could result in litigation.¹⁰⁷ The threat of litigation could prevent the execution of many economically beneficial transactions. As a policy matter, it is not clear that the benefits from the imposition of this sort of duty would outweigh the negative results.

V. CONCLUSION

The imposition of the duty running from majority shareholders, directors, and managers to minority shareholders is inefficient in that it places upon corporate insiders the perverse incentive of failing to maximize returns to the corporate coalition. The most obvious alternative, giving absolute free rein to corporate insiders, is distasteful. It violates one's sense of equity to allow powerful interests to use their power to abridge the rights of weaker parties.

The issue is no longer whether minority shareholders should be protected, but whether they can be efficiently protected and in what manner. Because the examination centers on existing institutions rather than theoretical markets, it is possible that we have reached the limits of legal economic theory in trying to examine the issues involved in this article.¹⁰⁸ Economic theory is not particularly helpful in determining the proper allocation of resources; it is perhaps more helpful in determining the manner in which the allocation should be accomplished. Because at the most fundamental level the issues addressed in this article involve the

¹⁰⁴ 488 A.2d 858 (Del. 1985).

¹⁰⁵ *Id.*, at 873 (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. Super Ct. 1984)). The standard has been restated as one of using "unintelligent and unadvised judgment", *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 167 A. 831, 833 (1933), and "without the bounds of reason and recklessly". *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599, 615 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. Super. Ct. 1974).

¹⁰⁶ See *supra* at note 88.

¹⁰⁷ Of course, this argument could be made against the promulgation of any law. In the corporate area this argument is more compelling because economic efficiency is the purpose for the creation of corporations.

¹⁰⁸ See Note, *Economic Analysis in the Courts: Limits and Restraints*, 64 IND. L. J. 769 (1989), arguing that economic theory is too nebulous and susceptible to manipulation to be used by the courts in a wholesale manner.

allocation of resources between majority and minority shareholders, the economic issues might be peripherally relevant rather than centrally relevant.¹⁰⁹

Even if economic analysis is not the acid test to determine whether a rule has positive utility for society, when economic efficiency and perceived fairness are strongly negatively correlated, the set of rules should be questioned and alternatives explored. The rule imposing fiduciary duties running from majority shareholders, directors, and managers to minority shareholders can not be viewed in a vacuum; it is part of the "seamless web" of corporate law. The inefficiencies may be the unavoidable result of other positive features of corporate law. To the extent that the inefficiencies are avoidable, alternatives should be explored, and if superior adopted. To the extent that the inefficiencies are unavoidable, the markets will presumably react to the known inefficiencies.

¹⁰⁹ In A. BLINDER, *HARD HEADS, SOFT HEARTS: TOUGH-MINDED ECONOMICS FOR A JUST SOCIETY* (1987), the author argues that a balance must be struck between the dual issues of whether the transaction is efficient and whether the transaction is fair. See also Johnson, *Book Review*, 67 *TEX. L. REV.* 659, 664 (1989).