Majority-Minority Relations in Canadian Corporation Law: An Overview

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The treatment of majority-minority relations in Canadian corporate law during the last century reflects a movement from a strong application of the principle of majority rule to an emphasis on protection of minority interests on the basis of apprehended notions of "fairness." While both approaches to the resolution of intracorporate conflicts involve a balance between the interests of majority and minority shareholders, this change of emphasis has resulted in enhancement of the avenues available for challenge of corporate conduct by minority shareholders whether the matter relates to corporate contracts, alteration of a corporation’s constitution, removal of shareholders or the standards by which such actions are evaluated. These questions emphasize the conflict of interest invariably found on the part of a majority shareholder when a transaction or course of conduct results in a peculiar benefit to the majority or some other form of differential treatment of the minority.

Canadian law has been influenced by its English forebears. 1 This paper discusses the treatment of majority-minority relations in Canadian common law, which derives largely from English law, 2 and describes a
pervasive shift in emphasis from the turn of the century to the present day.

The traditional notion of majority rule in early English case law was premised on enabling legislation which treated the corporate constitution as a contract. It was designed to give the majority shareholders, as the majority owners of the corporation, as much flexibility as possible to determine the policy of the corporation and to oversee the manner in which it carried on business, even where an adverse effect on the minority was the consequence.

The direction in Canada, primarily in the last twenty years, has been toward greater egalitarianism, emphasizing notions of fairness to minority shareholders in determining the balance to be drawn between majority and minority interests. This movement is seen not only in recently enacted corporations statutes and in case law, but also in the efforts of provincial securities commissions and particularly the Ontario Securities Commission. It has affected the standards applicable to the conduct of majority shareholders in carrying on their corporation’s affairs and the remedies available to minority shareholders for enforcing those standards in the event of a conflict.

The obvious starting point for an analysis of majority-minority relations in Canadian corporate law is the North-West Transportation Co. Ltd. v. Beatty decision, a case in which the majority shareholder sold to his own corporation an asset that the corporation needed and ratified the corporation’s purchase of the asset by voting his shares. The minority dissented from the ratification and sued. The Privy Council treated the purchased as a question of business policy and held that it was for the

enced by statutes in the United States; see R.W.V. Dickerson et al., Proposals for a New Business Corporations Law for Canada, vols. 1 & 2 (Ottawa: Information Canada, 1971). The CBCA has been followed in at least six provinces: Alberta, Manitoba, Newfoundland, Ontario, New Brunswick and Saskatchewan, and has influenced amendments to the Nova Scotia Companies Act.


4 See, e.g., CBCA, supra, note 2 at ss. 232-34; Ontario Business Corporations Act (“OBCA”) S.O. 1982, c. 4, ss. 188-90 & ss. 245-47. See also supra, note 3.


7 (1887), 12 A.C. 589 (P.C.).
majority to vote upon and that the majority owed no fiduciary obligation to the minority in such matters. It concluded that it would not interfere in matters of internal management. (English courts, in fact, tended to hold that they lacked jurisdiction to do so.)

The Beatty decision was confirmed, shortly thereafter, in another case in which a majority shareholder purchased an asset and ratified its sale to his own corporation at three times the value of the purchase. When a shareholder brought an action to challenge that transaction, the Privy Council held that no derivative action was available, based on the English rule in Foss v. Harbottle, because the transaction was ratifiable in that the majority shareholder could vote his shares to affirm the contract.

Even in the earlier cases, however, the majority could not do anything they wished. The English courts limited the conduct which a majority could vote to ratify, and which a shareholder could therefore not challenge, to transactions which were neither oppressive nor fraudulent to the corporation. But oppression and fraud were defined very narrowly, basically in terms of theft from the corporation.

The first of two cases that are prototypical is Cook v. Deeks, in which the majority shareholders in a closely held corporation, after a falling out with the minority, simply created a new corporation and used their corporate contacts to take a contract that would otherwise have gone to the former corporation. The second case is one in which the majority wound up a subsidiary corporation to enable the parent to benefit from entering into a transaction that the subsidiary otherwise would have controlled. The difficulty with these early English cases, without attempting an exegetical analysis, is in drawing the line between what is oppressive, or ratifiable, and what is not. This question can be quite controversial; the writers differ on it (and it is fair to say that the interpre-

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8 Ibid. at 601.
10 Burland v. Earle, ibid.
11 (1843), 2 Hare 461, 67 E.R. 189 (Ch.).
13 Ibid. See also, e.g., F.W. Wegenast, The Law of Canadian Companies (Toronto: Burroughs, 1931) at 315-17.
15 Cook v. Deeks, ibid.
16 The decision, involving a corporation with three shareholders, treated a corporate opportunity as an asset of the corporation, the deprivation of which could not be ratified. It arguably remained the leading authority on the corporate opportunity doctrine in Canada until 1973; see now Canadian Aero Service Ltd. v. O'Malley (1973), 40 D.L.R. (3d) 371, [1974] S.C.R. 592.
tation in this paper has not been universally adopted).

The Beatty court pointed out that the contract was reasonable, and some commentators, including the writer of the leading Canadian text, have interpreted the decision as limited to transactions which are reasonable or fair to the corporation. That is one way of attempting to reconcile the notion of oppression with that of majority rule. However they are read, these cases indicated that a very broad flexibility was to be given to majority shareholders to control the policy of their corporation, short of actually removing assets. The courts did not attempt to reconcile the doctrines governing majority contracts and corporate opportunities. In Beatty, for example, the majority shareholder set the price of the asset purchased without an evaluation and took a profit. There was no basis for assessing whether the profit was reasonable. In effect, the majority shareholder set his own price and his own profit, which arguably meant he was taking assets out of the corporation to the same degree as another majority shareholder would by diverting a corporate opportunity. The English common law, however, did not recognize this difficulty.

The complementary element was that a majority shareholder owed no fiduciary obligation to the minority, a notion that still pervades Commonwealth common law. It applies not only to transactions with the corporation but also in the context of amendments to the corporate constitution. But this imbalance has begun to be redressed, particularly in the past twenty years. Recently, the Ontario courts have moved toward the imposition of a fiduciary obligation owed by majority shareholders to

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19 Supra, note 7 at 600.

20 See Wegenast, supra, note 13 at 318.

21 The reasoning in the decision, however, was not premised on this finding and the subsequent decision of Burland v. Earle, supra, note 9, did not so read it. These cases have generally been read, therefore, as authorizing a majority shareholder to ratify a transaction between himself and his corporation unless the transaction is fraudulent or oppressive; see, e.g., A.J. Macintosh, "Corporate Governance and Minority Rights" (1983) 7 Dalhousie L.J. No. 3, 42 at 59-61. The price may, however, be relevant to this question; see, e.g., Gray v. Yellowknife Gold Mines Ltd. and Bear Exploration & Radium Ltd. (No. 1) (1947), [1948] 1 D.L.R. 473 at 479, [1947] O.R. 928 at 942 (C.A.), Robertson C.J. [hereinafter Gray cited to D.L.R.]; see also S.M. Beck, "The Shareholders' Derivative Action" (1974) 52 Can. Bar Rev. 159 at 201.

22 Compare the analysis of the facts in Beatty, supra, note 7 at 594-600 with the Supreme Court of Canada's account in Beatty v. North-West Transportation Co. Ltd. (1885), 12 S.C.R. 598.

23 See, e.g., Gray, supra, note 21 at 479; where Robertson C.J. characterized a purchase of an asset from a corporation by its majority shareholder as a misappropriation of corporate property. See also D.A. Soberman, "Letter to the Editor" (1976) 54 Can. Bar Rev. 225.

24 Similar difficulties of reconciliation of judicial doctrine exist with respect to corporate opportunities; compare, e.g., Cook v. Deeks, supra, note 14 with Regal (Hastings) Ltd. v. Gulliver (1942), [1942] 1 All E.R. 378 (H.L.); and see, e.g., Gower, supra, note 3 at 617-19.

25 See, e.g., Esplanade Developments Ltd. v. Dinive Holding Pty. Ltd. (1980), 4 A.C.L.R. 826 (W.A.S.C.); Bell v. Source Data Control Ltd. (1986), 39 A.C.W.S. (2d) 62 (Ont. H.C.), Eberle J. See also, e.g., Wegenast, supra, note 13 at 316.

26 See, e.g., Allen v. Gold Reefs of West Africa Ltd. (1900), [1900] 1 Ch. 656 (C.A.); Greenhalgh v. Arderne Cinemas Ltd. (1950), [1951] 1 Ch. 286 (C.A.).
the minority, in the context of false proxy circulars,\textsuperscript{26} and also in the context of the Ontario statutory follow-up offer requirement.\textsuperscript{27} The English courts have also begun to erode the strong majority principle. In \textit{Clemens v. Clemens Bros.},\textsuperscript{28} for example, the court imposed a duty on the majority to act fairly to the minority in amending the corporate constitution.

The balance has also been redressed through statutory provisions. Since 1948 there have been a series of attempts to create an effective statutory oppression remedy,\textsuperscript{29} and in the recent round of corporate law reform in Canada, a very broad oppression remedy has been adopted.\textsuperscript{30} While the following outline of these provisions emphasizes their breadth, it should be stressed that many of the issues have yet to be determined in Canada, for there has not been a great volume of litigation under the relatively new statutes.


\textsuperscript{27} See \textit{Re McLaughlin and S.B. McLaughlin Associates Ltd.} (1981), 14 B.L.R. 46 (O.S.C.), aff'd (1981), 128 D.L.R. (3d) 256 (Ont. Div. Ct), leave to appeal denied 2 O.S.C. Bull. 408C (Ont. C.A.). McLaughlin was denied an exemption from the follow-up offer obligation even though he controlled the "offeree" corporation prior to purchasing shares at a premium from two shareholders; the purchases brought his holdings from just under 53% to almost 58% of the outstanding shares on an undiluted basis and from 49.6% to 54.3% on a fully diluted basis. The commission treated the follow-up obligation in the \textit{Ontario Securities Act}, R.S.O. 1980, c. 466, s. 91(1), as imposing an obligation on a controlling shareholder to act evenhandedly toward the minority: see 14 B.L.R. 46 at 62. The follow-up offer requirement under the \textit{Ontario Securities Act} is discussed in B. Bailey and P. Crawford, "The Take-Over Bid by Private Agreement: The Follow-Up Offer Obligation" (1983) 7 Dalhousie L.J. No. 3, 93; Report of the Canadian Securities Laws Subcommittee of the State Regulation of Securities Committee of the Corporation, Banking and Business Law Section of the American Bar Association: \textit{Canadian Securities Legislation and the Sale of Control} (1982) (available from the American Bar Association). The follow-up offer obligation has been repealed. An offeror must now make a take-over bid to all shareholders of an offeree corporation in circumstances which previously would have required a follow-up offer to be made to them: see \textit{Ontario Securities Act}, \textit{ibid.} at s. 92(1)(c), added by S.O. 1987, c. 7, s. 8, which received royal assent on February 12, 1987, but has not yet come into force.


\textsuperscript{29} See, e.g., \textit{CBCA}, supra, note 2 at s. 234; \textit{OBCA}, supra, note 4 at s. 247. The new oppression remedy in these statutes derives from Dickerson \textit{et al.}, supra, note 2 at vol. 2, s. 19.04 (Draft of \textit{CBCA}); see also \textit{ibid.} at vol. 1, paras. 485-86 (Commentary). See also S.M. Beck, " Minority Shareholders' Rights in the 1980s" in Law Society of Upper Canada, \textit{Corporate Law in the 80s} (Don Mills: DeBoo, 1982) 311 at 312.
The statutory oppression standard is found in section 247 of the OBCA. It provides that a shareholder may obtain a remedy from a court whenever the business of a corporation or its affiliates is carried on in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any shareholder. It obviously includes minority shareholders and is likely to be interpreted quite liberally. It opens up many issues that have been treated in U.S. cases as involving the fiduciary obligation of majority to minority shareholders, although Canada may address them in a different way.

Section 247 moves the balance away from a largely unfettered freedom of the majority to do as they like in running the corporation, by imposing on them a duty to act fairly on behalf of all of the shareholders. It enables minority shareholders to bypass the traditional rule in Foss v. Harbottle, which had precluded derivative actions on behalf of the corporation where an act was ratifiable, by giving them a direct action for relief; they need not sue on behalf of the corporation. (Derivative actions too are made more readily available.) Further, the statutes now tend to eliminate the rule concerning ratifiable transactions that existed at common law.

What are some of the different types of conduct to which these standards have been applied? Perhaps the most obvious, in view of the exam-
ples above, is an interested transaction, a contract between the corporation and a majority shareholder. Both the courts and the legislatures are giving minority shareholders greater protection against the majority in this context. Even where an interested director's transaction is ratified by the majority shareholder, Canadian courts have begun to move away from the approach in Beatty. In two recent decisions, transactions entered into by a corporation, which would have benefited the majority shareholders exclusively (by providing payments to another corporation that they owned without the minority), have been struck down.

The more recent of these was a common law decision in which a court in Prince Edward Island held that the majority could not vote to ratify a contract with another corporation in which they also owned the majority interest, for they would, in effect, be benefiting themselves and arguably paying money out of the corporation to the detriment of the minority. In a similar case a corporation entered into an agreement with a franchisor that was owned by the majority. As a result, the minority was excluded from the payments for the franchise, which went exclusively to the majority. A British Columbia court held the action oppressive under its statutory oppression remedy. Thus, in effect, the concept of a fiduciary obligation owed by the majority is being adopted by the courts in the context of interested contracts, where a conflict of interest exists because the majority is on both sides of the bargain.

The recent Canadian legislation has also strengthened the standards applicable to interested director's transactions and to majority ratification of those transactions. The traditional Canadian common law doctrine was that any interested director's transaction was voidable unless ratified by the majority. Corporations tended, therefore, to adopt articles that gave broad powers to directors, and majority shareholders, to enter into contracts with the corporation in which they had an interest. The Canadian statutes build on and extend traditional approaches. They

37 See supra, note 7 and accompanying text.
39 Wedge v. McNeill, ibid. The appellate court reversed the decision because the agreed statement of facts on which it was based was not adequate to support it, but the court left open the question of ratification.
40 Diligenti v. RWMD Operations Kelowna Ltd., supra, note 5. The statutory provision is the Company Act, R.S.B.C. 1979, c. 59, s. 224.
41 But not without hesitation; see, e.g., Wotherspoon v. Canadian Pacific Ltd. (1982), 129 D.L.R. (3d) 1, 35 O.R. (2d) 449 (C.A.).
42 See, e.g., CBCA, supra, note 2 at s. 115; OBCA, supra, note 4 at s. 132. See also Dickerson et al., supra, note 2 at vol. 2, s. 9.17 & vol. 1, paras. 227-33.
44 See Dickerson et al., supra, note 2 at vol. 1, para. 226.
not only require that directors declare their interest and refrain from voting on a contract in which they have an interest, but also impose an objective standard that must be met with respect to the contract, namely that the contract be fair and reasonable to the corporation at the time that it is made, even if the majority ratifies it. While it might be argued that these statutes merely adopted the standard already espoused in *Beatty*, they seem to go much further. Section 132(9) of the *OBCA*, for example, grants a direct remedy to shareholders to enforce the standard without having to use the derivative action procedure.

The modern attitude to these problems is pervasive. The traditional approach of Canadian courts, the acceptance of majority rule, was that business decisions were matters for the directors and the majority shareholders; the courts would not interfere with them because they were internal management decisions. In *Burland v. Earle*, the Privy Council, on an appeal from an Ontario court, held that the question of corporate dividends was beyond the jurisdiction of that court to deal with, but was for the directors, and thus the majority shareholders, to determine. That conclusion was questioned by Wegenast in his 1931 text and would probably not be followed today.

The Dickerson Committee, when recommending the statutory oppression remedy, specifically referred to a “freeze-out” of minority shareholders in a closely held corporation by a refusal to declare dividends as an example of oppressive conduct which would provide a basis for invoking the new provisions. Thus the committee clearly contemplated that the courts would consider issues relating to internal management, where the business of a corporation is conducted in a manner unfairly prejudicial to, or which unfairly disregards the interests of, a minority, and a few cases have tended to move in this direction.

A number of cases brought under the oppression provisions have been based on notions of fairness which reflect the expectations of the

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45 See, e.g., *OBCA*, supra, note 4 at s. 132(7)-(8); see also Dickerson *et al.*, *supra*, note 2 at vol. 1, para. 228 (to prevent mutual “back-scratching”).
46 See *supra*, note 21 and accompanying text.
47 See *supra*, note 35. See also *CBCA*, *supra*, note 2 at s. 115(8). This conclusion seems clear on the plain words of the statutes, but the provisions have not yet been the subject of judicial consideration.
48 See cases cited *supra*, notes 7 & 9.
49 *Burland v. Earle*, *supra*, note 9 at 93.
50 See Wegenast, *supra*, note 13 at 618-19.
51 See Dickerson *et al.*, *supra*, note 2 at vol. 1, para. 484.

The appellant in *Ferguson*, *supra*, note 5 requested an order requiring the corporation to declare a dividend, but the court did not address this issue; see *ibid.*, Appellant’s Statement, Action No. 1024/81, filed 31 January 1983, para. 58(c). The author was of counsel on the appellant’s brief on the appeal.
parties in the context of closely held corporations. In short, the courts have attempted to implement the actual expectations of the shareholders, and where those expectations have been thwarted by the conduct of the majority, have provided remedies. In *Diligenti*, there was a diversion of assets through a special contract and a shareholder-director was removed from his office in the corporation. Similarly, in *Ferguson*, where the controlling shareholder of a closely held corporation attempted to squeeze out his wife, after their marriage broke up, through an amendment to the corporate constitution, the court considered the expectations of the parties when the corporation began and attempted to implement them by striking down the amendment.

This approach has also been adopted with respect to applications to wind up a closely held corporation. The expectations of the parties are implemented by allowing a winding-up on the basis of concepts generally applicable to partnerships. Canadian courts are thus moving toward a concept of fairness premised on the expectations of the parties, at least for closely held corporations.

Perhaps the most revealing area for majority-minority relations relates to amendment of the corporate constitution. An amendment can be used for any number of purposes and can affect shareholders differentially. For example, the constitution could be amended to give the directors or the majority shareholders powers that would enable them to squeeze out a minority. The traditional standard applicable to corporate amendments is that the majority shareholders have to act in good faith for the benefit of the corporation as a whole, a high-sounding phrase which can mean everything or nothing. In the early English cases


55 See *Ferguson*, supra, note 5 at 727-28.


57 See cases cited supra, note 56; see also, e.g., *Re Dunham and Apollo Tours Ltd. (No. 2)* (1978), 86 D.L.R. (3d) 395, 20 O.R. (2d) 9 (Ont. H.C.). The partnership analogy applies when the relationship between the shareholders is a personal one involving mutual trust and confidence and participation in the corporate enterprise and where no market for their shares exists; a falling out between them that precludes their continuing as shareholders therefore requires dissolution of the corporation or a similar resolution of their differences.


60 See, e.g., *Allen v. Gold Reefs of West Africa Ltd.*, supra, note 25 at 672 (per Lindley M.R.).
it tended to mean little.\textsuperscript{61} The standard requiring the majority to act in the interests of the corporation was generalized and objective; if a proposed amendment to the corporate constitution theoretically affected all shareholders in the same way, it was treated as being in the interests of the corporation as a whole.\textsuperscript{62} This was true even though it might have a discriminatory impact on individual shareholders.\textsuperscript{63}

An example will illustrate this point. The leading early case, \textit{Allen v. Gold Reefs of West Africa Ltd.},\textsuperscript{64} upheld an amendment to the corporate constitution which permitted the directors to impose a lien on fully paid shares in the amount owed on unpaid shares on which calls had been made. This amendment was upheld where the only shareholder who held both types of shares had died and the majority wanted to obtain his shares as payment without allowing his estate to transfer them. The court, even though it recognized that the transaction was intended for this purpose, upheld it on the basis that theoretically the directors could do the same with respect to any shareholder.

An amendment to the corporate constitution was also permitted even though it was designed to enable the directors to remove a specific shareholder.\textsuperscript{65} The amendment was allowed because the shareholder in question was viewed as a problem for the corporation; the court held that a corporation should be able to remove at any time shareholders who, for example, might compete with it.\textsuperscript{66} A few cases in the lower courts focused on the effect on the individual shareholder of a decision that would be made pursuant to a proposed constitutional amendment which was clearly intended to remove a minority shareholder rather than one who represented a broader problem.\textsuperscript{67} But those cases were disparaged in later decisions of the Court of Appeal.\textsuperscript{68}

The most recent case in England which typifies this approach was the last of a series of decisions in the late 1940s and early 1950s. In

\textsuperscript{61} See, e.g., \textit{ibid.}; see also \textit{Greenhalgh v. Arderne Cinemas Ltd.}, supra, note 25. The reasons of Lord Evershed in the \textit{Greenhalgh} case, a low point in English corporate jurisprudence, are more fully reproduced in the latter, unofficial report.

\textsuperscript{62} See, e.g., supra, notes 60-61; see also, e.g., \textit{Shuttleworth v. Cox Brothers & Co. (Maidenhead) Ltd.} (1926), [1927] 2 K.B. 9 (C.A.).

\textsuperscript{63} See, e.g., \textit{Greenhalgh v. Arderne Cinemas Ltd.}, supra, note 25.

\textsuperscript{64} See supra, note 25.


\textsuperscript{66} The court cited \textit{Phillips v. Manufacturers Securities Ltd.} (1917), 86 L.J.Ch. 305 (C.A.), in which a similar power was included in the corporation's articles of association (that is, bylaws) at the time of incorporation. Interestingly, the reasoning in these cases is similar to that in \textit{Unocal Corp. v. Mesa Petroleum Co.}, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH), para. 92,077 (Del. 1985) (discriminatory issuer tender offer upheld).


\textsuperscript{68} See \textit{Sidebottom v. Kershaw, Leese & Co. Ltd.}, supra, note 59 (limiting \textit{Brown}); \textit{Shuttleworth v. Cox Brothers & Co. (Maidenhead) Ltd.}, supra, note 62 (disapproving of \textit{Dafen}).
Greenhalgh v. Arderne Cinemas, the English Court of Appeal permitted an amendment to the corporation's articles of association designed to enable the majority shareholder to sell his control block, without having to give the only minority shareholder a first option to purchase those shares, by deleting a provision that would have required him to do so. The court, while reiterating the standard that the majority must act bona fide for the benefit of the corporation as a whole and declaring that an amendment could not be discriminatory, nevertheless permitted the amendment which deprived the minority shareholder of his right of first refusal.

In the last twenty years that approach has been substantially altered. A majority shareholder would now be quite unlikely to get by with such transactions. The statutory oppression standard is much broader than common law oppression, for it includes conduct that unfairly disregards the interests of a minority shareholder. Even without legislative redirection, the courts have of their own initiative begun to redress the balance. The Clemens decision, for example, disallowed amendments to a corporation's articles of association which would have deprived a minority shareholder of her negative control and enabled the majority to pass a special resolution alone. The court's analysis was not unlike that of the California Supreme Court in Jones v. H.F. Ahmanson & Co.; it considered the alternative methods which the majority shareholders could have used to implement their espoused goal, and, in concluding that their action was oppressive, took into account the fact that they went further than necessary to achieve it. Alternatives to accomplish their stated purpose that would not have harmed the minority were not attempted. The court viewed these facts as indicating an intent to oppress.

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69 See supra, note 25. The events and cases leading up to this decision are outlined in Gower, supra, note 3, at 624-26.
70 Ironically, the English courts applied a similar standard to votes by a class of shareholders in a more protective manner, by requiring shareholders to vote for the benefit of the class as a whole and precluding them from voting to further their non-class interests; see British American Nickel Corp. Ltd. v. M.J. O'Brien Ltd. (1927), [1927] 1 D.L.R. 1121, [1927] A.C. 369 (P.C.); Re Holders Investment Trust Ltd. (1970), [1971] 1 W.L.R. 583 (Ch.). A recent decision in Newfoundland applied the more protective class standard in the context of a squeeze-out arrangement proposed by a majority shareholder; see Re Standard Manufacturing Co. and Baird (1984), 5 D.L.R. (4th) 697, 45 Nfld. & P.E.I.R. 159 (Nfld. S.C.) [hereinafter Standard cited to D.L.R.].
71 See supra, note 30 and accompanying text; see also CBCA, supra, note 2 at s. 234.
72 Supra, note 28.
73 See supra, note 33.
74 See Clemens v. Clemens Bros. Ltd., supra, note 28 at 279-82. Although it drew an inference adverse to the majority from the fact that no evidence was presented to show a legitimate corporate purpose for the amendments, the court stopped short of shifting the burden of proving such a purpose to the defendants. Canadian courts have generally refrained from imposing an onus on a fiduciary to demonstrate the fairness or propriety of his self-interested conduct; see, e.g., Teck Corp. Ltd. v. Millar (1972), 33 D.L.R. (3d) 288 at 330, [1973] 2 W.W.R. 385 at 430 (B.C.S.C.); see also, e.g., Cheff v. Mathes (1964), 41 Del. Ch. 494, 199 A.2d 548; Jones v. H.F. Ahmanson & Co., supra, note 33 at 476. But see Gray v. New Augarita Porcupine Mines Ltd. (1952), [1952] 3 D.L.R. 1 at 14 (P.C.) (interested director's contract).
The cases that most clearly reflect this altered approach in the context of amendment of the corporate constitution deal with corporate squeeze-outs. A number of squeeze-outs, or “goings private,” in Canada and England in the last decade have provoked a much stronger inclination to protect minorities against a majority’s ability to impose its will. One of the most dramatic examples is the *Re Hellenic & General Trust* case, in which a majority shareholder proposed an arrangement that would have removed, or “cashed out,” the minority shareholders. The court concluded that the minority, because their economic interests were different, constituted a separate class of shareholders and gave them a separate vote which enabled them to veto the transaction.

In a number of cases in Ontario, both under the statutory oppression remedy and the common law, courts have accepted similar arguments and have enjoined “going private” transactions that would have forced the minority out of the corporation. In fact, the courts have tended to restrict the availability of a second stage squeeze-out following a tender offer on the basis of an express power of compulsory acquisition granted under the statutes. Canadian corporations Acts generally permit an offeror who acquires 90% of the outstanding shares (or of a class of shares) of a corporation through a takeover bid to expropriate the remaining 10% minority. The minority shareholders may utilize a judicial appraisal procedure to ensure that they obtain the fair value of their shares, but if the takeover bid has been at arm’s length the offer

75 (1975), [1976] 1 W.L.R. 123 (Ch.).
76 See *ibid.* at 125-27. See also *Standard, supra*, note 70 at 699-700.
80 See, e.g., *CBCA, supra*, note 2 at s. 199; *OBCA, supra*, note 4 at s. 187. The Ontario Act also permits a minority security holder to require a person who acquires over 90% of a class of securities,
price will usually govern.\textsuperscript{81} At least one Canadian court has held that the compulsory acquisition provision precludes a majority shareholder from using an amalgamation to go private after a takeover bid in which it acquired less than 90\% of the offeree corporation’s outstanding shares; the court prohibited a cash out amalgamation by interpreting the statutory provision as the exclusive method of expropriating shareholders.\textsuperscript{82}

The O.S.C. adopted the approach of \textit{Hellenic} in its \textit{Cablecasting} decision where it accepted a commitment from the majority shareholders not to proceed with a squeeze-out reorganization unless a majority of the

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81 See, e.g., \textit{Re Hoare and Co. Ltd.} (1933), [1933] All E.R. Rep. 105 (Ch.); \textit{Re Press Caps Ltd.} (1949), [1949] 1 All E.R. 1013 (C.A.); \textit{Re Grierson, Oldham & Adams, Ltd.} (1966), [1967] 1 All E.R. 192 (Ch.); \textit{Re Shoppers City and M. Loeb, Ltd.} (1968), 3 D.L.R. (3d) 35, [1969] 1 O.R. 449 (Ont. H.C.). See also, e.g., \textit{Halperin, supra}, note 79 at 36-41. The same approach would not apply where the compulsory acquisition provision is used in an attempt to squeeze out a minority shareholder of a closely held corporation; see, e.g., \textit{Re Bugle Press Ltd.} (1960), [1960] 3 All E.R. 791 (C.A.) (precluding use of provision for this purpose with respect to a single shareholder of a three shareholder corporation). The reasoning of this decision was extended back to public corporations as well, with the result that only the shares of minority shareholders, at least arm’s length offerees, are counted in the calculation of the 90\% threshold; see, e.g., \textit{Esso Standard (Intern-America) Inc. v. J. W. Enterprises Inc. and Morrisroe} (1963), 37 D.L.R. (2d) 598, [1963] S.C.R. 144; and this method of determining the percentage has been incorporated in the statutes; see, e.g., \textit{OBCA, supra}, note 4 at s. 187. The Ontario \textit{Act} also limits these powers of compulsory acquisition to public corporations; see \textit{ibid.} at s. 187(1) and compare \textit{CBCA, supra}, note 2 at s. 199(1) (“take-over bid”).

See also \textit{Re the Acquisition by Quegroup Investments Ltd. of all the Common Shares of Queenswear (Canada) Ltd.} (1976), [1976] C.S. 1458 (Qué. Sup. Ct), a summary of a decision in which the Quebec Superior Court denied use of the compulsory acquisition provision to further an attempt to “go private” by a corporation that had gone public only two and one-half years earlier; the transaction is described in P. Anisman, “Insider Trading under the Canada Business Corporations Act” in \textit{Meredith Memorial Lectures 1975: Canada Business Corporations Act} (Toronto: DeBoo, 1975) 151 at 271 n.699.

82 See \textit{Burdon v. Zeller’s Ltd., supra}, note 78; see also \textit{Alexander, supra}, note 77 at 123-24 (suggesting same result). It is not clear whether this conclusion is limited to squeeze-outs of minority shareholders following a take-over bid for all the outstanding shares of the offeree corporation in which the offeror fails to reach the 90\% threshold. In \textit{Ferguson, supra}, note 5, the appellant argued that the holding in \textit{Burdon} applied as well in the context of a closely held corporation where no prior take-over bid was made, but the court did not address this issue; see Appellant’s Statement, \textit{supra}, note 52 at para. 56(a)-(c). Although the compulsory acquisition section of the Ontario \textit{Act} applies only to public corporations, a variation of this argument may be made with respect to Ontario corporations.
\end{footnotesize}
minority shareholders voted in favour of it.\textsuperscript{83} As a result of this proceeding the commission reconsidered its policy governing going private transactions and added a majority-of-the-minority requirement to it\textsuperscript{84} which it too has applied where a single shareholder held a majority of the minority shares.\textsuperscript{85}

The commission's approach has been adopted in the \textit{OBCA}, which has gone further in this regard than any other corporations Act in the country.\textsuperscript{86} The \textit{OBCA} contains a provision which requires that the minority shareholders of a public corporation, in any type of "going private transaction,"\textsuperscript{87} be given a separate vote with respect to approval of that transaction.\textsuperscript{88} The approval required is a majority of the minority share-


\textsuperscript{85} See \textit{Re M. Loeb Ltd.}, (1978), [1978] O.S.C. Bull. 333. The O.S.C. imposed its going private requirements through adoption of a policy statement and enforced its policy by exercising or threatening to exercise its power to issue orders prohibiting trading in specific securities in Ontario; see \textit{Ontario Securities Act}, \textit{supra}, note 27 at c. 466, s. 123. The O.S.C.'s view of the obligations of majority shareholders was forcefully stated in its rejection of the corporation's argument that amalgamations should be regulated exclusively under the corporation's legislation:

When the company that now wishes to go private sold its securities to the public, it accepted certain obligations of so doing; one of those obligations is to deal fairly with those members of the public who have invested in the corporation. It is fairness that Policy 3-37 is directed to, and it is not for the majority to tell the minority what is fair or what is in its best interest. It is for the minority to make that decision by a majority vote. That is what Policy 3-37 requires and it is that Policy that we insist on being adhered to in this transaction and in issuing a cease trading order to prevent the amalgamation squeeze-out proposed. [1978] O.S.C. Bull. at 348.

\textsuperscript{86} See \textit{OBCA}, \textit{supra}, note 4 at s. 189.

\textsuperscript{87} A "going private transaction" is defined as any type of transaction which would result in the termination of the interest of a security holder of the corporation without his consent other than a redemption pursuant to the terms of the security, compulsory acquisition under section 187 of the \textit{Act} or dissolution of the corporation under the \textit{Act}. The definition also excludes a transaction in which a security holder will receive an equivalent security with respect to participation in earnings in the corporation or an affiliate or successor of the corporation. The provision's protection is not granted to holders of non-participating securities, that is, holders of securities that are limited in the extent of their participation in earnings "in all circumstances." A security convertible into a participating security and a warrant carrying a right to acquire a participating security or a security convertible into one are treated as participating securities. See \textit{ibid.} at s. 189(1).

\textsuperscript{88} See \textit{ibid.} at s. 189(4). The statute also requires that a valuation be prepared as of a date not more than 120 days before the announcement of a going private transaction indicating a per security value or range of values for each class of securities affected. The value may not reflect a minority discount, and if any part of the consideration to be received by the departing shareholders is other than cash, the valuation must include the valuer's opinion that it is equal to or greater than the securities to be received for it: \textit{ibid.} at s. 189(2). The valuation must be made available to security holders upon request and a summary of it must be included in the management proxy circular sent to security holders in connection with the meeting called to approve the transaction: \textit{ibid.} at s. 189(3)(a). At least 40 clear days' notice must be given for any such meeting: \textit{ibid.} See also \textit{ibid.} at s. 1(1)13 ("day").
holders voting, unless they are to receive consideration other than cash or cash in an amount less than the value of the securities as determined in a mandatory valuation, in which cases approval by at least two-thirds of the minority is necessary. Shares held by affiliates of the corporation, by persons who will receive in the transaction “a per security consideration greater than that available to other holders of affected securities of the same class,” by persons who effectively control the corporation, either alone or as a group, and by persons who before the proxy circular is sent “entered into an understanding that they would support the going private transaction” may not be counted when determining whether the requisite approval has been obtained. Again, this gives the minority shareholders a veto power based on notions of fairness and on the view that minority shareholders, who are necessary to the market, will only go into a marketplace which has integrity.

The protection of minority shareholders has been extended by the O.S.C. to a number of other types of transaction in which the majority may benefit. The commission requires a public corporation that intends to create non-voting or “restricted voting” shares to obtain the approval of a majority of the minority shareholders of the corporation. The same requirements apply to amalgamations and other forms of corporate reorganization which result in any outstanding securities becoming “restricted shares” and to any distribution of securities “by way of

89 For the purposes of the going private provision a right to receive cash within 90 days after a transaction is approved is treated as cash; see ibid. at s. 189(2)(a) & 189(4)1.i.
90 See ibid. at s. 189(4)1-2; see also supra, note 88.
91 Ibid. at s. 189(4)3.
92 See supra, note 85. The provision may, however, weaken the argument concerning the exclusivity of the compulsory acquisition provision with respect to public corporations, at least where the going private transaction does not follow a takeover bid for all the outstanding shares; see supra, note 82.
94 But not all such transactions, even where a breach of fiduciary obligation may be involved: see, e.g., Re Irving S. Lindzon and 370815 Ontario Ltd. (1982), 4 O.S.C. Bull. 43C at 59C-60C (interested director’s transaction which “could be regarded as oppressive and improvident by the shareholders of” the corporation not restrained as matter better left to courts).
95 See O.S.C. Policy 1.3, s. VI, 3 Can. Sec. L. Rep. (CCH), para. 471-103 (1984). “Restricted voting shares” are defined as shares other than common shares which are entitled to vote subject to a limit or restriction on the percentage of shares that may be voted by a person or group of persons. The O.S.C. interprets the definition to include a class of shares which has lesser voting rights than another class, even though it does not in terms do so; see, e.g., the definition of “subordinate shares” in the Policy.

For purposes of this Policy securities held by an affiliate of the corporation or by persons who effectively control the corporation may not be counted when determining whether minority approval has been obtained; compare OBCA, supra, note 4 at s. 189(4)3, and see supra, notes 87-93 and accompanying text.
stock dividend” or otherwise which has the same effect.96

The O.S.C. also imposes a double pre-emptive right, like that included in some U.S. state legislation with respect to closely held corporations,97 on certain distributions of securities by public corporations.98 The O.S.C. will not allow a rights offering to be made where a principal security holder of the corporation has agreed to provide a standby commitment to purchase rights not acquired by other shareholders in the rights offering “unless a second stage right to take up any such unsubscribed securities is offered on an acceptable pro rata basis to all security holders of the class who exercised their initial rights in full.”99 The stated purpose of the policy is to ensure that a majority shareholder not obtain an advantage unavailable to the minority which results in its unfairly increasing its proportionate interest in the corporation.100 Rights offerings that are priced at or above the market price of the shares or that involve an option on additional securities as “ostensible consideration” for a standby commitment by a controlling shareholder are therefore also precluded.101 The policy has been described as a “refinement of a majority shareholder’s fiduciary obligation.”*102

Finally, a subject which has had some attention in the United States, but not much in Canada, is the treatment of transactions between parent and subsidiary corporations where the subsidiary is not wholly owned, in


99 O.S.C. Policy 6.2, supra, note 98 at s. VI.3(b). The restriction applies to a similar commitment by an associate or affiliate of a principal security holder. The policy presents an acceptable method of second stage offer, namely, allowing shareholders who exercise their initial rights to purchase at the same price the same percentage of the remaining securities as they obtained of the initially offered securities, but states that other methods may also be acceptable.

100 Ibid. at ss. VIE.1-2.

101 Ibid. at ss. VIE.1 & 3. The pricing criterion was adopted because shareholders are unlikely to purchase rights offered at or above the market.

The O.S.C. derives its power to enforce the policy from the statutory notification procedure for such offerings. A rights offering may be made without filing a prospectus under the Securities Act only where notice of the offering, including its date, amount, nature and conditions and the net proceeds to be obtained by the corporation if it is fully subscribed, is given to the commission and the commission does not object to the offering within ten days; see Ontario Securities Act, supra, note 27 at s. 71(1)(k).

102 Anisman, supra, note 6 at 101. It is worth noting that one Canadian court has required a pre-emptive right in an action under the oppression section of the CBCA; see Re Sabex Internationale Ltée (1979), 6 B.L.R. 65 (Que. Sup. Ct).
other words, where there is a minority in the subsidiary. There are few Canadian cases dealing with the difficult issues raised by the need to balance the interests of a parent corporation against those of the minority shareholders in the subsidiary. This issue is raised directly in cases like Case v. New York Central Railroad in which a majority of a subsidiary’s tax savings was taken by the parent corporation and was not shared equally with the subsidiary.

Although this issue has not yet been addressed in Canada, there are statements in one oppression case which suggest that English courts would require a parent corporation to act with scrupulous fairness when dealing with a subsidiary. But that case involved a closely held corporation where the majority was squeezing out a minority shareholder. In Canada these issues will be dealt with through the oppression remedy and through the interested director’s provision. How these cases will be decided cannot be predicted with any assurance. But the standard in the oppression remedy that precludes a majority from unfairly disregarding the interests of the minority may suggest an answer.

In the last two decades, Canada has increased the protection available to minority shareholders when a majority engages in an interested

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103 Most of the cases in which the issue might have arisen have not addressed it; see, e.g., Gray, supra, note 21 (sale of property by a subsidiary to its parent at a price substantially below its true value declared void); see also Wotherspoon v. Canadian Pacific Ltd. (1979), 92 D.L.R. (3d) 545 at 697-711, 22 O.R. (2d) 385 at 537-51 (Ont. H.C.), aff’d (1982), 129 D.L.R. (3d) 1 at 40-46, 35 O.R. (2d) 449 at 485-90 (C.A.) [hereinafter cited to D.L.R.], leave to appeal to S.C.C. granted (1982), 37 O.R. (2d) 73, 44 N.R. 83. See supra, note 41 and accompanying text. The analysis in the latter case follows traditional lines, discussing many of the cases cited supra, notes 7-14, 25-26 & 59-62, without addressing directly the fact that the parent corporation obtained the exclusive opportunity to benefit from the exploitation of the property transferred to a wholly owned subsidiary. In short, the lower court’s reasons followed the approach in the early English cases and focused on “the benefit of the corporation as a whole” rather than the economic realities of the transactions. The Court of Appeal affirmed with only a cursory discussion of this issue; see 129 D.L.R. (3d) 1 at 40 & 44. The Supreme Court of Canada has heard arguments but has not yet decided the appeal.

104 Case v. New York Central Railroad (1965), 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607. The parent corporation took substantially all of the tax savings of the subsidiary. The case presents a dramatic test of the essential meaning of fiduciary principles, for the subsidiary would not have been able to obtain the tax savings without the parent and thus suffered no harm, while the parent took virtually the whole of the benefit to itself.

105 But see Gray, supra, note 21 at 479-82 (per Robertson C.J.). Recognition of the issue is also reflected in the CBCA, supra, note 2 at s. 42 and the OBCA, supra, note 4 at s. 20, both of which except intercorporate guarantees and other financial assistance from their strictures where they are given to a parent corporation by its wholly owned subsidiary; see CBCA, ibid. at s. 42(2)(c); OBCA, ibid. at s. 20(2)(c).


107 The cases cited supra, note 103, involved interested director’s transactions because of interlocking directors of the parent and subsidiary corporations. In fact, the majority in Gray based their decision on the failure of the interested directors to refrain from voting. The earlier statutory provisions governing such contracts, however, did not impose a fairness or reasonableness standard; see supra, note 42 and accompanying text. This new standard in the current corporations Acts provides a basis for addressing the fiduciary obligation of a parent corporation to its subsidiary.
transaction with its corporation. It is fair to say that Canadian legislative, judicial, and administrative decisions have reduced the ability of majority shareholders to pursue their own goals without regard for the interests of minority shareholders and, indeed, have made fiduciary standards applicable to their conduct. Although it is not clear yet where these initial steps will lead, it seems likely that for the foreseeable future the balance will continue to shift in favour of minority shareholders.\textsuperscript{108}

\textsuperscript{108} After this article went to press the Ontario and Quebec Securities Commissions issued orders preventing a takeover bid from proceeding for the common shares of Canadian Tire Corp. Ltd.: see 10 O.S.C. Bull. 509 & 517 (decision and order, respectively); (1987), 18 C.V.M.Q. Bull. A1 (16 January 1987, No. 3). The bid had been made for 49\% of the outstanding common shares after the offeror had obtained commitments from three members of the Billes family, the controlling shareholders, to deposit their shares at a price which the commission found was designed to provide the Billeses a substantial premium over the market price of the shares based on a sale of all of their shares without triggering a "coattail" provision attached to a class of non-voting common shares held by public investors for which a bid was not made. The common shares represented 8\% of the corporation's equity, the remaining 92\% being the non-voting shares. The O.S.C., in determining the "public interest" pursuant to the Ontario Securities Act, see supra, note 27 at s. 123, adopted a test requiring that a transaction "must clearly be demonstrated to be abusive of shareholders in particular and of capital markets in general" for it to exercise its prohibitive powers, and declared the standard to be different from and one that goes beyond "a complaint of unfairness." The O.S.C. took support for its decision from its finding that the Billeses in seeking and agreeing to the bid breached a fiduciary obligation owed by them as directors and controlling shareholders to the minority shareholders; \textit{Re Canadian Tire Corp. Ltd.} (1987), 10 O.S.C. Bull. 858 at 947-48 & 954-55, aff'd (1987), 10 O.S.C. Bull. 1772. Although the commission emphasized the public aspects of the abuse found by it, its concern was premised to a significant extent on fiduciary premises and its decision is a further step in the direction suggested in the text; compare, \textit{e.g.}, \textit{Honigman v. Green Giant Co.} (1961), 208 F. Supp. 754 (D. Minn.), aff'd (1962), 309 F.2d 667 (8th Cir.), cert. denied (1963), 372 U.S. 941.
Conflicts between the interests of the controlling and minority shareholders in stock corporations have been and continue to be a major — perhaps the single most important — problem in corporation law. Such conflicts undoubtedly account for almost all litigation among shareholders in closely held firms. In publicly held companies, litigation often results from the alleged violation of shareholders’ rights by managers, if there is no controlling shareholder or group of shareholders, or by managers and the controlling shareholder or coalition of shareholders, if there is one. There can be little doubt that problems of this sort are the most pervasive source of litigation in corporation law. The rubric under which such disputes are resolved is fiduciary duty: to what extent does the law require that in the transaction involved those in control take account of the interests of the shareholders who are not in control and share with them the benefits generated by the transaction?

This article will present an analysis and critique of the treatment of these problems under conventional corporate doctrine, from which it will conclude that the rhetoric of the law in this area consists largely of nonanalytical generalizations of “principles” which are unhelpful in predicting specific case results. The article will then offer an alternative mode of analysis and attempt to show that this alternative approach is more successful in accounting for and, hopefully, anticipating results in situations that frequently produce litigation.

I. THE TRADITIONAL CONCEPTUAL FRAMEWORK

Lawyers are accustomed to thinking of corporations as legal constructs whose essential features, including the rights of persons with different relationships to the corporation—shareholders, managers, directors, and creditors—are spelled out with varying degrees of completeness in the statutes and elaborated upon and supplemented by the case law. Once a business firm has been organized as a stock corporation, and the organizers have selected the specific structure from the various options available under the statute, the rights and obligations of those who subsequently buy stock are fixed, subject to the possibility of
future amendment under the procedure prescribed in the statute. Traditionally, the role of managers, whose obligations are to be loyal and diligent in serving the interests of the shareholders, and the responsibilities of the controlling shareholders to other shareholders have gone unmentioned in the statutes, being left to the law of agency as developed by the courts. In many respects organizing a stock corporation under a modern statute is like buying a ready-made suit: some features are variable and may be selected by the purchaser, but many essential characteristics are automatically included in all models. It does not follow, of course, that purchasers do not desire these unmentioned standard features; on the contrary, they are often what the purchasers intend to buy. The point is that these features are not the subject of negotiation; they are standard forms. To the extent that standard forms reflect the desires of the parties, they reduce the costs of transacting. Difficulties arise, however, where the meaning of the standard forms is not clearly spelled out and, therefore, cannot be anticipated by the parties and would not have been agreed to by them in advance.

Fiduciary duties of managers and controlling shareholders are, as the frequency of litigation shows, an extremely important part of the corporate package. They are a fixed feature of the legal model; rarely does bargaining occur with respect to them. Lawyers and judges interpreting the law as it applies to a particular transaction will advise the parties what their rights and obligations are or were in a particular situation based on their analysis of the legal model. Little or no reference will be made in the process to the ex ante expectations of the parties. The law is said to determine the existence and the extent of fiduciary obligations. In the words of an English judge in a 1887 leading case dealing with a contract of purchase between a company and its principal shareholder, "[I]t would be very undesirable even to appear to relax the rules relating to dealings between trustees and their beneficiaries."¹ It was apparent then, as it is today, that fiduciary standards were set by the courts, not by the parties, and it was true then, as now, that the limits of those obligations were ill-defined.

At the same time, the vigor of judicial rhetoric describing fiduciary obligations in cases in which such obligations are found and enforced is extreme. The standards have been said by Judge Cardozo, whose opinions on this subject are among his most famous, to be "inveterate" and "unbending."² Parties found to have violated these obligations are con-

² Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928). This was a joint venture case in which the court of appeals, by a 4-3 vote, held that one participant had breached his duty of loyalty to the other. Id. at 480, 164 N.E. at 553. Judge Cardozo's opinion characterized the standards of fiduciary duty as requiring "not honesty alone, but the punctilio of an honor the most sensitive," id. at 464, 164 N.E. at 546, which is undoubtedly the most widely cited pronouncement on the subject in both partnership and corporation law as applied to directors and officers. Cardozo's most famous case dealing with a corporate director is Globe Woolen Co. v. Utica Gas & Elec.
demned as morally delinquent. There is no talk here of party autonomy, or of such pale and tentative concepts as interest balancing or reasonable expectations.

The tone of the opinions in this area is, of course, deliberate. By obscuring the limits of fiduciary obligations under moralistic rhetoric and by verbally chastising those who are found to have violated the standard, or come close to doing so, the courts seek to maintain the standard by discouraging marginal behavior which might or might not violate it. It is the imprecision of the standard and the fact that there are limitations on its scope which cannot be acknowledged in the judicial formulations that lead the courts to employ excessive rhetorical force in promulgating fiduciary doctrine. Where content and limits of rules are clear, one need only state the rule. Ambiguity breeds vehemence. Further, the knowledge that fiduciary principles cannot be precisely and minutely enforced leads to the use of strong language as a control mechanism. This type of judicial rule-making has the effect of discouraging bargaining among parties. Bargaining is facilitated by precise ex ante allocations of rights: lacking such an allocation, parties do not know what they are giving up or receiving, and the likelihood of negotiation is reduced as its difficulty is increased. The relationship between managers and shareholders, and among shareholders involving fiduciary obligations, are the only voluntary relationships in commercial law in which the applicable legal "rules" inhibit party negotiation. It is also true that fiduciary rules are a response to the difficulty of formulating the precise content of the obligations assumed by managers and controlling shareholders. It is ironic that judicially formulated and imposed obligations, which are useful because of the difficulty parties have in anticipating events and bargaining out the details of on going relationships and the extent of sharing obligations themselves, become an obstacle to party-negotiated solutions. Even the suggestion that the scope of fiduciary obligations is or should be negotiable is suspect. Many lawyers would consider an attempt to modify fiduciary obligations by agreement to be invalid on policy grounds, like an

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Co., 224 N.Y. 483, 121 N.E. 378 (1918), in which he asserted that the standard to be applied to directors was one of "constant and unqualified fidelity." Id. at 489, 121 N.E. at 379. The leading Delaware case is Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939).

3 See Scott, Two Models of the Civil Process, 27 STAN. L. REV. 937 (1975). Professor Scott argues that civil litigation performs two functions: first, settlement of the dispute before the court, and second, modification of future behavior of nonparties. Appellate opinions are largely concerned primarily with the latter cautionary or behavior modification function.

4 MODEL BUSINESS CORP. ACT § 8.31 (1984) provides that a transaction in which a director has a substantial adverse interest to the corporation is valid and not voidable by the corporation if, after full disclosure, the transaction is approved by a majority of the disinterested directors, or by the shareholders (excluding shares owned by the interested directors), or is "fair" to the corporation. It is quite unlikely that a charter provision or bylaw which is more favorable to interested director transactions than this provision would be sustained. See, e.g., Newton v. Hornblower, Inc., 224 Kan. 506, 582 P.2d 1136 (1978) (character providing that all corporate officers are permitted to do business with the corporation does not negate need for officers' full disclosure of material facts of transactions between themselves and corporation); Abeles v. Adams Eng'g Co., 35 N.J. 411, 173
effort to contract out of the duty to exercise due care in the law of torts. In this respect, the law dealing with fiduciary obligations contrasts sharply with other areas of commercial law in which party autonomy is the dominant principle and general law-supplied rules are designed to fill in gaps in party-negotiated transactions which are based on the presumed intent of the parties.

Finally, initial burden of fiduciary obligations rests on corporate officials. This burden is derived from the familiar principles of agency law which require that agents be diligent and loyal in the service of the interests of their principals. Shareholders, on the other hand, have traditionally been said to owe no fiduciary obligations to each other. Each shareholder, in exercising his voting rights, was said to be free to consult only his own interest and preferences without regard to those of other shareholders. The obligation now said to be imposed on majority shareholders is based on their ability to control the outcome of a shareholder vote and to select and remove directors and other corporate officials. The obligation is based in part on the cynical but realistic assumption that elected officers, in exercising their discretionary authority, will favor the interests of those whose votes elected them. In the case of public officials, this tendency to prefer the interests of those who elected them is tolerated so long as it falls short of outright bribery and corruption. To guard against excessive favoritism, laws against bribery and laws requiring sealed bidding on public contracts were adopted. In private corporations, the courts have devised a simpler and more direct solution. It makes no sense to hold majority shareholders responsible to the minority for managerial decisions which adversely affect the minority and benefit the majority, while permitting the majority to exercise its voting rights to benefit itself and injure the minority. Therefore, the law has taken the additional step of imposing fiduciary obligations on controlling shareholders.

Despite the all-embracing tone of judicial rhetoric in fiduciary duty cases, the results make it clear that these pronouncements, like the first amendment, are not to be taken literally. There are limits. Directors and officers are not expected to toil ceaselessly for the welfare of the company

A.2d 246 (1961) (agreement between corporation and director, made without consent of stockholders, not enforceable unless "honest, fair and reasonable").
5 For a comparison of fiduciary principles applied to close corporations and relations between ordinary contracting parties, such as business organization-customer and debtor-creditor, see infra notes 18-31 and accompanying text.
7 The United States Court of Appeals for the Second Circuit has stated that the fiduciary duty of a director "includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation in any dealings which may adversely affect it. . . . [T]he same rule should apply to his fiduciary duties as majority stockholder, for in that capacity he chooses and controls the directors, and thus is held to have assumed their liability." Perlman v. Feldmann, 219 F.2d 173, 176 (2d Cir.), cert. denied, 349 U.S. 952 (1955) (citations omitted).
8 H. HENN & J. ALEXANDER, supra note 6, § 240, at 651.
and its shareholders. They need not lend money to the company. They can sell property to the corporation at a substantial profit, and it has been held that when an advantageous sale of corporate property can be consummated only if a director agrees to sell his personally owned adjacent property, he may refuse to sell or demand a disproportionate share of the total proceeds. Majority shareholders can sell property to the company at a profit and demand a “fair” price. Except in special circumstances, majority shareholders can generally sell their shares at a premium not available to minority shareholders. Executives and directors can take knowledge acquired in the business with them when they leave and start competing firms as long as they do not steal trade secrets or customer lists or breach a specific non-competition agreement. It now appears, after some initial confusion, that majority shareholders may compel the minority to sell its shares either to an outsider or to the majority itself for any reason at any time as long as there is full disclosure of the relevant facts respecting value and the price is “fair.”

The fiduciary doctrines enunciated by the courts provide little or no basis to account for these limitations on the scope of managerial and majority shareholder fiduciary responsibility. These results have been considered by commentators as unprincipled and unjustifiable limitations on the broad sweep of conventional fiduciary doctrine. The analysis presented in the following section suggests that this not the case. On the contrary, it is argued that these limitations on the operation of fiduciary doctrine are the working out of a balancing of interests among the par-

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9 Hart v. Bell, 222 Minn. 69, 81, 23 N.W.2d 375, 382 (1946).
13 There is an extensive literature on this subject. For references to the rule stated in the text, see W. Cary & M. Eisenberg, Cases and Materials on Corporations 707-10 (5th ed. 1980) and sources cited therein.
14 The leading case on executives and directors utilizing knowledge acquired through their positions is Lincoln Stores v. Grant, 309 Mass. 417, 34 N.E.2d 704 (1941). The court observed that the defendant directors and officers who purchased a store which they caused to compete with the plaintiff “intended to utilize the knowledge and experience that they had acquired in the [plaintiff’s] company’s employ” in competing with the plaintiff. Id. at 419, 34 N.E.2d at 706. The court further stated that “[d]irectors and officers of a corporation are not, by reason of the fiduciary relationship they bear toward the corporation, necessarily precluded from entering into an independent business in competition with it, but, in doing so, they must act in good faith.” Id. at 423, 34 N.E.2d at 707. See also Wexler v. Greenberg, 399 Pa. 569, 160 A.2d 430 (1960) (use by defendant, chief chemist, of secret formula he developed while employed by plaintiff does not, in absence of express contractual prohibition against same, constitute breach of confidential relationship).
16 The most widely cited critique of conflict of interest standards in corporate law is Marsh, Are Directors Trustees?, 22 Bus. Law. 35 (1966). Extensive recent literature is cited in H. Henn & J. Alexander, supra note 6, at 641 n.10.
participants in corporate enterprises and that they are consistent with the interests and ex ante expectations of investors.

II. CONTRACT: AN ALTERNATIVE CONCEPTUAL FRAMEWORK

The basic process by which goods and services are produced and distributed in our society is the voluntary exchange transaction. The economy is a network of such transactions between individuals and organizations. The voluntary exchange transaction is the fundamental unit of economic intercourse: customers buy goods and services for cash or on credit; lenders supply capital; employees and independent contractors sell services; and suppliers sell goods to firms in such transactions. Individuals become members of organizations and acquire equity investments similarly through voluntary exchanges. Such transactions are not the only means through which organizations deal with outsiders; they are the means by which the organization itself is built. The only difference in a transaction between an organization and an outsider, such as a customer or creditor, and an insider, such as a member or a shareholder, is in the nature of the consideration which the organization gives to the person on the other side of the transaction. An equity investor buys a different commodity than a creditor. While the creditor usually receives an obligation for a fixed or determinable payment, the equity investor buys a contractual right to a share of the future residual income generated by the enterprise. Modern organizational theorists have come to regard business organizations as complex structures composed of large numbers of different and overlapping contracts under which all who deal with the "organization" seek to promote their own welfare through exchange transactions.

The relations between a business organization and its customers, creditors, employees, and suppliers are governed by various specialized branches of contract law. These transactions are generally characterized by the enterprise’s clearly, specified advance promise of performance. The business organization promises to deliver the goods or services called for by its contracts with its customers and pay the specific amounts owed to its employees, suppliers, and other creditors. If either party fails to fulfill the contractual obligation it has incurred, the law may be invoked to compel payment of whatever damages the injured party can prove it suffered as a consequence of the breach. Such transactions are characterized in legal parlance as “arm’s length,” which means that no fiduciary obligation is involved. Debtors, whether natural or corporate, are not

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17 The contractual nature of shareholder rights is explicit in Delaware. See E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 109 (1972).
19 An “arm’s length transaction” is a transaction negotiated by unrelated parties, each acting in his or her own self-interest, and is the basis for a fair market value determination. BLACK'S LAW DICTIONARY 100 (5th ed. 1979).
said to owe fiduciary obligations to their creditors. The management of a corporation, therefore, is not considered to owe a fiduciary obligation to its creditors to manage the corporation competently so that it will be able to pay its debts. If those who extend credit to incorporated firms consider it worth the trouble to bargain for protection to reduce the risk of nonpayment, they may, and often do, demand security or covenants to prevent the management or the shareholders from increasing the risk of nonpayment by adopting more risky business activities. In any event, it is clear that debtors, including corporations, are not the fiduciaries of their creditors, since creditors are entitled only to the protection they bargain for plus that provided by the law against dispositions of the debtor's property which are fraudulent in fact or in law.

Where the investor buys an equity interest in the corporation, however, the law imposes a fiduciary obligation on management to manage the enterprise so as to enhance the wealth of the investor. The explanation for the difference in the treatment of this type of obligation from all others lies in the performance which the purchaser is buying. In sales of goods and services in the market and in money loans, the expected performance by the parties can be specified in advance. The buyer or creditor can readily determine whether the seller or debtor is delivering the contemplated performance. But the equity investor is buying a residual claim, the value of which depends on the discretionary performance of management. The details of this performance cannot be specified in advance, and the results are inescapably uncertain. Thus, it is not practica-

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20 The point is so obvious that cases in which it is discussed are rare. See Byrns v. United Telpherage Co., 105 A.D. 69, 70, 93 N.Y.S. 906, 907 (1905). The settled law on this point, however, has recently been criticized. See McDaniel, Bondholders and Corporate Governance, 41 Bus. Law 413 (1986). McDaniel argues that corporate managers should owe fiduciary obligations to bondholders (but not, presumably, other creditors). Id. at 456. The author also argues that the extensive use of debt securities in takeovers has demonstrated the inadequacy of contractual protections of holders of debt securities. Id. at 413-14. The fact that contractual provisions developed in the past have proved insufficient because of then unforeseen developments does not, however, establish a need for changes in the legal rules governing financial contracting. Nor is there reason to think that the buyers of debt securities cannot and will not demand changes in contractual protection or rates of return in future debt securities based on recent experience. It is important to remember that some courts regard conflicting interests between different classes of equity securities as matters of contract, and that holders of one class owe no fiduciary obligation to another. The classic case is Goldman v. Postal Telegraph, Inc. 52 F. Supp. 763 (1943). For a more recent case in this area see Baron v. Allied Artists Pictures Corp., 337 A.2d 653 (Del. Ch.), appeal dismissed, 365 A.2d 136 (Del. 1975).

Uncertainty and ambiguity concerning financial rights would arise if managers were subjected to fiduciary obligations to classes whose interests were in conflict, thereby introducing substantial and very costly uncertainty into financial contracting. The exclusive claim of holders of junior equity issues on the best efforts obligations of managers to enhance their wealth is the essential contractual obligation which equity investors buy.

21 For a discussion of the law regarding the contractual protection afforded creditors, see Justice Adams' dissenting opinion in Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R., 680 F.2d 933, 946-54 (3d Cir.), cert. denied, 459 U.S. 1056 (1982). The majority imposed liability in favor of the holders of convertible debentures, not on fiduciary duty grounds, but principally on the ground that the debenture holders' rights under the federal securities laws had been violated. See id. at 943.
ble for the equity investor to demand, or management to promise, specific results. Management may be both skillful and diligent, and the venture may nevertheless fail. It is impracticable because it is too costly for investors to subject the efforts of the managers to continuing personal oversight and scrutiny. Other means must be found to give some assurance of management's continuing efforts to enhance shareholder wealth. Easily the most important spur to management's efforts is self-interest. Successful results increase managers' personal wealth through direct compensation and through the resulting increase in the value of any investment they have in the firm. Success also enhances managers' prestige and value in the hiring market and reduces the possibility of dismissal by the present owners or through a take-over by outsiders. The incentives provided by these considerations are supplemented by the legal sanctions for breach of the duties of loyalty and competence. That managers are bound to exercise due diligence in pursuit of this goal has not been seriously challenged in American law since *Dodge v. Ford Motor Co.* was decided in 1919. In comparison with the inducements or self-interest and the risk of removal, the risk of legal liability for breach of fiduciary obligations is undoubtedly of secondary and perhaps of minimal importance in inducing managers to seek to promote the economic interest of shareholders.

There can be no question that the purpose of legally imposed fiduciary obligations is to induce managers to act in conformity with the expectations and interests of the shareholders. It would seem to follow that the boundaries or limits of managers' obligations should be sought in the express and implied contemplations of the parties, rather than in the immutable dogmas of judicial rhetoric invoking "inveterate" principles.

If one looks at fiduciary obligations as being derived from the intentions of the parties, the first question that arises is how much of a manager's fiduciary obligation would a rational shareholder seek to buy, and how much would rational managers seek to sell. The same question arises in connection with the obligations which have been imposed on the majority shareholders toward the minority. In principle, the answer to these questions is clear: shareholders in general would want to purchase such obligations from managers up to the point at which the cost of any further obligation would exceed the anticipated benefit the shareholders

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22 204 Mich. 459, 170 N.W. 668 (1919). The case is also reported at 3 A.L.R. 413 (1919) and discussed in the subsequent annotation entitled "Right of business corporation to use its funds or property for humanitarian purposes."

23 In an economy in which services and goods are bought and sold in voluntary exchange transactions in markets, the function of the law is primarily to support market forces by enforcing bargains and only infrequently by dictating their terms. Speaking of the role of the law in U.S. economic history, Professor Hurst recently observed that "[r]elative to the whole play of factors that produced the market, the law was marginal. This is not to say that the law was unimportant." J. HURST, LAW AND MARKETS IN UNITED STATES HISTORY 9 (1982). He concluded that the "challenge to legal processes . . . [at present] is to reach adjustments which will usefully supplement the market without wastefully displacing it . . ." *Id.* at 90.
expect to receive. Managers presumably will demand more compensation in various forms as they agree to additional duties. Similarly, as the equal sharing obligation on the controlling shareholders is broadened, the less valuable a controlling position becomes. For their part, rational minority shareholders would not seek sharing rights with the majority beyond the point at which such rights cease to enhance the value of their investment.

In practice, of course, it is uncertain where these limiting points are, and the parties to such hypothetical negotiations might find that the cost of identifying them in advance exceeded any projected benefit. But it is absolutely clear, nevertheless, that there are such limitations. Shareholders could insist on such onerous burdens of loyalty on the part of managers that the price charged for such services would exceed the benefit. Similarly, if it were practicable to insist that all the benefits of control were equally shared among the shareholders, the value of control would in theory be zero. As a result, it would not be worthwhile to any shareholder to try to assemble a controlling position. Under such a rule there would be very little incentive for outsiders to buy in to displace management, and the effectiveness of the principal managerial control mechanism would be greatly reduced. This analysis suggests that demands for the elimination of control premiums, and the suggestions that control is a corporate asset, are based on a profound misapprehension concerning the relationship among, and the interests of, the shareholders.

There are important business relationships in which parties explicitly bargain for the “right” amount of fiduciary obligation. Such bargaining occurs in transactions in which long-term business arrangements are created by contract under which the parties share the gains from cooperative activity. Agreements creating such relationships have been called “relational contracts.”

A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.24

Arrangements of this kind include distributorships, franchises, and exclusive dealing arrangements, such as output and requirements contracts, all of which contemplate the sharing of the benefits of coordinated behavior over a period of years.

For example, in an exclusive dealing contract, a manufacturer may agree to sell its entire output to a distributor who agrees to purchase all of its requirements from the manufacturer. The price set in the agreement is a means of allocating to each the gains from their joint activities. The parties have created a business firm in which their respective returns

are dependent on their joint efforts and are subject to some risks which cannot be identified in advance. A serious risk is that under changed conditions the arrangement may become very profitable to one and unprofitable to the other.

This problem is often dealt with by a number of provisions in the contract. There may be a price adjustment clause so that if the supplier's costs change significantly, the price will be adjusted. Also, each party will agree to use its "best efforts" to further the purposes of the venture—the buyer to have requirements and the supplier to maintain output. This is a fiduciary obligation in which the precise degree of effort required is not clear. Best efforts may require a party to incur some losses to continue to perform, but not to bankrupt itself.25 Significantly, for present purposes, the law expressly acknowledges the right of the parties to modify, by agreement, the usual meaning of the "best efforts obligation."26 These provisions of relational contracts illustrate the party autonomy principle which underlies much of contract law.27 Finally, such contracts often include a fail-safe provision in the form of a unilateral termination clause.28 This gives the cancelling party the ability to cut its losses if its expectations are not realized.

The same basic problem is often dealt with in debtor-creditor transactions through the use of clauses permitting acceleration, either at will or upon the occurrence of certain events. In these transactions, as in those discussed previously, the parties making long-term commitments have attempted to limit their exposure to risks resulting from unanticipated events.

The role of the courts in interpreting these various fail-safe or loss-

25 See U.C.C. § 2-306 comment 2 (1978); see also Feld v. Henry S. Levy & Sons, 37 N.Y.2d 466, 335 N.E.2d 320, 373 N.Y.S.2d 102 (1975) (output contract did not compel baker to manufacture bread crumbs for full term of contract, absent explicit language to contrary; however, termination of production must be made in good faith).

26 See U.C.C. § 2-306(2) & comment 5 (1978). This section of the code imposes a best-efforts obligation and acknowledges the parties' right to contract for a different standard. Id. The comment speaks of "reasonable effort and due diligence." Id.; see also Goetz & Scott, supra note 24, at 1117 (best efforts offers a plausible way in which the legal rule can allocate unknown risks in advance of individual bargaining, thereby reducing the uncertainty costs of an imprecise legal standard).

27 The most extensive and explicit recognition of this principle is in Article II of the Uniform Commercial Code, which throughout defers to party intent by providing that many prescribed rules are applicable "unless otherwise agreed." See, e.g., U.C.C. § 2-303 (1978) (allowing parties to agree to shift or divide risk or burden contrary to provisions of Code).

28 See Goetz & Scott, supra note 24, at 1134-49, in which difficulties under termination provisions are extensively analyzed. The drafters of the U.C.C. included an excuse clause based on unanticipated contingencies. U.C.C. § 2-615 (1978). The theory of this provision is that enforcement of contracts under circumstances to which enforcement would not have been agreed upon or anticipated, is beyond the parties' expectations. Hence, enforcement of the obligation under such unforeseen contingencies amounts to the making of a new contract ex post. The courts have been reluctant to grant relief under this provision, usually on the ground that the contingency ought to have been foreseen; hence a kind of negligence liability is imposed. See cases collected in 3 U.C.C. CAS. DIG., ¶¶ 2615.1-10 (1985).
limiting arrangements is to limit their use to the intended purposes as revealed by the dealings between the participants.

The determination of the scope of fiduciary obligations among shareholders is both similar to and different from the long-term contractual arrangements briefly discussed above. Since the legal life of almost all stock corporations is perpetual, the problem of changed conditions affecting the relationship among shareholders is almost certain to arise. In the foregoing contractual arrangements the period of time contemplated by the parties is invariably specified in the agreement and is usually not longer, and often shorter, than a decade. The most important difference between the contracting problem in the foregoing instances and the rights of shareholders, however, concerns the purpose of the arrangement and the conditions under which one party may wish to terminate it. In these contracts, each party has contracted to buy or supply goods or credit at a fixed or adjustable price, and the purpose of the limiting clause is to release the supplier or buyer from the commitment upon the occurrence of unexpected events which make the commitment seriously disadvantageous. In these arrangements, particular risks are allocated to one party or the other, and some type of fail-safe clause permits the reallocation of the risks on the occurrence of the triggering events. 29

The relationship among owners of the same class of stock is significantly different, because this is a contract in which most anticipated and unanticipated risks and benefits are shared by the participants in proportion to their investments in the enterprise. With respect to the benefits and risks which the parties intend to share, fiduciary obligations between shareholders are enforcement devices for implementing the intent of the parties. As in most private contracting arrangements, the only basis for imposing obligations on one party or the other is their expressed or implied intention (which may be found in tacit acceptance of reciprocal obligations imposed by the courts on shareholders in similar situations). It follows that the courts must be able to limit the scope of fiduciary obligations in situations where it appears that the parties intended such limitations. It must be equally plain that the parties may do explicitly what the courts have found them to have done implicitly in the cases in which the courts have set limits on the sharing obligations.

The variations in expectations with which we are concerned in discussing the fiduciary obligations of majority or controlling shareholders concern only sharing expectations; they do not concern transactions in which all shares are equally treated. The limit-setting problems involve

29 See U.C.C. § 2-303 (1978), which permits parties to sales transactions where risks are allocated to one or the other “unless otherwise agreed . . . not only to shift the allocation but also [to] divide the risk or burden.” Id. In sales transactions in which parties are thinking primarily in terms of price and performance in an arm’s length context, sharing of risks is apparently almost never explicitly done.
transactions in which there is a basis for claiming that there was no ex ante expectation of equal sharing.

We have come to recognize that shareholders do not intend to buy the same package in all incorporated firms. The ex ante expectations of shareholders in close corporations are now seen to be quite different from those of investors in publicly traded companies. Fiduciary obligations should accordingly be regarded as implied contract terms whose content varies according to circumstances and ultimately depends upon the shared expectations of the parties. The courts have recognized such circumstantial variations in cases later criticized on the ground that such tailoring of fiduciary obligations represents a "weakening" of fiduciary principles. The difficulty has been caused by the uncompromising rhetoric of the fiduciary concept which misleadingly implies that there ought to be no limitations and suggests that, in this area, in contrast to the rules in other areas of commercial law, the law, not the parties, determines the substantive content of contractual obligations.

When the courts import substantive obligations into private contracts, those obligations are certain to differ to some extent from those the parties themselves would have made. The degree of divergence will, of course, vary. When this divergence is small, the parties have little to gain by negotiating to modify or avoid the impact of the law-created term; the greater the divergence, the greater the incentive. Bargaining is costly, and the parties may be expected to engage in it only when the prospective benefits exceed the costs. In resolving disputes ex post, the

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30 The difference between the relationships and expectations of shareholders in close corporations and those of shareholders in publicly held companies is increasingly being explicitly recognized in the case law. For a discussion of cases recognizing this difference see infra, notes 56-60 and accompanying text.

31 Johnston v. Greene, 35 Del. Ch. 479, 121 A.2d 919 (1956), the famous divisible corporate opportunity case, provides an interesting context in which to discuss the balancing concept with respect to fiduciary obligations. The president of a company which had liquid assets but no active business received in his personal capacity a lucrative business opportunity, a portion of which he gave to the corporation. Id. at 482, 121 A.2d at 922. (There was a business reason for dividing the opportunity.) The division was sustained. Id. at 493, 121 A.2d at 927. The correctness of the result is indicated by asking the following questions: Would the president, who was a well-known financier, have been willing to agree in advance to give all business opportunities which came to him to this one firm? (He was involved in numerous businesses.) Would the shareholders in this company have been better off under an ex ante rule which required that all such opportunities be given to the firm? See also in this regard Burg v. Horn, 380 F.2d 897 (2d Cir. 1967), where directors, who were not salaried employees and had engaged in business activities similar to those of the corporation before it was formed, continued to do so afterward. It was held that, under the circumstances, the corporation had no claim to other opportunities subsequently developed by the directors. One commentator, arguing that more fiduciary obligations are better for shareholders, has criticized the result in Burg. See Note, Property Acquired by Directors of Close Corporation For Their Own Benefit Held Not to Be a Corporate Opportunity, 43 N.Y.U. L. Rev. 187 (1968); see also A. CONARD, R. KNAUSS & S. SIEGEL, CORPORATIONS 491 (2d ed. 1982) (suggesting that the result in both Johnston and Burg, effectively holding that directors who serve on boards of other corporations engaged in similar businesses owe a "reduced" duty to each corporation, "does not seem very satisfactory from a policy point of view").
efficiency and productivity of exchange transactions would be enhanced if the courts sought the allocation which the parties would have made ex ante had they then considered that the gains of bargaining exceeded the costs.

Finally, recognition of the properly dominant role of party autonomy in corporation law, as in other commercial law subjects, does not necessarily lead to a wilderness of complex factual variations. Shareholder expectations are remarkably uniform, and the situations in which they vary are quite well defined. Closely and publicly held companies are the two basic prototypes. In the following discussion, a contractual party-expectation analysis is applied to a number of familiar majority-minority conflict problems. The effort is to show that this approach is more useful in predicting the results which the courts have often reached than is the conventional law-imposed fiduciary doctrine.

A. Close Corporations

The problem in close corporation cases almost invariably is that, in one way or another, the majority has substantially or totally excluded the minority from sharing economic benefits generated by the business, while retaining and employing the minority's investment in the firm. The minority's exposure to "oppressive," i.e., unexpected, conduct by the control group in close corporations is directly related to the absence of a market for the company's stock. Successful operation of a publicly held firm is, of course, reflected in the market price for its stock, and the control group therefore enhances its own wealth by policies which increase stock prices. Hence, the minority cannot be excluded from some of the benefits of profitable operation. In the absence of a market, the majority has both an incentive and an opportunity to prevent the minority from receiving any direct or indirect benefit from successful operations. Accumulation of wealth in the firm does not proportionately increase the value of its stock to outsiders because of the majority's ability to deny the minority any direct benefit from the increase. On the other hand, the majority has no incentive to buy the minority's shares for any price in excess of the discounted value of that portion of the income allocable to the minority's investment which the majority is unable to divert to itself through its control of the enterprise. Within the comfortable limits of the business judgment rule, the majority can, in effect, use the minority's investment without paying for it.

Traditional judicial fiduciary duty rhetoric has not been conveniently adaptable to this situation. So long as the firm is profitable, and salaries and management perks are reasonable by general business standards, and all shares are formally treated alike, there is no basis under the traditional formulations of fiduciary obligation for judicial intervention. The difficulty is that judicial interference involves matters of policy concerning control group decisions which are not on their face unlawful.
Involuntary dissolution statutes\textsuperscript{32} were attempts at protecting the minority, by permitting the dissolution of firms when it became apparent that those in control were pursuing otherwise lawful policies which adversely affected the interests of the minority without having a similar effect on the control group. This has proved to be a costly solution to the problem because it requires individual analysis of each case. Plausible justifications for the policies and practices adopted by the majority, under most circumstances, must be sorted out to avoid unwarranted interference with the majority's legitimate managerial prerogatives. Additionally, there was and is a perceived danger of permitting the minority to interfere with effective management, a practice once considered to be contrary to a state policy requiring majority rule.\textsuperscript{33} This policy has been rejected by legislative enactments which implicitly recognize the contractual nature of close corporations by permitting departures from majority rule.\textsuperscript{34}

It is unusual for the parties in closely held corporations to alter the usual majority rule, single class of stock format.\textsuperscript{35} When a dispute subsequently arises, the judicial problem in these cases is to find a basis for imposing a "fair sharing" obligation on the group in control. The difficulty with this approach is that the initial mutual understanding and expectation of the parties, which was that there would be an equitable sharing of burdens and benefits, has broken down, usually as a result of disagreements over policy, failure of all parties to participate in the business as originally anticipated, or other unforeseen or at least unanticipated events.\textsuperscript{36} The close corporation is a joint venture, that is, a long-term relational contract which contemplates that each participant will contribute capital or services and that proceeds will be equitably shared. Control is conceded to the majority shareholders because of their larger investment or special competence, and it is contemplated that control would be used to protect the majority's larger exposure to risk of loss, 


\textsuperscript{33} Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945).

\textsuperscript{34} \textsc{Model Business Corp. Act} §§ 7.27, 10.21, 10.22 (1984).

\textsuperscript{35} Studies have found that special contractual arrangements permitted by close corporation statutes are very infrequently used. Karjala, \textit{A Second Look at Special Close Corporation Legislation}, 58 Tex. L. Rev. 1207, 1266 n.236 (1981); see also Blunk, \textit{Analyzing Texas Articles of Incorporation: Is the Statutory Close Corporation Format Viable?}, 34 Sw. L.J. 941 (1980) (in a sample of 1033 close corporation filings, special statutory close corporation options were used only 37 times).

\textsuperscript{36} Frequently, the event is the death of one of the active participants in the business. The remaining active participants then find themselves sharing the result of their efforts with a passive and sometimes obstructive investor. An example is the leading New York case, \textit{In re Radom & Neidorff, Inc}., 307 N.Y. 1, 119 N.E.2d 563 (1954) (dissolution inappropriate where stock held equally by two hostile parties but business flourishing). The partnership form provides for the solution of this problem through the automatic dissolution of the partnership upon the death of a partner. \textsc{Uniform Partnership Act} § 31(4) (1914).
not that it would be used to take advantage of shareholders with smaller investments.

If the close corporation is regarded as a legal vehicle designed to implement such an understanding among the parties, a number of remedial alternatives become clearly visible and distinguishable. First, a party who fails to protect himself against the possibility of a breakdown of the mutual understanding can be left to bear the consequences of that oversight. Second, rights can be allocated among the parties on the basis of fault in bringing about the breakdown of the original understanding. Third, without assigning fault, the withdrawal of a disappointed participant could be permitted on the basis of a finding that the common understanding no longer exists. The choice among these views is a familiar contracts problem. The first possibility simply treats minority shareholders as parties who made a bad bargain. The second choice attempts to allocate the risk on the basis of fault in the abrogation of the tacit understanding about benefit sharing. The third possibility imports a termination clause similar to those commonly found in long-term relational contracts, such as franchise agreements and loan agreements, and sometimes supplied by the law when unforeseen events make performance of an obligation "commercially impracticable."  

Imposition on the majority of an obligation to exercise its managerial prerogatives in furtherance of an assumed initial understanding that the benefits of the business would be equitably shared seems a reasonable rule when compared with the opposite. It is unlikely that the parties would have agreed, had they addressed explicitly the issue at the outset, that in the event of disagreement the majority should have the right to exclude the minority from the profits of the business.

The risk that the common expectation of participants in close corporations will be disappointed differs in three respects from similar risks facing buyers of stock in publicly held companies. In the first place, the risk of managerial shirking in publicly held corporations is taken into account in the purchase price. The greater the perceived shirking risk, the greater the discount. (This would lead one to expect a greater discount on the shares of firms which depend primarily on human capital, such as an advertising agency.) There is a paradox in the market discount on shares of controlled firms: the discount appears to be based on the fact that the management is exempt from removal because it holds a controlling position in the stock. But what if there is a single controlling shareholder? Such an owner has the incentive and ability to prevent or reduce managerial shirking and thereby make all shareholders better off. Why, then, the discount? The answer is that the controlling shareholder

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37 U.C.C. § 2-615 (1978). The courts have had great difficulty with this provision and have been reluctant to grant relief under it. For further discussion of U.C.C. § 2-615, see supra note 28 and accompanying text.

38 For a related discussion of self-interest as a spur to managerial diligence in closely held corporations, see supra text accompanying notes 22-23.
has an incentive to appropriate as much as possible of the savings created by her supervision of management and little reason to share such gains with the noncontrolling shareholders. The position of the noncontrolling public shareholders resembles that of the minority of a closely held firm, except that there is a public market for their stock. The reason the market price for the noncontrolling public shareholders' stock is lower than it would be for the stock of a comparable firm in which there is no controlling stockholder, is the ability of the controlling shareholder of the publicly held firm, like her counterpart in the close corporation, to extract gains which are not shared with the minority shareholders. To the extent that the controlling shareholder in a publicly held firm does not fully exploit her position, she is acting benevolently toward the noncontrolling shareholders.

Second, buyers of shares in publicly traded, majority controlled firms can and presumably do, reduce their exposure to the risk of managerial or majority abuses by holding diversified portfolios. Minority shareholders in closely held firms are much less likely to be in a position to do this, since such firms are often organized and launched by individuals with limited resources. Further, the control group in a publicly traded firm is to some extent restrained in exploiting its controlling position by the risk of an outside takeover if it holds less than a majority of the shares. Even a majority control group may be to some extent constrained in exploiting its position by reporting requirements and the attendant risk of litigation. Any control group in such a firm has an incentive to adopt policies which cause its stock to perform well in the market if it is considering selling its own stock or raising additional capital.

The third difference between close corporation stockholders and owners of stock in publicly held companies is directly related to the considerations previously discussed. Owners of stock in publicly held companies rely on management's self-interest, market forces, and general principles of corporation law to induce management to operate the firm in their interest. Participants in closely held firms expect the controlling group to seek to promote the wealth of the firm because of their own interests, and they look to the assumed shared understanding and mutual interests to assure that they will share proportionately in the success of the firm. This suggested implicit mutual understanding appears to be finding recognition in case law, in the call for an expectations analysis of disputes in close corporations, and in the language of the statutes.

39 For a discussion of related inducements such as self-interest and risk of removal as methods of heightening managerial diligence, see supra note 24 and accompanying text.
under which shareholders may petition for involuntary dissolution. Typically, "illegal, oppressive or fraudulent" acts by those in control are the grounds upon which such relief may be sought. Illegality and fraud are terms with relatively clear legal meanings and include violations of statutory requirements and misappropriations of corporate assets. To have any independent meaning, "oppressive" must refer to conduct not embraced by either of these terms. Occasionally, its meaning is elaborated upon. For example, the New Jersey statute provides in part that a dissolution suit may be brought where "those in control . . . have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers or employees." Unfairness and oppression can only be given concrete meaning by reference to the explicit or implicit ex ante understanding of the parties and reasonable expectations based upon that understanding. These statutes can reasonably be viewed as treating the corporation as a vehicle through which the participants seek to implement an understood sharing arrangement in the operation of a business enterprise. Under these statutes, a transaction brought about by those in control which benefits only the control group or adversely affects only the noncontrolling shareholders may be the basis for rescission of the agreement, which takes the form of dissolution of the corporation. These statutes are relevant only to closely held firms, the only incorporated firms in which such a contractual understanding is likely to be present or necessary to protect the expectations of investors.

Three Massachusetts cases illustrate judicial responsivity to the problems arising from one party's repudiation of the implicit equitable sharing expectation. In *Donahue v. Rodd Electrotype Co.*, the majority had caused the corporation to repurchase that portion of its stock not needed to maintain control. The majority was subsequently required to cause the corporation to buy back the minority's stock at the same price on the same terms, thus terminating the jointly owned firm. *Wilkes v. Springside Nursing Home Inc.*, the second case, involved four equal shareholder-directors of a closely held corporation, one of whom was denied equal treatment with the others, contrary to past practices, as a result of a disagreement. On the surface, there was no reason to question the exercise of the discretionary authority to determine who should be employed to render services to the corporation. The court implicitly re-

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42 For a discussion of involuntary dissolution statutes, see supra note 32 and accompanying text.


ognized, however, that the corporation was a device by which the four individuals had contemplated sharing in the operation and benefits of a jointly owned business. Accordingly, the court held that the fourth member could not be excluded by the other three. The court said that the three members comprising the majority "breached their fiduciary duty to Wilkes as a minority stockholder." Finally, in the third case, a minority shareholder was held personally liable for using his contracted-for power to block corporate action in a manner which subjected the firm to unnecessary and avoidable tax liability. The court found that the defendant abused his power to veto corporate action, a power presumably given him to enable him to protect his investment against business decisions which he considered ill-advised, and perhaps to protect against the possibility of oppressive conduct by his associates, where such conduct was indisputably contrary to their common economic interest as shareholders.

The feature common to all three cases is that the defendants subsequently used their voting power to promote their own interest to the detriment of other participants. The courts imposed liability in such situations by finding a duty not to employ one's voting power, either as a shareholder or as a director, inconsistently with the purposes for which the power was originally agreed to. In other words, the defendants in each case had breached an implied understanding.

In other situations, the courts have concluded that the original sharing understanding was modified by subsequent events. For example, if the business was initially undercapitalized and only one of the participants was willing to make additional contributions, the courts have found that the parties by their conduct have implicitly agreed to a modification of the initially contemplated sharing of benefits understanding. Conversely, where the corporation has been immediately and unexpectedly successful, it is exploitative for some shareholders to cause additional shares to be issued to themselves at the initial offering price, even though the parties had originally contemplated that such shares would be issued.

The similarity between these problems and those arising in relational contracts is obvious. In both situations, a long-term business relationship has been created on unstated assumptions concerning the future course of events. Difficulties arise when events other than those contemplated occur or when one participant uses her managerial prerogatives to promote her own interest at the expense of the interests of the others.

48 Id. at 854, 353 N.E.2d at 664.
50 It appeared that the shareholder whose veto exposed the corporation to the tax liability was motivated by personal dislike and perhaps the desire to avoid additional personal income tax. Id. at 202, 422 N.E.2d at 800, 803.
The courts have resolved these disputes under the rubric of fiduciary duty. The difficulty with this approach is that law-imposed fiduciary obligations are a crude and unpredictable tool for this analysis; in fact, the heart of the matter, as in contracts and exchange transactions generally, is party intent, expressed and implied. These situations differ from contracts calling for immediate or short-term performances because of the higher risk that unforeseen contingencies may make performance disastrous for one party, a difficulty which they share with relational contracts.

The approach suggested here is in effect a revival and extension of an argument rejected by older cases which held that parties could not be partners as between themselves and an incorporated firm at the same time. Frequently, the issue in such cases was whether the prior joint

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53 Lash v. Lash Furniture Co., 130 Vt. 517, 296 A.2d 207 (1972). In Lash, three brothers owned equally all the outstanding shares of a corporation which held a right of first refusal to buy the shares of any one of them who wished to sell. Id. at 519, 296 A.2d at 209. One shareholder who had agreed to buy the stock of another in order to acquire control voted as a director against the corporation's exercising the option. Id. Since the selling shareholder abstained, this action prevented the corporation from exercising the option. In a lawsuit brought by the third shareholder challenging the corporate decision not to exercise the option, the court held that by blocking the corporation's exercise of its purchase option, the shareholder who had arranged to buy the shares himself had violated his duty to consider the repurchase transaction solely "from the standpoint of benefit to the corporation." Id. at 521, 296 A.2d at 210. The court said that this shareholder had violated his "duty to decide the question on the basis of property corporate policy." Id. There was no showing that the corporation was in any way adversely affected by its failure to exercise the option. In fact, it may well have been in a stronger financial position because this decision prevented its capital from being depleted. The only party who was adversely affected by the refusal was the shareholder who was deprived of a share of control as a result of the purchase by the second shareholder. A realistic analysis and justification of the result can be made only in terms of some obligation owed to this shareholder. A plausible basis for such an obligation is an understanding that the brothers contemplated equal shares in the enterprise and that the corporate repurchase option was designed to implement this understanding if one shareholder wished to withdraw from the firm. It would follow that the two brothers ought not to be able to alter this arrangement to the detriment of the third without his consent. A discussion of duties to the corporation in this context could lead either to liability or nonliability and is analytically meaningless.

54 Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910) (property of corporation formed under agreement with express intent to carry on business as partnership cannot be taken under control by court of equity for purposes of dissolution); Weisman v. Awnair Corp., 3 N.Y.2d 444, 144 N.E.2d 415, 165 N.Y.S.2d 745 (1957) (not possible for individual to carry on a joint venture through the instrumentality of a corporation). This view survives in some states. See Johns v. Caldwell, 601 S.W.2d 37 (Tenn. App. 1980) (close corporation treated as such by court despite plaintiff's argument that intent of organizing parties was to work as partnership); see also Boss v. Boss, 98 R.I. 146, 200 A.2d 231 (1964) (director-shareholders of corporation owe no fiduciary duty as stockholders to act in corporation's best interest by voting to refuse to purchase stock which they were personally interested in buying). This problem could be solved by issuing all of the stock in the corporation to the participants as co-partners. The stock would then be a partnership asset. The participants' respective interest in the partnership and its assets could then be set forth in the partnership agreement. The parties would then have the benefit of the mutual fiduciary obligations provided in partnership law, as well as the unilateral right of partner to terminate the partnership. In general, it appears that special control arrangements in close corporations are not an area of business organizations law which has received the benefit of imaginative or creative lawyering.
venture agreement survived the subsequent formation of the corporation. Now that it is clear under both statutes\textsuperscript{55} and case law\textsuperscript{56} that participants in close corporations can alter the standard hierarchical management structure of stock corporations, the earlier view—holding that joint venture arrangements could not survive the formation of the corporation—should be rejected, as it has been in more recent cases.\textsuperscript{57}

The view suggested here builds on that development. It simply assumes that parties who form closely held firms intend an equitable sharing of returns. It may be expected that those in control will take reasonable compensation for managerial services and that their views will prevail when there are disagreements over policy; but, it assuredly is not the common understanding that, in the event of serious disagreement, they would be free to use their managerial prerogatives to exclude the minority from sharing in gains generated by the business.

Such an implicit sharing understanding, it is suggested, is really what underlies the working-out of the duties imposed on the majority in Donahue and Wilkes. The Donahue and Wilkes recognition of this obligation does not break new ground or invade the majority's managerial prerogatives. In essence, the implied understanding requires the same inquiry that is involved under the involuntary dissolution statutes which permit the court to order dissolution because of "oppressive" conduct by those in control. The notion of an implicit understanding concerning sharing of gains gives a meaning to the term "oppressive" which is peculiar to the close corporation situation with which these statutes are exclusively concerned. It is oppressive for the majority to run the business efficiently and profitably while excluding the minority from the resulting gains. The courts have had no difficulty identifying such conduct in de-

\textsuperscript{55} E.g., N.C. GEN. STAT. § 55-73(b) (1982).
\textsuperscript{56} See, e.g., Helms v. Duckworth, 249 F.2d 482, 486-87 (D.C. Cir. 1957).
\textsuperscript{57} Cressy v. Shannon Continental Corp., 177 Ind. App. 224, 378 N.E.2d 941 (1978) (evidence sustained finding that parties intended equal ownership and control of "incorporated partnerships"); DeBoy v. Harris, 207 Md. 212, 113 A.2d 903 (1955) (partner's claim of breach against two other partners allowed where partners agreed to undertake joint venture under corporate form, then together voted to amend charter to allow increase in capital stock); McDonald v. McDonald, 53 Wis. 2d 371, 192 N.W.2d 903 (1972) (where corporate form used as instrumentality of partnership, form should be disregarded upon dissolution); see also Hallahn v. Halton Corp., 7 Mass. App. Ct. 68, 70, 385 N.E.2d 1033, 1034 (1979) ("Within ... a [close] corporation the principal stockholders owe to each other and minority shareholders the rigorous fiduciary duty of partners and participants in a joint venture"). For a critical review of New York's rejection of the joint venture approach, see Conway, The New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures, 30 FORDHAM L. REV. 297 (1961). A tacit understanding of equal sharing underlies the result in a later New York case in which one faction in a corporation whose shares were held equally by two families caused additional shares to be issued to themselves. Schwartz v. Marien, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975). In sending the case back for trial, the court of appeals held that the board of directors owed a "fiduciary duty" to the complaining shareholder not to disturb "the equality of the two-family ownership" and indicated that in order to sustain the transaction the board would have to show compelling reasons for doing so. Id. at 493, 335 N.E.2d at 338-39, 373 N.Y.S.2d at 128.
ciding cases under these statutes. Such explicit recognition of the implied contractual basis of the duties imposed on those in control invites the parties to bargain explicitly over these matters, by indulging a presumption of equitable sharing in the absence of contrary agreement. Once it is clear that the law will seek to imply, or will construct, such an understanding based on the dealings among the participants, the parties may be induced to make their understandings more explicit, and even to make advance arrangements for the possibility of disagreement, perhaps in the form of a dissolution or buy-out arrangement.

The remedial statutes adopted in many states give courts discretion to grant or withhold relief. These statutes have varied in the degree of discretion courts have been given to devise remedies to fit particular cases. Under the older statutes the only power given to the court was to grant or deny dissolution. The newest statutes grant a wide array of remedies. The Minnesota statute, for example, enumerates fifteen remedies which, in effect, permit the court to assume full control of the business. These statutes follow a pattern that has become familiar in other fields, notably the area of civil rights, in which the courts have undertaken to supervise the operation of school systems in order to assure compliance with the law. In commercial and business organizations law, such a broad and general legislative delegation to the courts of on-going control over the internal affairs and property of private firms occurs only when a firm is unable to pay its debts. It is highly unlikely that the participants, had they addressed the question ex ante, would have opted for such a potentially cumbersome and costly solution. Once a dispute has arisen, however, the disadvantaged party would welcome the availability of any statutory scheme which would be useful in negotiating a more advantageous outcome than is otherwise available.

The courts in recent years have shown an increasing willingness to


60 The writer is one of the commentators who continues to think that a simpler, easier, self-executing solution, such as a statutory buy-out right, would provide the same advantages at less cost to the parties, the judicial system, and the economy. A discussion supporting this approach is presented in Herington & Dooley, Illiquidity and Exploitation: A Proposed Solution to the Remaining Close Corporation Problem, 63 Va. L. Rev. 1 (1977). It has been suggested that an advantage of the discretionary approach is that it avoids the loss to the economy resulting from the liquidation of viable firms and that a serious disadvantage of a mandatory buy-out-or-liquidate rule is that it may result in such loss. Hence, it is said that the buy-out solution "would often be unworkable and could be inequitable" while it is "highly improbable" that discretionary remedies "will have the effect of depriving the community of a viable business." Olson, A Statutory Elixir for the Oppression Malady, 36 Mercer L. Rev. 627, 634, 643 (1985). Usually, as in this example, no authorities are cited for these propositions. In the cases examined by Professor Dooley and this writer, there was no example of a "viable business" being destroyed by dissolution. Typically, the parties promoted their mutual economic interests through a buy-out whether dissolution was ordered or not. Nor did we find any more reason to conclude that buy-outs were any more "unworkable" than cancellation or rescission of contracts.
sustain unanimous contracts among shareholders in close corporations which significantly alter the standard statutory management structure. 61 These cases implicitly recognize the contractual basis of the incorporated business enterprise and take the logical step of validating explicit contractual arrangements made by the parties to promote their joint interests and to manage their potentially conflicting interests. On the other hand, the courts have persisted in scrutinizing and limiting the enforceability of non-unanimous agreements among shareholders. Generally, such agreements are valid so long as they are limited to voting for the board of directors, as in the famous Ringling 62 case. However, where the agreement extends to the control of managerial decisions by the board, these agreements continue to be struck down, primarily on the ground that they infringe the rights of the non-participating shareholders. 63 This result is consistent with the thesis of the present discussion because such non-unanimous agreements are invariably entered into some time after the formation of the corporation, and insofar as such agreements attempt to control management policy, they are likely to be inconsistent with the ex ante expectations of the non-participants. Even a Ringling-type arrangement to some extent adversely affects the interest of the non-participating shareholder, because it forecloses the possibility of her forming a coalition with one of the parties to the agreement. However, since the possibility of an agreement among the members of a share-voting coalition was present from the beginning, the courts have considered this a risk that the non-participant should be deemed to have agreed to take. Non-unanimous agreements on matters of corporate policy which detrimentally affect the non-participating shareholder are another matter, and the courts have been unwilling to consider that such arrangements were within the implied bargain made by the minority investor.


63 This view is settled law in New York. Triggs v. Triggs, 46 N.Y.2d 305, 385 N.E.2d 1254, 413 N.Y.S.2d 325 (1978) (provisions of an agreement between principal shareholders affecting election and compensation of officers illegal since not all shareholders were party to agreement) (dictum); Christal v. Petry, 275 A.D. 550, 90 N.Y.S.2d 620 (1949) (agreement between two principal shareholders to reduce statutorily designated number of directors and select all directors held invalid); aff'd, 301 N.Y. 562, 93 N.E.2d 450 (1950); Flanagan v. Flanagan, 273 A.D. 918, 77 N.Y.S.2d 682 (1948) (contract between principal stockholders for distribution of corporate property held invalid on grounds corporation and other shareholders were not parties to contract); see also Glazer v. Glazer, 374 F.2d 390 (5th Cir.), cert. denied, 389 U.S. 831 (1967). Non-unanimous agreements affecting policy which do not differentially affect the minority may receive favorable treatment. See generally Comment, "Shareholders' Agreements" and the Statutory Norm, 43 CORNELL L.Q. 68, 74-76 (1957).
The difference in the judicial treatment of unanimous and non-unanimous agreements follows from the thesis of the present discussion. Unanimous agreements are likely to have been made at the outset, or if entered into subsequently are a revision of the original understanding to which all parties consent. Non-unanimous agreements are invariably the result of a subsequent alignment among the participants, usually on the basis of an intervening disagreement with the non-participants. Such agreements are almost certain to be inconsistent with the reasonable ex ante expectations of the non-participating shareholders. As unilateral coalitions among some shareholders which affect the non-participant’s investment, nonunanimous agreements may be struck down if there are ex post changes in the terms of that investment which adversely affect its value.

B. Elimination of Public Shareholders in Publicly Held Firms

The state of the law that emerges from the more recent cases on this subject is that the controlling shareholder in a publicly held firm may force the minority to sell its shares at a “fair” price. The requirement that such transactions have a business purpose, apart from the interest of the control group in eliminating the minority, has been explicitly abandoned or severely eroded.4 Full disclosure of information relevant to the determination of the value of the stock is required, and there may be judicial review of the valuation. This much discussed, and often deplored, state of the law is the converse of the usual problem of minority shareholders in closely held firms whose usual complaint is that their investment is retained in the business while they are excluded from sharing in present and prospective returns generated by the firm. The remedy frequently sought for this situation is a forced buy-out by the majority at a price which fairly reflects the minority’s pro rata share of the value of the firm. Forced buy-outs are the solution in the close corporations and the problem in publicly held companies. The behavior of close corporation minorities in seeking this form of relief points to the obvious conclusion that it is better from the investor’s standpoint to sell out, provided there is a reasonable assurance of price fairness, than to be locked in while being deprived of earnings generated by one’s investment.5

64 Weinberger v. UOP, 457 A.2d 701 (Del. 1983) (upholding “freeze-out” merger of minority’s acres in subsidiary corporation, directors of which were also directors of purchasing parent corporation; remanded to determine fair market value of shares); see also Laird v. ICC, 691 F.2d 147 (3d Cir. 1982) (railway’s elimination of minority shareholders’ support system deemed proper purpose for reverse stock split), cert. denied, 461 U.S. 927 (1983); Harman v. Masonelian Int’l, 442 A.2d 487 (Del. 1982) (invalidating “freeze-out” merger for defendant’s failure to establish business purpose for merger other than freeze-out); Cross v. Communication Channels, Inc., 116 Misc. 2d 1019, 456 N.Y.S.2d 971 (1982) (invalidating “freeze-out” by which controlling shareholder sought to “go private”; legitimate business purposes established).

65 Of course, the majority shareholder in a close corporation would pay some price for the minority’s stock, but not a price which reflects is proportionate share of the value of the firm.
both publicly held and close corporations, the sale itself produces costs for which there may not be full compensation, e.g., the seller is subjected to immediate tax liability and may incur search costs in finding a new investment. There may also be a loss of idiosyncratic value if the shareholder values the particular investment for reasons apart from its economic value.

The forced liquidation of a stockholder's investment may be characterized in various ways. It has been called private eminent domain, a label which implies that such a forced sale is or should be improper. The forced taking of one person's property by another, even at a fair price, is a substantial invasion of property ownership rights. As applied to almost any form of property other than an investment security, a forced taking would be unacceptable. But investment securities are a peculiar form of property, as a contractual analysis shows. Majority shareholders have traditionally been able to force changes in the minority's investment and even to force a sale of the investment, through mergers and sales of assets approved by majority vote. The effect of a squeeze-out on the minority is exactly the same. However, the identity of the purchaser is important because of its effect on the majority's incentive. Where the business is being sold to a third party, the majority has an incentive to negotiate the best possible price; where the majority itself is the purchaser, its incentive is the opposite.

In contract terms, the situation of the public shareholder under the present state of the law can be described as follows: the buyer of stock in a publicly held corporation purchases an interest in the company's future income, subject to the possibility that because of circumstances over which she will have no control she may be forced to sell at a price which fairly reflects its then value. One of the circumstances under which such a forced liquidation may occur is the sale of the stock to a person who has assembled a controlling position in the company. Such a controlling shareholder may force such a sale whenever she concludes that her wealth would be enhanced by eliminating public investors in the enterprise. In analyzing this aspect of corporation law, the initial question is not whether such a forced sale of private property should be permitted; it is whether buyers of stock in publicly held companies should be permitted to make contracts containing this provision. The answer to this question ought to turn, at least initially, on whether buyers of stock would wish to make such a contract. If they would, then the question becomes whether there is a reason they should not be permitted to do so, because it appears, judging from the behavior of investors in the market, that they do not regard such contracts as undesirable.

Ex ante, there is no reason for public shareholders to object to this provision, because it enhances the value of their investment by increasing

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the number of potential bidders for their stock. In view of the fact that
repurchase prices in decided cases have always been substantially higher
than the then prevailing market prices, there seems to be little reason to
think, despite the possibility of undiscovered values being appropriated
by insider purchasers, that buyers of stock would object to this rule. The
probabilities are that this rule increases the value of their stock and
should, therefore, increase the attractiveness of publicly offered equities
to rational wealth maximizers.

Rules enabling minority shareholders to challenge buy-outs under a
business purpose test or other rules permitting an inquiry into the buyer’s
motives reduce the value of the investments of all shareholders in pub-
clicly held companies by increasing the difficulty (and thereby reducing
the frequency) of attempted buy-outs by insiders. Any rule which
reduces the aggregate demand for shares held by the public, therefore,
reduces their value.

A rule which enables individual shareholders to obstruct such trans-
actions gives rise to the problem that made the old unanimity rule for
mergers and sales of assets unworkable, \(i.e.,\) the last shareholder whose
approval was required could capture a disproportionate share of the gain
by holding out. The possibility of strategic behavior arises whenever one
party stands to lose less from blocking a transaction than another. In
such a situation, there is a temptation for the individual with blocking
power to coerce a side payment for permitting the transaction to proceed.
This suggests that there are serious efficiency costs in permitting minori-
ties to obstruct reorganization transactions and that these risks arise
whenever the minority is given rights which enable it to demand more
than the “fair” value of its shares as a condition for its consent to a
reorganization transaction. As has been demonstrated by Professor Eas-
terbrook and Fischell, a rule which requires gains from reorganization
transactions to be equally shared among all shareholders, thereby deny-
ing controlling shareholders a premium for their control position, will
decrease the frequency of such transactions, interfere with the movement
of corporate resources to more highly valued uses, and reduce the aggre-
gate wealth of all shareholders.\(^6\)\(^7\)

There has been some demand by academic writers that investors
should be protected against (that is, should not be permitted to make)
investment contracts containing the provisions which have grown up
under present law as described above. Of course, the state may restrict
or prohibit contracts which, for sufficient reason, are found to be inimical
to public or private welfare. However, as long as sellers are permitted to
offer investment contracts with differing features and buyers can decline
to purchase if the combination of features of the particular investment
contract seems disadvantageous as compared with other available oppor-
tunities, the fact that some observers disapprove of the terms of some of

the investment contracts being traded in the market does not make a case for proscribing them. In corporations, as in contract law generally, the substantive content of exchange transactions can in the first instance be left to the participants and intervention reserved for situations in which it appears that the reasonable expectations of the participants are being frustrated.

C. Parent-Subsidiary Relationships

Initially it seems plain that the responsibilities of a parent corporation to the minority shareholder in a partially owned subsidiary are the same as those owed by any other majority shareholder to the minority in a publicly held firm. There are, however, some important practical differences. In discussing the obligations of the majority to the minority up to this point, this article has dealt with the sharing of gains generated by the corporation in which the majority and minority were stockholders and with the power of the majority to compel the liquidation of the minority's investment in the firm. It made no difference in these situations whether the controlling shareholder was itself a corporation or not.

Two types of problems, however, arise primarily or solely in the parent-subsidiary situation. The first concerns corporate opportunities. Where the two corporations operate related businesses, there may be a problem in allocating business opportunities between them. This is a standard corporate opportunity problem. Parent-subsidiary conflicts are often factually more difficult than those in which management seeks to take for itself an opportunity arising from the business of the firm it is managing: in the parent-subsidiary situation, each corporation may have a plausible claim to the opportunity based on its relationship to each corporation's existing business. The management of the parent owes its shareholders an obligation to permit the subsidiary to take no more than it is entitled to take under the law. The problems are similar to those that arise when the parent and the subsidiary do business with each other. In such cases, the permissible terms of such a transaction are those that would result from arms' length bargaining.68

The allocation of gains and losses arising directly from the control relationship itself poses a different problem. Most of the reported litigation concerns the allocation of tax savings resulting from the fact that parent corporations and their eighty percent-owned subsidiaries may file

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68 Where a parent sells to or buys from its partially owned subsidiary, it is clear that it must do so at a "fair" price. Where the goods bought or sold are traded in an active market, the parent-subsidiary transactions must occur at the open market price. The leading case on parent-subsidiary transactions is Price v. Standard Oil Co., 55 N.Y.S.2d 890 (1945). Where the transactions are more complex, such as the operating of the partially owned subsidiary's railroad as a part of the parent's system, this is not an administrable standard. In such a case, it has been said that objecting minority shareholders in the subsidiary can prevail only by showing that the terms on which revenues were shared were outside a zone of reasonableness within which unrelated parties could have contracted. See Ewen v. Peoria & E.R.R., 78 F. Supp. 312 (S.D.N.Y. 1948).
FIDUCIARY RESPONSIBILITIES

There is no obligation to file such a return under the Internal Revenue Code.\(^69\) It would appear, however, that in the absence of a business reason for not doing so, the management of the parent owes an obligation to its shareholders to file a consolidated return, if doing so would increase their wealth. This obligation follows from the normal expectation of shareholders as residual claimants that managers will operate the firm so as to benefit their economic interests. From the standpoint of the shareholders of the parent corporation, the tax saving is a control premium made available by their collective purchase of eighty percent of the subsidiary's stock. As the following analysis indicates, however, it is more difficult to discover a similar expectation and obligation on the parent's management to benefit the minority shareholders in the subsidiary.\(^70\)

Consider first the situation in which the parent's profits are sheltered from income tax by filing the subsidiary's losses on a consolidated return. If the parent takes no further action, the minority shareholders in the subsidiary will get no benefit from the resulting tax savings except to the extent that it is better to be a minority shareholder in a subsidiary controlled by a wealthier (rather than a less wealthy) parent corporation.

Without the filing of the consolidated tax return, the subsidiary would have had a tax loss carried forward which would have value, since, if the subsidiary were sold or merged, the price received by the selling shareholders would have included some payment for the tax loss which could be used to shelter the purchaser's future income. It may be just this tax saving that the parent corporation sought to purchase when it acquired eighty percent of the subsidiary's stock. There is no obvious reason why the parties to the purchase and sale transaction would, or should, anticipate that a gain generated by that transaction would have to be shared with non-participants. From the minority's standpoint, the tax saving is truly an accident, the existence of which is wholly dependent on the voluntary conduct of others who, in bringing about this benefit, are in no way obligated or motivated to increase the wealth of the minority. The parent, on the other hand, has made the tax saving possible through the commitment of resources to the enterprise and may reasonably be assumed to have done so in part to achieve this particular benefit. On the other hand, minority shareholders are not worse off by

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\(^69\) I.R.C. § 1501 (1982).

\(^70\) The argument developed in the text is to some extent anticipated in Note, Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations, 74 YALE L.J. 338 (1964) which argues that "fairness" as a test of the validity of such transactions has "an inherent bias in favor of the dominated unit," and that this test "has served principally as a means of rationalizing decisions against defendant control-groups." Id. at 340. The Note writer argues that it would be "more fruitful to define fairness . . . in terms of the shareholders' 'expectation' " because this approach leads to a search for party intent "on their entrance in to the relationship." Id. at 349. "Fairness should be sought in the degree to which the particular transaction . . . conformed to the expectations of the parties, as of the time the relationship was entered into, or perhaps, as of the last time when the complainant had a realistic chance of ending his participation therein." Id. at 350-51.
being denied a share of such purchase-generated gains; they simply are not better off. Denying them a share of these gains is unlikely to violate any of their ex ante expectations as investors. Shareholders look for gains from the operation of the business. Those accruing solely from changes in its ownership that do not affect its operations or revenues should not be considered to be within the range of their legally recognized expectations. Further, purchases of controlling interests in failing firms are often rather risky investments, and there are obvious policy reasons for encouraging them. A rule which reduces the incentive to make such purchases would, to that extent, seem undesirable. On the other hand, failing to recognize the claim of the minority to participate in such benefits would not appear to have any adverse behavioral consequences. Finally, it should be noted, if the parent does not have a legal obligation to share the tax savings with the subsidiary's minority, for it to do so voluntarily would be a waste of its assets for which its shareholders should have an action against its management.

The analysis of the converse case, in which filing a consolidated return shelters subsidiary's profits from income tax because of the parent's losses, leads to a similar result. If the parent takes the entire tax saving, the minority shareholders are no worse off than they would have been if they were no parent corporation or if a consolidated return had not been filed. The claim of the minority to be made better off must be based on one of two views either that: (1) the parent owed the minority a duty to cause a consolidated return to be filed, or (2) the parent owed no such duty but was obligated to share any resulting gain if it elected to file a consolidated return. The claim of minority shareholders in the subsidiary can only arise from a contractual obligation, express or implied, quasi-contract, or a fiduciary duty imposed on the parent to the minority. It seems implausible to suggest that such an obligation would have been agreed to at the time control was bought by the parent had the issue been raised. This seems a fairly safe assumption, since neither the parent nor those from whom it was buying control would have anything to gain from the creation of such a sharing obligation to benefit a nonparty. Similarly, there appears to be no reason why the nonparticipating minority shareholder would expect that, in a purchase of control transaction, a sharing obligation would be considered or agreed to for their benefit. They would therefore have no reason to attach any value to the possibility that a sharing obligation would be negotiated.

Finally, there is no basis for implying a sharing obligation in favor of the minority as a matter of law. The usual requirement of quasi-contract that the claimant have conferred a benefit upon the defendant due to circumstances under which the law would imply an obligation to pay to avoid unjust enrichment seems not to be met here, because the minority shareholders have done nothing to create the benefit of which they demand a share. Nor can they be said to have acted in reliance, reasonable or otherwise, on an expectation of sharing. Consequently, a judicially
imposed sharing requirement seems unjustifiable.\(^7\) An expectation model of the corporation, therefore, supports the conclusion that no such obligation should be imposed. As a matter of policy and quite apart from party intent and expectations, there are reasons why such an obligation should not be imposed. In terms of the efficient deployment of assets, the cost of a rule which requires that gains be shared by those whose activities produce them with those who have not invested in their production reduces the incentives of the efficient deployment of resources. If it is correct, as previously suggested, that the minority shareholders have no expectation of sharing such gains, permitting them to share at the expense of those whose activities produced these gains simply creates an unnecessary cost of purchasing control. Like any other such cost, it reduces the incentives to acquire control and, therefore, inhibits the movement of resources to their most highly valued use. A rule which has this effect is, of course, contrary to the economic interests of investors.

The results in the cases have been more consistent with the contractual analysis suggested here than with any other. Where a loss has fallen on the subsidiary because of third party’s conduct based on the control relationship, the parent has not been required to share it.\(^7\) Where the result has been a benefit which in the first instance has fallen to the parent, the parent has been allowed to retain it.\(^7\) Where the benefit has initially accrued to the subsidiary, the parent has been allowed to appropriate most of the benefit to itself,\(^7\) although some courts have required some sharing of the benefit in this situation.\(^7\)

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\(^7\) Generally accepted formulations of quasi-contractual principles are not sufficiently inclusive to encompass sharing claims on behalf of the subsidiary's minority shareholders in this situation. See Wade, Restitution for Benefits Conferred Without Request, 19 Vand. L. Rev. 1183, 1212 (1966). Consequently, the only available basis upon which such a claim must be asserted is an ex ante contractual exception.

\(^7\) Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970).

\(^7\) Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).


\(^7\) Smith v. Tele-Communication, Inc., 134 Cal. App. 3d 338, 184 Cal. Rptr. 571 (1982); Alliegro v. Pan Am. Bank, 136 So. 2d 656 (Fla. Dist. Ct. App. 1962), cert. denied, 149 So. 2d 45 (Fla. 1963). In Smith, the parent caused the subsidiary to write a check to it for the amount of the tax saving, 134 Cal. App. 3d at 342, 184 Cal. Rptr. at 573. The court held, as suggested in the text and contrary to the argument made here, that "[f]airness requires a proportionate sharing of the benefit." Id. at 346, 184 Cal. Rptr. at 575. Had the court followed the analysis argued here and held that the parent was entitled to the entire saving, a further difficulty would have arisen, with which the argument in the text does not deal. On what theory can the parent instruct the subsidiary to issue a check for the amount of the saving? Corporations can disburse funds only to pay legal obligations or dividends, and such a disbursement is neither. In Alliegro, such a payment was held to be an unlawful non-pro rata dividend. Alliegro, 136 So. 2d at 661. It follows that, if the theory argued in the text were followed, a contract would need to be entered into between the parent and subsidiary. See Case
III. CONCLUSION

The thesis of this article can be simply stated. It begins with the proposition that stock corporations should be viewed as networks of contracts by which persons contribute goods, capital, and services to the enterprise and purchase outputs produced by it. These contracts are exchange transactions governed generally by contract law. The contracts made by the purchasers of an equity investment in the firm differ from those made by others who deal with the corporation because only the equity purchasers buy interests in the future residual income which the business is expected to generate. The expectations of others who contract with the firms are protected by contract law, therefore, if the corporation fails to deliver the goods, services, or payments called for in the agreement, the adversely affected parties have legal remedies and may ultimately force the firm into insolvency if it fails to perform.

While stock buyers, like others who contract with the firm, have purchased contract rights, the performance they expect cannot be promised. The firm may or may not succeed, despite the best efforts of those in control. Under these circumstances, if the buyer is not assured of the best efforts of managers, she has nothing. Contracts made by stock buy-

v. New York Cent. R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965). The argument in the text supports the view that an agreement under which the parent takes virtually the entire gain is "fair".

Commentators have been critical of the results in the cases cited in this and the preceding three notes. See Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 308-309 (1974), arguing for proportional sharing based on the market prices of shares of each corporation. Brudney and Chirelstein's view has been criticized as being "devoid of any connection with the relative contributions to the tax saving, [and therefore] entirely haphazard and arbitrary." Shreiber & Yoran, Allocating the Tax Saving Derived from Filing Consolidated Corporate Tax Returns, 29 BAYLOR L. REV. 243, 249 (1977). These authors argue for allocation of the entire tax benefit to the loss subsidiary on the basis of "considerations of economic efficiency" and, in the reverse case, allocating the entire benefit to the loss parent "for considerations of symmetry." Id. at 253. The basis of this suggestion is that in the loss subsidiary case a rule permitting the parent to take virtually all the tax saving is inefficient because it gives the parent an incentive to cause the subsidiary to undertake "projects with a high degree of risk and low expected rate of return." Id. at 252. It is difficult to know how seriously to regard this possibility. It is not clear why any management would want to invest in such projects, quite apart from the considerable risk of suit by the minority in the subsidiary. Suits against parent corporations by minorities in subsidiaries have considerable nuisance value and have the substantial advantage, as compared with suits by shareholders against managements generally, of a solvent defendant whose conduct is measured by a strict standard of fairness. See generally Sinclair Oil Corp. v. Leven, 280 A.2d 717 (Del. 1971). One of the "skews" immanagerial incentives which is said to adversely affect the economic incentives of shareholders in publicly held companies is that managers, whose portfolios are generally not diversified, are excessively risk averse. A recent article on the point is Marcus, Risk Sharing and the Theory of the Firm, 13 BELL. J. ECON. 369 91982), which suggests that minority shareholders in the subsidiary may, therefore, not be disadvantaged by some reduction in risk aversion by management. Id. at 377.

There is simply not enough substance in these speculations to justify interference with private ordering. Taken together, the proposals of Brudney and Chirelstein, and Shreiber and Yoran point to the inappropriateness of having judges or academics make contracts for investors based on their own visions of fairness and efficiency.
ers, therefore, contain a number of explicit and implicit provisions which
together provide some assurance that the management will in fact en-
deavor to produce net revenues. The most important explicit provision is
that the common shareholders have the collective right to select and re-
move directors. The most important implicit provision is that managers
are under an obligation to be competent, diligent, and loyal to the eco-


nomic interests of the common stockholders. The fiduciary duty of man-
gers and of majority shareholders to minority shareholders is derived
from the expectations of the parties to the transaction in which stock is
bought by investors. The reason this obligation follows from the inten-
tions and expectations of the parties in the issuance of common stock,
and from no other transaction between a stock corporation and those
who deal with it (customers and creditors, for example), is the difficulty
of precisely defining the terms of the obligation that the management has
assumed.

This model for deriving the fiduciary obligation of corporate manag-
ers and controlling shareholders from the contracts and expectations of
shareholders differs from the conventional legal treatment of fiduciary
obligations, which considers such obligations as being imposed by the
law on managers and controlling shareholders without reference to the
expectations and intentions of the parties. The objection to the tradit-
ional derivation and formulation of the fiduciary concepts is that it pro-
vides no basis for determining the limits of such obligations. Established
and generally acknowledged limitations on the fiduciary obligations of
managers and controlling shareholders therefore appear to be anom-
alous, unpredictable, and unprincipled exceptions to fiduciary obligations.

Further, this traditional approach makes no allowance for differing obli-
gations in different settings: specifically, that the content and the direc-
tion of fiduciary obligations differs in closely and publicly held firms.
Much of the initial difficulty experienced by courts in close corporation
cases resulted from the fact that shareholders in publicly held firms were
said to owe no obligation to each other, and this notion carried over to
closely held firms.

This article has argued that, if fiduciary obligations are viewed as
rooted in the expectations of the parties, the limitations on the scope of
such obligations can be seen as both principled and logical. Most impor-
tant, is the fact that the limitations are consistent with the enhancement
of the wealth of shareholders. Equity investors are assumed to be ra-
tional wealth maximizers who would seek to have an equal sharing rule
imposed on controlling shareholders only to the extent that such a rule
would enhance their wealth. Ex ante, rational investors would not favor
a rule prohibiting control premiums, because such a rule would be an
obstacle to the transfer of control to persons who are likely to manage
the corporation more efficiently to the benefit of all stockholders. Simi-
larly, experience has shown that ongoing private transactions result in
payments to public shareholders which exceed market prices and prob-
able prices that could be obtained from other buyers; hence, a rule barring such transactions is not wealth enhancing to investors. Gains accruing solely to the creation of a parent-subsidiary relationship appear (so it was argued) not to be within the sharing expectation of minority shareholders in a subsidiary. Denying shareholders the right to participate pro rata in such gains, as the courts have done, is not inequitable. The principal that emerges from these examples is that the economic interests of noncontrolling shareholders are enhanced by rules that permit majority shareholders to engage in some transactions from which they receive gains that are not shared with noncontrolling shareholders.

In close corporations, the most, indeed the only, plausible assumption concerning the ex ante expectations of the participants is that the majority would not use its controlling position to exclude the minority from participation in the earnings of the firm without cause, i.e., unless the minority ceases to participate in the enterprise as anticipated. The transactions giving rise to litigation in close corporations have been exploitative: that is, the majority has in fact used its position to appropriate a disproportionate share of the value of the firm. No efficiency gains have been involved, and the value of the minority's investment has been adversely affected. The imposition of liability on controlling shareholders under these circumstances, in effect, implements the implicit ex ante understanding of the participants.

It is not suggested that recognition of the dependence of fiduciary obligations on the underlying understandings and expectations of the parties is an easy and final solution to the problem of allocating gains and losses among shareholders. It is submitted, however, that this approach is a more precise and accurate tool for determining the scope of such obligations and will yield results more consistent with the ex ante intent of the parties than the uncompromising dogmas which have characterized judicial opinion in this area. This approach is also more consistent with the central role of party autonomy and intent in commercial law generally and with the results in cases in which the courts have recognized limits on fiduciary obligations of majority shareholders. One might even hope that explicit recognition of the contractual basis of these obligations will facilitate bargaining with respect to the scope of these obligations, a practice which traditional doctrine discourages.