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Corporations — California Expands Majority Shareholders' Fiduciary Duty to Minority Shareholders

Defendants, majority shareholders in a closely held savings and loan association, formed a holding company and exchanged their interests in the savings and loan association for holding company shares. The savings and loan shares, unlike those of the holding company, were not readily marketable because of their high book value. The minority shareholders of the savings and loan association were excluded from participating in this scheme, and the defendants thus retained control over the savings and loan association. Later, holding company offers to purchase the minority interests were substantially below savings and loan association book value. The minority shareholders claimed loss of significant profits due to exclusion from holding company participation. The lower court found no property right of the minority to have been damaged, and therefore no breach of fiduciary duty.

Held, reversed: Majority shareholders have a duty to allow minority shareholders equal proportional participation in any scheme that utilizes or affects control of the corporation. Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

I. Standards of Fiduciary Duty in Corporations

Courts have long been plagued with the problem of defining standards of conduct among the principals in corporate activities. At the heart of the problem are the competing policy considerations of assuring investors reasonable protection from the self-interest of dominant, controlling corporate interests, while avoiding entrepreneurial paralysis. Resort has thus been made to the fiduciary principles of agency and trust for a workable balance. Imposition of a fiduciary duty upon majority shareholders often is an extension of the duty imposed upon corporate directors. But the factors giving rise to the duty and its subsequent application vary, depending upon the relationship between the parties.

Duty of Directors. Generally, corporate directors are charged with the

1 The holding company offered to purchase association shares for $1,100 per share when the book value was $1,411.57 plus earnings of $301.15 per share. At the same time, those holding company shares which derived from one savings and loan share had an equivalent value of $3,700, and there had been a $927.50 return of capital subsequent to the holding company's initial stock offering.


3 Note, Fiduciary Duty of Officers and Directors Not To Compete with the Corporation, 54 Harv. L. Rev. 1191 (1941).

4 The extension of the "good faith" obligation of controlling stockholders to the minority is not a recent development. This duty was established in Ervin v. Oregon Ry. & Nav. Co., 27 F. 625, 631 (C.C.S.D.N.Y. 1886), where the court determined that "when a number of stockholders combine to constitute themselves a majority in order to control the corporation as they see fit, they become for all practical purposes the corporation itself, and assume the trust relationship occupied by the corporation towards its stockholders."
basic fiduciary duties of good faith in managing corporate affairs, not profiting from insider-information, and not utilizing corporate opportunities for personal gain. However, the various states differ in their views as to when and to whom these duties attach. The courts have developed three basic approaches in delineating proper and improper conduct by directors.

The old majority rule holds that the fiduciary duty is owed only to the corporation. Thus, injury to the corporation is necessary to establish a breach of duty. In recognition of the potential inequities of the majority rule, many courts have created the "special facts" exception. This rule is that where special circumstances exist which make withholding information unfair, the duty to disclose arises. The minority view, which is gaining support, imposes a duty upon those in control of a corporation to act in the best interests of the corporation and the individual shareholders. This duty runs to all shareholders, and a director is precluded from receiving any personal advantage by dealing with the corporation without the fullest disclosure to all affected parties.

Duty of Majority Shareholders. Two approaches may be used to place fiduciary duties upon majority shareholders. The direct approach looks at the relationship between majority and minority shareholders, and concludes that equity establishes a fiduciary relationship. The majority's position of superiority and influence forces the minority to rely upon principles of good faith and fair dealing. In the words of Justice Brandeis: "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority." The indirect approach looks first at the relationship between the dominant stockholders and the directors, and concludes that if the shareholder dominates the corporation through his influence over the directors, then the shareholder assumes the directors' fiduciary duty to the minority. Agency principles are used to extend the legal fiduciary obligation of the directors to the controlling stockholders who are responsible for the directors' acts.

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5 Justice Cardozo defined this good faith duty as "something more than the morals of the market place." He further elaborated that this was not honesty alone but "the punctilio of an honor most sensitive." Meinhard v. Salmon, 249 N.Y. 459, 464, 164 N.E. 545, 546 (1928).
8 The following, oft-quoted language is representative of this majority view: "[The] stockholders . . . had a perfect right to dispose of their stock . . . without the slightest regard to the wishes and desires or knowledge of the minority shareholders . . . ." Ryder v. Bamberger, 172 Cal. 791, 806, 158 P. 753, 759 (1916).
10 Practically every legal writer in this field has approved the so-called minority view. "Id. at 380, 159 P.2d at 984.
13 This is the approach taken by the court in the Ervin case. See note 4 supra.
14 For a thorough examination of the direct and indirect approach theories, see Comment,
The United States Supreme Court, in *Southern Pacific Co. v. Bogert*,
recognized that the dominant shareholders should be charged with a fidu-
ciary duty. The Southern Pacific Company, through one of its subsidiaries
as majority shareholder, exercised control over the old Houston Company.
Pursuant to a reorganization, a new company was formed and all of the
new stock was issued to Southern Pacific. The lines of the old Houston
Company were merged with the transcontinental railroad system of
Southern Pacific. The minority stockholders received nothing for their
stock in the old Houston Company. The Supreme Court imposed a fidu-
ciary duty upon Southern Pacific as the controlling shareholder, and de-
clared a trust for the benefit of the injured minority shareholders. A fidu-
ciary obligation was placed upon controlling shareholders as if they were
"the corporation itself or its officers and directors."

In *Pepper v. Litton* the Supreme Court said that a dominant stock-
holder could not use the corporation for his own personal advantage and to
the detriment of the other stockholders and creditors. Litton had formed
a one-man corporation and utilized the corporate form and fraudulent
salary claims to force the corporation into bankruptcy to avoid payment of
valid debts. Litton used his dominant influence over his corporation to
manipulate its affairs in such a manner that when one of its creditors came
to collect a valid debt, the assets had disappeared into another Litton
company. In a suit against Litton by a defrauded creditor, the Court im-
posed a fiduciary duty to exercise the power of control at all times for the
benefit of the corporation and not for the "aggrandizement, preference,
or advantage of the fiduciary to the exclusion or detriment of the
cestuis."

The *Pepper* case was extensively relied on by the California courts in
*Remillard Brick Co. v. Remillard-Dandini Co.* This case involved two
brick companies whose common directors used their majority power to
strip the companies of their sales functions and transfer them to a corpora-
tion in which these same directors were the sole owners. The brick com-
panies’ minority shareholders sued for the large profits made by the sales
corporation. The Court held that a director was a fiduciary and must ad-
minister the corporation for the common benefit of all shareholders.

Majority shareholder fiduciary duty was expanded in the celebrated case
of *Perlman v. Feldmann*. Feldmann was director and majority stock-
holder of Newport Steel Company during the steel shortage period sur-
rounding the Korean conflict. Feldmann sold his control block of shares at
a premium price to a group of the company’s customers, thereby destroying
the competitive edge enjoyed by Newport. The court of appeals held that

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10 210 U.S. 483 (1919).
11 Id. at 487-88.
12 308 U.S. 295 (1939).
13 Id. at 311.
14 Id.
16 Id. at 413, 241 P.2d at 74.
17 219 F.2d 173 (2d Cir. 1955).
the control premium was, in effect, a corporate asset, and Feldmann could not appropriate it for his own benefit. Minority shareholders were entitled to share in the premium paid for control.

California reached a similar decision recently in *Brown v. Halbert.* Halbert, majority shareholder, board chairman, and chief executive officer of a savings and loan association, sold his controlling interest at a premium price of $1,548 per share. He then used his authority to assist the buyer in obtaining the remaining minority interests for only $300 per share. The state court of appeals said that a sale of a control block of shares is not subject to attack per se, but when the price available to the minority is highly disproportionate, the fiduciary seller bears the burden of proof of good faith. The *Brown* case set forth the rule that the dominant majority shareholder must act affirmatively and openly to obtain for the minority substantially the same advantages as are due to the majority.

II. Jones v. H.F. Ahmanson & Co.

To take advantage of investor interest in savings and loan associations, the defendants, majority shareholders, formed a personal holding company, rather than make the association's stock more attractive. The California supreme court found this action to be in violation of their fiduciary duty to the minority to use their majority shareholder power to promote a marketing scheme to benefit all shareholders proportionately.

The defendants relied on the majority rule that no duty was owed to the minority absent fraud or use of insider-information. They pointed out that control of the association had not changed hands, nor had the association been damaged. However, Justice Traynor, speaking for the court, rejected this argument. Relying on *Remillard Brick Co. v. Remillard-Dandini Co.* and *Pepper v. Litton,* the court found that the controlling interest in a corporation, whether it be directors, officers, or shareholders, owed a duty of "common decency and honesty" to the individual shareholders as well as to the corporation itself.

The court discussed the minority and special facts rules concerning fiduciary duty of directors and officers. The minority rule was summarized as one of "inherent fairness from the viewpoint of the corporation and those interested therein." The court cited with approval the long line of cases in which the traditional rule was applied to enforce a fiduciary obligation. The same duty was then flatly applied to controlling majority

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23 *Id.* at 176.
25 *Id.* at 791.
26 *Id.* at 793-94. Compare advantages available to minority and majority in the *Jones* case as detailed in note 1 supra.
28 *Id.* at 110, 460 P.2d at 472, 81 Cal. Rptr. at 600.
shareholders. Quoting Professor Lattin, the court agreed that "self-dealing in whatever form it occurs should be handled with rough hands." The increasingly complex business world was cited as reason for the inadequacy of these traditional standards of fiduciary obligation, and the court fashioned a new standard "of good faith and inherent fairness to the minority in any transaction where control of the corporation is material."

The court found that the defendants' business decision to form a holding company rather than increase the marketability of the association shares failed to meet this new standard. The majority chose a course of action which prohibited the minority from receiving the benefits or increased marketability of the shares. The burden of proving good faith in the transaction was upon the defendants. The court seems to indicate this burden would have been met if defendants had offered all shareholders the opportunity to exchange their stock on the same basis. Absent a showing of good faith and compelling business purpose, Jones was entitled to exchange her minority shares for holding company shares under the terms of the original issue, as well as all distributions subsequently made to these original shares.

III. Conclusion

Unlike Perlman and Brown, the Jones fact situation involved no sale of control, no change in minority shareholders' proportional interest, no damage to the association, and the fullest disclosure concerning all transactions. The finding of a fiduciary duty in such a situation is against traditional views. Jones in effect sanctions the views of Professors Berle and Andrews. Berle considers control a corporate asset. Andrews proposes that any sale of corporate control must always benefit all shareholders proportionately. Under this view, sale of control would necessarily be allowed only on a tender-offer basis whereby each shareholder sold a pro rata amount of his stock. Such reasoning may force a majority shareholder to share every selling opportunity with the minority. However, the fact that buyers are willing to pay a premium for a control block of shares is an economic reality, and mere receipt of a premium through an honest transaction should not afford minority stockholders a claim of right. Hopefully, Jones will not be extended so far.

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20 N. LATTIN, CORPORATIONS ch. 12, § 8, at 565 (1959).
21 1 Cal. 3d at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.
23 The question of proof of good faith was not before the supreme court in this case, and was to be decided by the lower court upon remand.