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Statutory Regulation of the Fiduciary Duty of Majority Stockholders

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STATUTORY REGULATION OF THE FIDUCIARY DUTY OF MAJORITY STOCKHOLDERS

IT has long been established that the majority stockholders of a corporation are obligated to exercise care and diligence to conserve and protect the interest of the minority stockholders. The standards judicially imposed upon directors and dominant stockholders in dealing with the corporation and the interests of the minority have traditionally been phrased in terms analogous to those which describe the duties of a trustee toward his cestui que trust. But regardless of the terms used to characterize the legal relation, whether they be principal and agent or trustee and beneficiary, they are intended to express the existence of a fiduciary relation between the majority and the minority stockholders. It is upon this theory that the courts have held that the holder or holders of the majority of the stock in a corporation owe to the other stockholders the duty to exercise good faith, care and diligence to conserve the property of the corporation, and to protect the interests of the minority stockholders.[1] The courts of Texas, as well as those of other jurisdictions, have recognized that such a fiduciary relation exists not only between the majority and the minority stockholders but also between the directors and the stockholders; and interference by the court will follow upon conduct of dominant stockholders or directors characterized by ultra vires, fraudulent, and injurious practices, and abuses of power or oppression, all of which are clearly subversive of the interests of the minority shareholders and leave the latter remediless without such judicial interference.[2]

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[1] Lebold v. Inland Steamship Co., 82 F. (2d) 351 (C. C. A. 7th, 1936); Steinfield v. Copper State Mining Co., 37 Ariz. 151, 290 Pac. 155 (1930); Red Bud Realty Co. v. South, 153 Ark. 380, 241 S. W. 21 (1922); Commonwealth v. Muir, 170 Ky. 435, 186 S. W. 194 (1916).

[2] San Antonio Street Railway Co. v. Adams, 87 Tex. 125, 26 S. W. 1040 (1894); Cates v. Sparkman, 73 Tex. 619, 11 S. W. 846 (1889); Farwell v. Babcock, 65 S. W. 509 (Tex. Civ. App. 1901); 2 HILDEBRAND, TEXAS CORPORATIONS (1942) § 561.

The theory of the fiduciary relation between majority and minority shareholders, conceived for the purpose of protecting the interests of the minority, was utilized by courts of equity for a time for this purpose. Frequently, however, as a result of the protection thus afforded his interest by the fiduciary relation doctrine, a single dissenting stockholder was able to hinder the development and growth of a corporate business. Realizing the danger involved to desired economic expansion, the legislatures of various states promptly sought to remedy such a situation. Accordingly, acts were passed which expressly authorized the corporations to make from time to time, as deemed necessary, those fundamental changes which were most frequently desirable, such as merger or consolidation, voluntary dissolution, alteration of the corporate purpose, sale of the corporate assets even though solvent, and the issuance of new classes of stock or the alteration of preferences of stock already issued without concurrence of all stockholders.[3]

However, it rapidly became apparent that these statutes which had been relied upon to save corporate enterprise from the burden of dissenting stockholders, might well work an injustice upon the dissenting stockholders by forcing them to submit to changes which they had not contemplated at the time they became shareholders in the corporation, and at the same time leaving them without legal basis for complaint. The need for further legislation to remedy such situations resulted in legislative enactments for the just compensation of the dissenting minority.[4] To the statutes permitting consolidation of private business corporations were added provisions for the appraisal and purchase of the

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[3] Stebbins v. Michigan Wheelbarrow and Truck Co., 212 Fed. 19 (C. C. A. 6th, 1914) (sale of assets); Peters v. United States Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1912) (alteration of preferences); Page v. Whittenton Manufacturing Co., 211 Mass. 424, 47 N. E. 1006 (1912) (reclassification of stock); Colgate v. United States Leather Co., 75 N. J. Eq. 229, 72 Atl. 126 (Er. & App. 1909) (consolidation and merger); Meredith v. New Jersey Zinc and Iron Co., 59 N. J. Eq. 257, 44 Atl. 55 (Ch. 1899) (change of purpose); Logie v. Mother Lode Copper Mines Co. of Alaska, 106 Wash. 208, 179 Pac. 835 (1919) (sale of assets).

[4] 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS (1919) § 4799.

shares of those not voting in favor of such action.[5] And almost simultaneously several states enacted statutory provisions for appraisal of shares upon the sale of the corporate assets, changes in the corporate objective, or dissolution.[6] Compensation to the dissenting stockholders has been allowed in more recent statutes in instances where the majority elects to alter preference rights or to reclassify the corporate stock.[7] As a result a majority of the states now have statutes providing for appraisal in the event of consolidation, and a large number provide for appraisal in the event of a sale of the corporate assets. However, very few have provided any remedy for the dissenting shareholders in the event of a change in the nature of the business and upon a reclassification of stock or alteration of preference.[8] The Uniform Business Corporations Act, which has been adopted by Idaho,[9] Louisiana,[10] and Washington,[11] affords the minority shareholder legal grounds for complaint in regard to such transactions as voluntary transfer of corporate assets, changes in the corporate purposes, and merger or consolidation.[12]

While Texas courts recognize the existence of a fiduciary relation between the minority and the majority shareholders, and while statutes have been enacted which establish a procedure by which the majority shareholders must exercise corporate transactions, no statutes have been enacted in this state prescribing the remedy of appraisal or other remedies for the complaining minority shareholder. In Texas a voluntary dissolution of a corporation may be accomplished if four-fifths in interest of all the shares outstanding votes therefor at a stockholders' meeting, or if in the

[5] N. Y. Laws 1890, c. 564, § 7; N. J. Laws 1896, p. 312; Md. Laws 1908, c. 240, § 32.

[6] N. Y. Laws 1890, c. 564, § 33 (sale of assets) and § 57 (dissolution); Mont. Laws 1905, c. 103, § 1 (sale of assets); Mass. Laws 1908, c. 437, § 44 (change of purpose).

[7] N. Y. Laws 1923, c. 787; Ohio Corporation Act 1927, § 72.

[8] N. Y. Cons. Laws (Cahill, Supp. 1934) c. 60, § 21, § 38, subdiv. 12.

[9] Idaho Code (1932) §§ 29-101, 29-164.

[10] La. Gen. Stat. (Dart, 1932) §§ 1080, 1184.

[11] Wash. Rev. Stat. (Rem., 1931) §§ 3801, 3803-68.

[12] Uniform Model Business Corporation Act, § 20.

absence of a stockholders' meeting all the stockholders consent in writing to the dissolution.[13] It has also been enacted that the board of directors of a corporation, when empowered by a two-thirds vote of all its outstanding stock with voting privileges, may increase its authorized capital stock.[14] And legislative enactment has provided that by a charter amendment, par value stock, issued or unissued, may be converted into preferred stock,[15] or stock without nominal or par value[16] when so voted by the holders of a majority of the outstanding stock of the corporation.

Although the desirability of statutory enactments depends upon the special needs of the locality, it should be recognized that the statutes of Texas have gone no further in the protection of the minority shareholders than to prescribe the procedure which the stockholders are to follow in the exercise of certain powers that may affect the interest of minority shareholders and that the remedies of a minority shareholder whose interests have thus been abrogated by the majority must be sought in a court of equity where he is without the aid of statutory protection.

While the continued enactment of statutes protecting the minority shareholder is indicative of the desirability of such legislation, such statutes which differ widely from state to state are still for the most part fragmentary and perhaps inadequate, and are often uncertain in application. Nevertheless they are proving increasingly effective in protecting the minority, and it seems reasonable that the trend toward such statutory protection will continue.

In considering those statutes which give the majority a power to act in certain designated cases, it is of primary importance to recognize that such statutes do not alter the status of the majority as fiduciaries and place them in a privileged position so as to

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[13] TEX. REV. CIV. STAT. (Vernon, 1925) art. 1387.
[14] TEX. REV. CIV. STAT. (Vernon, 1925) art. 1330.
[15] TEX. REV. CIV. STAT. (Vernon, 1925) art. 1330.
[16] TEX. REV. CIV. STAT. (Vernon, 1925) art. 1538h.

terminate the duty which they owe to the minority.[17] Instead, the exercise of the power of the majority is restrained by the right of the minority to receive a fair price in the event of sale or merger or consolidation, and by their right to equal participation in the fundamental change. The duty of the majority, as now conceived since the enactment of such legislation, has been thus formulated by the Chancery Court of Delaware:

> "The majority who are favoring the sale owe something more to the minority than to merely refrain from appropriating, either directly or indirectly, the corporate assets unto themselves. They owe the further duty of seeing to it that the assets shall be sold for a fair and adequate price. Any other kind of price would fail to meet the requirement of the statute that the terms and conditions of the sale should be such as are expedient and for the best interest of the corporation. Indeed, even if the statute contained no such requirement, equity would impose it. For if a trustee who has the right to sell the assets of his cestui que trust undertakes to do so, the duty is exacted of him that he demand and secure an adequate price. Even though the sale is of no affirmative advantage or profit to himself, yet, taking the negative aspect of the matter, if it injures the beneficiary by letting his equitable assets go for an unfair and inadequate price, the act of the trustee in making the sale will in equity be condemned as wrongful."[18]

In like manner it follows that the statutes cannot be utilized as a means of bringing pressure upon the minority to accept payment and in turn squander their investment. In a leading New Jersey decision[19] in which the minority contested a merger agreement which was procedurally in legal form, the court held that in actuality the transaction amounted to a seizure of the corporate property by the majority stockholders, and, while no legal objection could be interposed upon that score, still the merger agreement necessitated careful scrutiny, with the burden resting upon the majority to show that the consideration was equitable and fair. It was ade-

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[17] Nave-McCord Mercantile Co. v. Ronney, 29 F. (2d) 383 (C. C. A. 8th, 1928); J. H. Lane and Co. v. Maple Cotton Mills, 226 Fed. 692 (C. C. A. 4th, 1915); Doe Run Lead Co. v. Maynard, 283 Mo. 646, 223 S. W. 600 (1920).

[18] 14 Del. Ch. 1, 120 Atl. 486 (1923).

[19] 103 N. J. Eq. 461, 143 Atl. 729 (Ch. 1928), *aff'd*, 104 N. J. Eq. 490, 146 Atl. 196 (Sup. Ct. 1929).

quately emphasized that the minority's only remedy was not statutory appraisal.

Although regulation of the majority shareholder's fiduciary relation to the minority by legislative enactment has been generally acclaimed, this legal innovation has not been without its perplexities. The basic problem arising has been one of conflict between strong and divergent interests: On the one hand is the need of freedom and flexibility in the control and management of corporate business, and counter-balanced therewith is the interest of the vulnerable minority. Although a loss in flexibility of corporate management may result by granting too much latitude to the dissenting stockholders, still any tendencies which license unlimited corporate transactions through majority vote should be balanced by permitting the dissenter to demand an appraisal of his holdings if he does not desire to accompany the majority. Once, however, it has been determined that appraisal and purchase of dissenting shares as provided generally by statutes achieves a desirable balance of these conflicting interests, it then becomes necessary to determine the particular circumstances under which the dissenting shareholder is to be legally entitled to demand an appraisal, and to set forth with clarity the conditions precedent to his obtaining such relief. It may be contended that it is impossible to specify the various possible fundamental corporate changes under which the dissenting shareholder would be obliged to determine whether he will demand appraisal and payment or remain a stockholder. While to a certain extent this difficulty is substantial, yet there are certain fundamental changes which have come to be recognized as perilous to the minority shareholder. Within this classification may be catalogued such transactions as reorganization, voluntary dissolution, and merger and consolidation.

It is evident from the outset that the giving of adequate notice to the shareholder of the intentions of the majority is of prime importance if the shareholder is to be permitted to act intelligently upon the matter. Under existing statutes the period of time for notice ranges from twenty days to less than ten in the various jurisdictions. No uniformity as to notice requirements exists. Of equal importance is the need for compulsory disclosure of what is transpiring and the reasons therefor. Since the average stockholder is deficient in both means and knowledge that are necessary for protection of his rights, it has seemed wise to require the notice to the shareholder to inform him of his right to an appraisal should he repudiate the action of the majority and of all the conditions precedent that he must satisfy in order to be entitled to make a demand for payment. So far, the intricacies of the procedure to be followed by the dissenting stockholder have made his task burdensome, especially since the strictest compliance with minute procedural details has been demanded by the courts.[20]

As to the proportion of the stockholders which must approve the fundamental change, statutory provisions vary widely. For a sale of all of the assets of the corporation, one statute requires the concurrence of two-thirds of the directors and subsequent ratification by four-fifths in value of the capital stock;[21] another provides for a two-thirds vote of the board of directors which must later be approved by a two-thirds vote of the stock entitled to vote;[22] while yet another requires the directors to ratify the declarative vote of the stockholders of record who hold such stock as entitles them to exercise a majority of the voting power upon a motion to sell.[23]

Equally lacking in uniformity are the statutory provisions relating to the value that the dissenting shareholder shall receive for his holdings. However, on the basis of the descriptive terms

[20] Johnson v. C. Brigham Co., 126 Me. 108, 136 Atl. 456 (1927); *In re* Camden Trust Co., 121 N. J. 222, 1 A. (2d) 475 (Er. & App. 1938); Geiger v. American Seeding Machine Co., 124 Ohio 222, 177 N. E. 594 (Sup. Ct. 1931).

[21] ALA. CODE ANN. (Michie, 1928) § 7036.

[22] N. C. CODE ANN. (Michie, 1927) § 1126, as amended by N. C. Laws 1929, c. 269.

[23] Kans. Acts 1929, Act 184, art. VIII, § 31.

used in regard to the value of dissenter's shares, the statutes may be roughly divided into three classifications. First, and most common, are those using such terms as "fair cash value," "fair value," and "value."[24] In the second class, the terms used are "full market value" or "market value."[25] The statutes in the third category also use the terms "market value" and "full market value" but add qualifying statements to the effect that in no event is the dissenter to receive less than the fair value of his holdings, the latter value being determined by a fair evaluation of the selling corporation's net assets at the time the demand is made.[26]

One of the most pronounced difficulties originating under the appraisal statutes concerns the dissenting shareholder's election of remedies. It has been suggested that the dissenter may have a choice of remedies: that he may either demand an appraisal or he may seek an avoidance of the contemplated action, the election of one constituting an estoppel to assert the other.[27] Before the appearance of the appraisal statutes, and even today in the jurisdictions where they are nonexistent, actions in the alternative were dominant. A suit would be brought either to enjoin the contemplated action or to avoid the consummated action, and in the alternative to receive the value of the complainant's shares at the time the conversion transpired.[28] Even under the modern appraisal statutes it has been permissible to bring a suit in the alternative.[29] Such a conclusion seems highly desirable, for if the shareholder has been mistaken in his contention that the corporate action has not been in accordance with the authority granted by statute, then his request for compensation pursuant to the statutory provisions should be entertained.

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[24] CONN. GEN. STAT. (1930) § 3385; ILL. REV. STAT. (1941) c. 32, § 157.73; MINN. STAT. (1945) § 301.44.

[25] N. M. STAT. (1941) § 54-231.

[26] N. Y. CONS. LAWS (Cahill, 1930) c. 60, § 21; KY. REV. STAT. (1943) § 271.415.

[27] Wall v. Anaconda Copper Mining Co., 216 Fed. 242 (D. Mont. 1914).

[28] Garrett v. Reid-Cashion Land & Cattle Co., 34 Ariz. 245, 270 Pac. 1044 (1928); Finch v. Warrior Cement Corp., 16 Del. Ch. 44, 141 Atl. 54 (1938).

[29] Petry v. Harwood Electric Co., 280 Pa. 142, 124 Atl. 302 (1924).

Loose phrasing in some appraisal statutes has resulted in raising the issue as to when the remedy afforded the dissenting stockholder shall be positively binding upon the corporation to the extent of prohibiting the corporation's retraction from the contemplated action in order to avert payment of the dissenter's share. At least one court has permitted such retraction prior to the consummation of the proposed fundamental change,[30] but did not suggest what the remedy of the dissenter might be if the corporation had completed the transaction and thereafter had insufficient assets with which to satisfy the demands of the dissenters. In such an event the minority shareholders would find themselves forced into a new arrangement without a remedy, although the statute had been preeminently directed toward the prohibition of just such occurrences. The most potent preventative against such contingencies is a statutory declaration granting a lien in favor of the dissenting shareholder upon the property of the consolidating corporation, which lien shall take precedence over any incumbrances that have attached to the property subsequent to the vote to effectuate the change.[31]

Thus, while it is obvious that the attempts at statutory regulation of the fiduciary relation of the majority stockholder have not been free from imperfections, it is equally discernible that the ambiguous standards of "good faith" and "fairness" cannot be hoped to achieve a satisfactory solution of the paradoxical situations existing in modern corporate litigation. The practicability of applying the fiduciary concept to corporate management in protection of the minority shareholder is questionable; and especially in view of the unaccountability of majority groups, a prophylactic rule which would exact liability without reference to the principles of "good faith" and "fairness" seems essential.

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[30] Matter of Millard, 221 App. Div. 113, 222 N. Y. Supp. 633 (1927).

[31] N. C. CODE ANN. (Michie, 1927) § 1224(c); ME. REV. STAT. (1930) c. 56, § 67; MD. ANN. CODE (Bagby, 1924) art. 23, § 36; S. C. Laws 1926, Act 599, § 2; N. J. COMP. STAT. (Supp. 1924) c. 142, § 47-108a; N. M. STAT. ANN. (1930) § 32-218.