Corporate Natural Law: The Dominance of Justice in a Codified World

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I. INTRODUCTION

If asked to imagine the stereotypical statute-oriented, rule-bound attorney, a likely vision will be that of a dark suited and carefully coiffured corporate lawyer. A corporate lawyer does not exist without a statutorily created client. That lawyer's fidelity is owed to an entity that is entirely the product of meticulously drafted statutes, articles of incorporation, and by-laws.

Formalism abounds in corporate law. That which "is" rules the creation, organization, operation, and eventual death (by dissolution or

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merger) of the corporate client. Every effort is made to avoid "oughts" in this world. Where statutes and corporate documents end, written shareholder agreements take over, governing such disparate conduct as the election of directors, officer salaries, dividend distributions, sale of shares, and whatever else may appeal to the fruitful mind of the corporate lawyer. Nothing is left to chance, or so it appears. Now let us move from appearance to reality.

I practiced and taught corporate law for more years than I care to count before it dawned on me that courts answered most of the really difficult and interesting corporate law problems by resort to principles of fairness and equity, rather than statutory or similar positivist standards. That realization obsessed me to the point that I began writing an article entitled, "What Would Immanuel Kant Have Said About Hostile Takeovers?" Of course I had no idea what he would have said (which is the principal reason the article never moved beyond its title), but the point was, and remains, that Kantian principles of reason and universal maxims may well apply to the hostile takeover battleground.

Hence the notion of "corporate natural law." The notion is intended to convey the fact that equitable principles rather than statutes and other seemingly authoritative sources answer many of the most substantial corporate law questions. I use the term "natural law" to mean an effort by courts to find an answer based upon fairness and "rightness." Even where codified or written standards exist, a court will apply and interpret them in accordance with what the court finds "just." As stated by no less an august corporate law authority than the Delaware Supreme Court, "inequitable action does not become permissible simply because it is legally possible." Even where application of the fairness doctrine is not apparent on the surface, inarticulate major premises of equity and fairness often lead courts to their stated results. What is surprising is not that this phenomenon exists, but that it is so pervasive. Our dark suited corporate attorney thus shares with the tweedy public defender the burden to persuade the court that the urged outcome is just. This essay examines a handful of corporate law areas where "natural law" abounds. These include challenges to corporate action for exceeding proper corporate purposes, attempts to hold shareholders liable for corporate obligations, claims against management and directors under the duty of

1. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (holding that an action by board amending bylaw to move annual meeting date was technically proper but inequitable conduct in light of pending shareholder proxy fight).

2. Oliver W. Holmes, The Path of the Law, 10 HARV. L. REV. 457, 466 (1897) ("Behind the logical form lies a judgment as to the relative worth and importance of competing legislative grounds, often an inarticulate and unconscious judgment, it is true, and yet the very root and nerve of the whole proceeding.").
care rubric, criminal and regulatory actions, challenges to transactions that appear to favor controlling shareholders, claims arising out of conflict of interest transactions, attempts to protect shareholder preemptive rights, disputes regarding close corporation "freeze outs" of minority shareholders, and claims based upon insider trading profits.

Before embarking on this review, I should address the question—"O.k., even if you're right, so what?" To my mind, it is a big "so what?" If corporate law is perceived as rule-bound and formalistic, advice to corporate decisionmakers, legal arguments, and some judicial decisions will reflect those constraints. If, on the other hand, corporate law is perceived (as it is) as a human drama involving open-ended, equity-oriented conflicts among competing interests, then legal advice, decisions made thereunder, and courtroom arguments could take on a much different hue. It is a hue that brings into focus the underlying purposes of rules and the impact of particular decisions upon varying corporate constituencies. Sensitivity to these broader, underlying questions means that lawyers faced with advising clients in difficult areas may have to take the somewhat courageous course of admitting that their specialized legal training and expertise is not sufficient to the task. Additional elements of fairness and equity demand considerations for which the lawyer's expertise is no better than the average person's. Professor Elkins has described the attributes of legal professionalism as detached, objective, unemotional, and in control of the client—attributes that define a legal persona that is a "facade for the public, a mask for the private self of feelings." Recognition of natural law's role in corporate law encourages the elimination of the mask and enlargement of the lawyer's field of inquiry and analysis.

Positivist analysis is comforting when an attorney must draft opinion letters affecting substantial assets and potential liabilities. Yet, analysis limited to formalism is, as the accountants would say, cold comfort alone, and lawyers aware of that limitation better serve their clients by directing attention to equity's potential response to the consequences of intended action. Corporate law is fundamentally about relationships among people. However much we have come to reify corporations, the fundamental fact remains that corporations do not act except through and upon human agents. Professor Harold Laski noted years ago the consequence of not appreciating the human drama within every corporate action:

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The danger of the doctrine that corporate personality is real is the danger that we give our consciences into the keeping of some national government, some church, or some other association and that their operation is then organized from without until we fail to realise [sic] that we have become nothing more than an automatic instrument in the hands of men into the validity of whose power it never occurs to us to enquire.\(^4\)

Inquiry is the essence of the judicial process, and more often than is generally assumed, that inquiry is directed (explicitly or not) by "natural law" doctrine.

II. REPRESENTATIVE AREAS DOMINATED BY EQUITY

A. Corporate Purpose

Fairness and equity doctrines surfaced early in corporate law history with the judicial reaction to the ultra vires doctrine. Courts avoided the unnecessarily limiting and inequitable results of the ultra vires doctrine even in the nascent days of corporate development, when state statutes demanded limited definition of corporate purpose as a brake on unregulated corporate growth.\(^5\) Fairness was often the specifically stated basis for a decision. In one Florida case, an obligor under a contract to sell land argued that the contract should be voided because the assignee purchaser was a corporation whose charter forbade the corporate indebtedness that would be incurred through the purchase.\(^6\) Having found that the corporation was authorized to acquire title to property, the court rejected the obligor's ultra vires argument with the assertion that the doctrine "should never be applied where it will defeat the ends of justice, if such a result can be avoided."\(^7\) Doctrines of implied powers and estoppel frequently were invoked to avoid the harsh results of declaring a corporate contract or act invalid.\(^8\) Implied powers and

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5. In the past 30 years, state statutes have moved from requiring a detailed statement of corporate purpose in the articles of incorporation to permitting corporations to state their purpose in as broad a manner as desired, for example, to engage in any lawful business. Most corporations take advantage of this open-ended invitation and thereby substantially eliminate recourse by shareholders or others to the ultra vires doctrine.
6. Palm Beach Estate v. Croker, 143 So. 792, 802 (1932).
7. *Id.* The court noted that, having tendered the purchase price pursuant to contract, the corporation also was estopped to deny its ability to purchase the property. *Id.*
8. E.g., Jacksonville, Mayport, Pablo Ry. & Nav. Co. v. Hooper, 160 U.S. 514, 523-26 (1896) (holding that a corporation with the stated purpose to run a railroad had implied power
estoppel principles can be broadly or narrowly applied. They are, at bottom, equitable doctrines clothed in legalese. Courts inclined to formalism could well deny the “implication” of the power to operate a hotel by reason of the stated power to operate a railroad. Few courts exhibited such tendencies regarding the ultra vires doctrine. Most courts chose to do that which it perceived to be most fair under the circumstances.

The ultra vires doctrine is virtually dead. Statutes now permit corporate purpose to be defined in the articles in broad, open-ended terms. There might be corporations occasionally formed whose charters adopt limited purposes, perhaps as a protective device insisted upon by shareholders to assure that the company does not branch into unexpected fields without shareholder approval. In such circumstances, the question may arise whether a particular activity is beyond the stated powers of the corporation, thus raising traditional ultra vires claims. We can expect that courts will continue their tradition of refusing to apply the ultra vires doctrine where fairness to the parties dictates otherwise.

Shareholder challenges to corporate charitable contributions and other public interest oriented activities are perhaps the most fertile area for arguments analogous to the ultra vires doctrine. Arguments are sometimes heard that charitable expenditures and projects serve no corporate purpose and are contrary to profit-maximizing goals. Express statutory provisions permitting charitable contributions have made such arguments more difficult in recent years.\(^9\) However, even before express statutory authority was granted, courts were denying shareholder challenges based on strict readings of corporate statutes and charters. One such case involved a $1500 contribution to Princeton University by a New Jersey maker of valves and fire hydrants.\(^10\) Despite the seeming disparity between the corporation’s products and the lofty goals of the ivory tower recipient, the corporation’s president boldly testified that such a contribution generated good will and created a favorable business climate.\(^11\) Not a scintilla of direct evidence was or could be introduced to support such assertions. The court wisely chose not to rely on such ephemeral speculations. Instead, the court rested its opinion on a

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9. See Rev. Model Bus. Corp. Act § 3.02 (1984) (“Unless its articles of incorporation provide otherwise, every corporation has... power:... (13) to make donations for the public welfare or for charitable, scientific, or educational purposes. ...”).


11. Id.
presumed moral obligation of a corporation to "discharg[e] its high obligations as a constituent of our modern social structure."\textsuperscript{12}

Challenges to charitable contributions, or analogous activities consonant with social causes, have continued even after statutory authorization. Rarely have such challenges succeeded. Case law reflects judicial adoption of the moral notion that corporations, like persons, ought to have the freedom to make charitable donations and engage in socially constructive projects. Courts need not go as far as Professor Elliott Weiss's argument that corporations, having been created by law, "have as their ultimate purpose the welfare of society."\textsuperscript{13} It is sufficient that courts recognize, as they do, that corporations may choose altruism over profit-maximization provided that long-term corporate goals are not sacrificed.

B. The Corporate Shield

Creditors who find their corporate obligor lacking in funds often are inclined to seek redress from the principal shareholders or parent company. That requires convincing a court to "pierce" the traditional corporate shield against personal liability of shareholders for corporate debts. Although such attempts lose more often than not, the success rate is sufficient to make the "piercing the corporate veil" concept perhaps the most litigated of all corporate law subjects.\textsuperscript{14}

The proclivity toward litigation may stem in part from the ambiguity of standards. Jurisprudence in this area is rife with phrases such as "alter ego," "agency," and "instrumentality," all of which suffer from lack of clarity. Some courts insist that fraud is a necessary element for a piercing case, yet that concept too is fundamentally an eye-of-the-beholder issue. Ultimately, as some courts profess, the issue is one of fairness.\textsuperscript{15} Given the inability of the corporate obligor to pay the liability, is it "right" that the shareholders, or the parent company, should bear that burden? Often this is not an easy question. This is not a simple good-guy versus bad-guy shootout. Both sides often wear gray hats. Shareholders responsible for depleted corporate assets are confronted by creditors who contracted with the corporate entity without

\begin{footnotes}
\item[12] Id. at 590.
\item[14] This is admittedly anecdotal, but I am convinced after years of reading advance sheets that no corporate law subject is as frequently litigated as the piercing doctrine.
\item[15] See, e.g., Fletcher v. Atex, Inc., 68 F.3d 1451, 1458 (2d Cir. 1995) (holding that in order to state an alter ego claim under Delaware law, a plaintiff must "demonstrate an overall element of injustice or unfairness").
\end{footnotes}
security or shareholder guarantees. Creditors shift their focus only because the relationship soured. In seeking judicial recourse, creditors ask courts for all-or-nothing decisions in cases where neither side might have a complete equitable claim or defense. Yet courts have no choice but to make an all-or-nothing decision.\textsuperscript{16} Judicial decisions become clothed in traditional language. Yet such language does not alter the underlying question which is to decide what is "right" in the given set of circumstances.

C. Management Obligations and the Duty of Care

The contour of the director's duty of care presents perhaps the most heated area of corporate litigation in recent years. The issue became so embroiled that state legislatures intervened at the behest of corporate management to alter the course of over one hundred years of judicially developed jurisprudence.\textsuperscript{17} The result of such legislation is that the duty of care doctrine remains only in a weakened condition, shorn of effective sanctions against offending management.

Still, the duty of care doctrine exists and will continue to be asserted by shareholders and others seeking injunctive or other appropriate relief from allegedly unreasonable board decisions. It is, for example, the most important question in the monumental battles incurred in the corporate takeover arena when target management imposes defensive measures against unwanted suitors. It is also the central concern for board decisions that may have a disparate effect on varying classes of stock within the corporation, especially in the handful (although growing number) of corporations that issue so-called "alphabet" or tracking stocks that provide equity stakes in limited segments of the corporation's business. Indeed, one commentator has suggested that in such situations the directors are necessarily governed by a "duty of fairness."\textsuperscript{18}

\textsuperscript{16} One of the failings, I believe, of our system of jurisprudence is that we have no alternatives for courts other than all-or-nothing decisions. A winner-take-all philosophy exacerbates adversarial conflict and constrains courts from decisions that could be the fairest under the circumstances. This is the grist for another article.

\textsuperscript{17} In the past decade nearly every state has adopted provisions that allow corporations to immunize their directors from personal liability for breaches of duty of care except in very limited contexts. \textit{See, e.g.}, DEL. CODE ANN. tit. 8, § 102(b)(7) (1997) (permitting a charter provision eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages for breach of fiduciary duty except in limited, defined circumstances).

\textsuperscript{18} Jeffrey J. Hass, \textit{Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness}, 94 MICH. L. REV. 2089, 2092 (1996) (arguing that traditional duty of care and loyalty concepts fail to address the unique fairness issues raised by intergroup
The duty of care doctrine is based entirely on the elusive concept of "reasonableness." Scores of law review articles have attempted to define that standard, and judicial decisions roam over the negligence field from ordinary to gross, as if those terms impose an objectivity on this subject. Delaware's notorious Smith v. Van Gorkom case is a good illustration of the lack of objectively defined standards. The decision by the Trans Union Corporation board of directors to accept an acquirer's offer of merger was made with unusual speed, with no significant advance notice, and with minimal supporting documentation. Did these factors indicate a lack of due care? A majority of the Delaware Supreme Court believed so. However, neither Delaware's respected Chancery Court nor Justice McNeilly, dissenting from the Supreme Court's finding, agreed. Justice McNeilly based much of his dissent on the collective experience of the board members, which for the outside directors constituted seventy-eight years of combined experience as chief executive officers and fifty-three years cumulative service as Trans Union directors. In his opinion, these directors "knew Trans Union like the back of their hands and were more than well qualified to make on the spot informed business judgments." Many post-opinion conflicts among various equity securities.

19. Among them is one that I attempted. See Stuart R. Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591 (1983).

20. Delaware, for example, has the most extensive body of case law regarding duty of care. Yet, precise standards appear lacking. A gross negligence standard was expressly adopted as Delaware law in Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("under the business judgment rule director liability is predicated upon concepts of gross negligence."). Yet, in Rabkin v. Philip A. Hunt Chem. Corp., 1987 WL 28436 (Del. Ch. 1987), Vice-Chancellor Berger reviewed cases and commentary and concluded that ordinary negligence is Delaware's standard in director neglect claims. New York appears to embrace the ordinary negligence standard. See Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 274 (2d Cir. 1986) ("[T]he duty of due care requires that a director's decision be made on the basis of 'reasonable diligence' in gathering and considering material information."). In trying to sort out the subtleties of differences among such standards, the game may not be worth the candle, given the dearth of successful actions regardless of standard. For a discussion of the reasons for such dearth, see Cohn, supra note 19, at 598-600.

21. 488 A.2d 858, 893 (Del. 1985) (finding breach of duty of care in directors' decisionmaking process which lead to acceptance of acquiring company's merger offer).

22. See id. at 869 (noting that the board only met two hours before approving the merger).

23. Id. at 893.

24. Id.

25. Id.

26. Id. at 898 (McNeilly, J., dissenting).

27. Id. at 894 (McNeilly, J., dissenting).

28. Id. (McNeilly, J., dissenting).

29. Id. at 895 (McNeilly, J., dissenting).
commentators supported Justice McNeilly's views. For our purposes, the question is not which side was correct. Our inquiry is, rather, whether it is possible objectively to determine such correctness? Would the Supreme Court's decision have been different had the directors extended the meeting by another two hours to discuss corporate valuation? What if they had made a quick phone call to obtain on-the-spot advice from an investment brokerage firm? What if they had advance notice of the purpose of the special meeting? All of these factors would have been weighed in the balance, but would the scales have tipped? Such uncertainties only highlight the inescapable conclusion that the duty of care doctrine is ultimately decided on the basis of what a court believes is the "right" answer, that is, the fairest answer under the circumstances.

In the overwhelming majority of cases, courts are reluctant to find breach of that duty. Does that mean directors are uniformly circumspect in the discharge of their fiduciary duties? Much more likely is the conclusion that the "right" answer as far as most courts are concerned is to protect directors from the draconian results of finding a breach of duty. This is a value judgment which has little if anything to do with the expressed statutory standards.

An equally uncertain standard exists with regard to derivative actions. Shareholder demands on the board, required by most corporate statutes, may result in the board deciding that the action should be dismissed. The court must then decide whether the board's decision was made in good faith. How is a court to decide good faith? Beyond the fact of disinterestedness of the board committee, there is no objective standard to measure "good faith." In the absence of objective criteria, a court's decision to accept or reject the board's recommendation will be based on general equitable principles.

D. Criminal Liability and Regulations

In criminal and regulatory contexts, fairness principles also play dominant roles. Corporations are subject to a host of regulatory statutes, including antitrust, OSHA, environmental, securities, tax, and employment discrimination issues. Violation of such regulations can lead to

30. Perhaps now that directors often are shielded from personal monetary damages, see supra note 17, courts will be less hesitant to find a breach of duty. However, there is not much evidence to date that courts have relaxed their protective vigilance of directors despite the immunization statutes.

31. The Revised Model Business Corporation Act provides that a derivative action shall be dismissed by the court on motion by the corporation if the directors' litigation committee "has determined in good faith" that maintenance of the action is not in the corporation's interests. REV. MODEL BUS. CORP. ACT § 7.44(a).
substantial fines and other penalties. There is no blueprint in corporate codes or black letter law to assure avoidance of these sanctions. What is apparent, though, is that adherence to corporate formalities is insufficient. A recent article examining the issue of corporate criminal sanctions noted that:

[O]rganizations are viewed as public trustees with duties to ensure that activities initiated on their behalf generally are undertaken within applicable laws. In practical terms, these duties require firms to couple the delegation of job responsibilities to individual corporate employees with further management efforts to ensure the employees act lawfully in carrying out their duties. A “good citizen” corporation that takes reasonable steps in this regard can escape blame and criminal liability for subsequent misconduct.32

The corporate “good citizen” concept permeates other fields33 and incorporates (no pun intended) duties not specified in corporate codes and articles of incorporation.

E. Majority Shareholder Obligations

If you pay the piper you call the tune. So conclude many a controlling shareholder.34 Yet, controlling shareholders occasionally discover to their dismay that corporate tunes might not be quite the ones they want to call. Limitations are particularly evident regarding actions or proposals that may involve unequal treatment between controlling and minority shareholders. A “hot” subject matter for a while concerned whether minority shareholders have any claim to the premium on the sale of a corporation’s controlling shares. Perlman v. Feldmann35 was the high watermark for minority shareholders, but in recent years that case has lost its value as precedent supporting minority shareholder claims on control share premiums. Yet, many other areas remain for

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33. See supra text accompanying note 13.

34. The term “controlling shareholder” includes both those who own a majority of the voting stock as well as those who, by virtue of substantial stock ownership, group voting patterns, family ties, or other arrangements, effectively control corporate decisionmaking.

35. 219 F.2d 173, 177-78 (2d Cir.) (holding that, in a sale of controlling shares to an end user of the corporation’s product, controlling shareholders could not retain the premium and were required to share it with non-selling minority shareholders), cert. denied, 349 U.S. 952 (1955).
judicial scrutiny. They range from corporate buybacks of securities to parent-subsidiary allocations of tax benefits. Indeed, judicial scrutiny will arise in any circumstance in which minority shareholders allege that the controlling interests have utilized their power to aggrandize their interests. It is not difficult to imagine the controlling shareholders’ non-legal response—namely, if they can’t use their power to aggrandize their interests, then what is their power for?

*Jones v. H.F. Ahmanson & Co.*\(^{36}\) presents the apogee thus far for judicial protection of minority interests. The defendants, controlling shareholders of a highly profitable savings and loan association, formed a separate corporation and exchanged their S&L shares for the shares of the new corporation, which then became the S&L's controlling shareholder as a holding company.\(^{37}\) The holding company's shares were issued in large numbers, thus permitting development of a public market in the shares, something that had not existed for the S&L shares.\(^{38}\) The controlling shareholders were thus able to create liquidity for their investment in the S&L.\(^{39}\) The remaining S&L shareholders (approximately fifteen percent) continued to hold illiquid shares in the operating company.\(^{40}\) Although the minority was disadvantaged vis-à-vis the prior control shareholders regarding market liquidity,\(^{41}\) the minority was no worse off than it had been prior to formation of the holding company. Despite this, the California Supreme Court found that the majority had breached a duty to them.\(^{42}\) The Court declared that no action by control shareholders could result in a benefit to themselves without a similar benefit to minority shareholders unless there was a “compelling business purpose that would render their action fair under the circumstances.”\(^{43}\) What was the judicial rule based upon? It was based solely on fairness among the parties, as there is no statutory doctrine demanding equality among differing economic interests. The court acknowledged as much in its conclusion that there exists a “comprehensive rule of good faith and inherent fairness to the minority in any transaction [involving] controlling shareholders.”\(^{44}\)

Courts in other jurisdictions have not announced as sweeping a formula as that in *Ahmanson*, but numerous cases reflect the influence

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37. *Id.* at 467.
38. *Id.* at 468, 469.
39. *Id.* at 469.
40. *See id.* at 467, 468-69.
41. *Id.* at 476.
42. *Id.*
43. *Id.*
44. *Id.* at 474.
of the goal of achieving a just distribution of benefits among the parties. Thus, for example, a buyback of shares from controlling shareholders of a close corporation gave the minority shareholders the right to demand equal treatment. Corporations have the undeniable right to repurchase shares from shareholders, and there was no evidence in the particular case that the buybacks caused economic injury to the corporation or to the minority shareholders. The decision was based simply on a doctrine of fairness, a doctrine not enunciated in corporate codes or instruments.

The influence of the fairness doctrine is illustrated in a case between shareholders of a close corporation where one of the shareholders objected to the trial judge’s instructions to the jury that defined the duties among shareholders to include “furthering the interests of one another.” The objecting shareholder argued that shareholders, like directors, owe a duty to the corporation, and that their acts must be judged in relation to the corporation’s interests, not the interests of individual shareholders. The court rejected the argument and emphasized the personal relationships inherent within a close corporation and the concomitant fiduciary duties that flow among the participants. That decision was not based, nor could it be, on any statutory principle. It was grounded on the court’s perception of what ought to be the reciprocal obligations of business associates.

Fairness is an “eye of the beholder” concept. Thus there will be instances where similar facts lead to differing judicial results. Take, for example, the situation where a profitable parent corporation with a loss subsidiary files a consolidated tax return that creates substantial tax savings to the parent. Should the parent retain the entirety of the savings or distribute the savings in some proportionate manner to the subsidiary (that, after all, was responsible for the savings and probably needs the money worse than the parent)? This is ultimately a fairness question. There are no other standards. Some courts have held that the parent may choose to keep the entire savings, others have required a sharing of the tax savings with the subsidiary. Both decisions are similarly grounded on the perceived equity of the circumstances despite the differences in conclusions.

46. See Tillis, 395 So. 2d at 619.
48. Id. at 352.
F. Conflict of Interest Transactions

Corporate law has moved a long way from the early days when strict trust doctrine demanded the per se voidability of transactions between the corporation and its directors. Every state has modified common law by statute, and today such transactions are voidable only under limited conditions. Generally, such statutes provide that a conflict of interest transaction between the corporation and a director or officer may be voided if: (a) the transaction was not approved by a disinterested majority of the board, (b) the transaction was not approved by a disinterested majority of shareholders, or (c) the transaction is not fair to the corporation.51 The formula set forth in most states is in the disjunctive. A literal reading of the conflict of interest provision suggests that any one of the three stated conditions is sufficient to validate a conflict transaction. Under such interpretation, fairness (the third alternative) is not at issue unless the transaction was not approved either by disinterested directors or by shareholders.

Despite statutory language, courts have insisted that fairness to the corporation is an indispensable element in judging the validity of a conflict transaction. Courts have regarded the statute as authorizing conflict transactions, thus modifying early common law, but such transactions remain voidable unless proven fair to the corporation. The disjunctive statutory language therefore does not eliminate the need to examine fairness; it simply operates in some jurisdictions to shift the burden of proof on the fairness question from the directors to the complaining shareholders. As one California court stated, the fact that there was literal compliance with the disinterested shareholder provision "does not operate to limit the fiduciary duties owed by a director to all the stockholders, nor does it operate to condone . . . a harsh and unfair bargain with the corporation he is supposed to represent."52 Delaware courts, often criticized for pro-management bias, are no less demanding in requiring examination of the fairness of the transaction despite the directors' technical adherence to the approval portions of Delaware's conflict of interest statute.53 The Delaware Supreme Court has emphatically stated that "when directors . . . are on both sides of a transaction,

52. Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. 1952) (holding that the directors of a manufacturing corporation improperly entered into sales distribution contracts with a sales company controlled by majority shareholders, thus reducing profits of the manufacturing corporation).
53. See, e.g., Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (stating that Delaware's conflict of interest statute does not eliminate the intrinsic fairness test for conflict of interest transactions).
they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.”

G. Dilution of Shareholder Interests

Some black letter corporate law provisions have their genesis in equity. Consequently, despite specific regulatory standards, underlying equitable doctrine retains considerable force. Recognition and application of shareholder preemptive rights is an example of equity’s irrepressible role in an area that express statutory provisions appear to dominate.

Preemptive rights developed judicially to protect shareholders against involuntary dilution of their equity interests. Such rights were—and remain—particularly important in smaller corporations where particular percentage interests are extremely important for voting and profit-distribution purposes. Where such corporations sought to raise capital through additional equity offerings, existing shareholders were protected against dilution through preemptive rights, which accorded them first options to purchase the new equity in proportionate amounts necessary to maintain their percentage interests. Shareholders were deemed to have a proprietary interest in their percentage allocation within the corporation, thus giving rise to their right to the proportionate purchase of newly-issued shares.

In recent years, the preemptive rights doctrine has fallen on hard times. Many states, consistent with the Revised Model Business Corporation Act, have enacted provisions expressly negating the existence of preemptive rights unless otherwise stated in the articles of incorporation. Moreover, statutes set forth specific limitations on preemptive rights even if adopted in the articles, unless the articles state otherwise. The backlash against preemptive rights was fuelled by the concern by many corporate promoters that the doctrine is disruptive of capital-raising efforts. Moreover, it is a matter that can be determined contractually rather than doctrinally. If potential equity dilution is a serious issue for some shareholders, they may fend for themselves—so the argument goes—through protective shareholder agreements or

56. E.g., id.
57. REV. MODEL BUS. CORP. ACT § 6.30 (providing that shareholders do not have preemptive rights unless the articles of incorporation so provide).
58. Under Revised Model Business Corporation Act § 6.30(b)(3)(i), there is no preemptive right with respect to authorized shares issued within six months from date of incorporation.
limitations on board actions. The concerns led to amendments to state statutes that essentially replaced the judicially-developed preemptive rights doctrine by statutory standards.

Not surprisingly, positive law's absorption of the preemptive rights doctrine has not quieted judicial application of equitable principles. For example, several courts have examined circumstances in which preemptive rights granted to minority shareholders raised equitable concerns, such as the purchase price is set too high for shareholders to afford, or is set so low that shareholders must purchase for fear of substantial dilution of their economic interest. Although the courts have not uniformly settled the issue, some courts have denied the validity of the corporation's intended issuance of shares despite the fact that the preemptive rights provisions were literally followed. The overriding concern of fairness to minority shareholders trumped literal compliance with the statutory requirements.

Similarly, courts have intervened to protect shareholder interests even where the statute or articles of incorporation expressly deny preemptive rights. In one New York case, two families each owned fifty percent of the shares and each elected two directors to the four-person board (a sure recipe for danger). Upon the death of one of the directors, the board was temporarily controlled by one faction which proceeded to authorize the issuance of several shares to its side, thus tipping the balance of power. Although no preemptive rights were formally accorded by statute or the articles, the court declared that proportionate stock interests in a close corporation cannot be altered without consent except for a bona fide business purpose. The court thus created preemptive rights contrary to statutory authority. One can readily imagine corporate counsel's concern if asked to opine on the validity of the board's resolution to issue additional shares. Here again is a clear case of corporate "natural law" superseding black letter law.

H. Personality Clashes and Freeze-Outs

Students of corporate law are familiar with the internecine battles that often arise within close corporations. A common scenario is as follows: (i) founders (whether they be brothers, sisters, best of friends,
or anyone else) form a company; (ii) no written shareholder agreements or other protective measures are created—after all, the parties love one another; (iii) the company prospers; (iv) after some period of time, either (a) one of the founders dies, with his or her interest being transferred to a spouse or child who does not get along with the other founders, or (b) relationships among the founders or families sour due to personal or business-related reasons; (v) one family side or group controls a majority of the shares or the board and a decision is made that the services of the person or family on the "outs" are no longer needed; (vi) the "outs" are removed from all salaried positions, thus losing the income stream received since the initial corporate formation; and (vii) dividends are cut or suspended, thereby eliminating the only other source of distributions to those in disfavor. Variations on this theme abound. The common thread is that those in control of the corporate machinery "freeze out" the disfavored minority from all profit-sharing distributions. The company continues to prosper, but the "outs" have neither salaries nor dividends in which to share. The typical pattern might include efforts by the majority to purchase the minority shares, probably at substantially discounted values, but often the majority sees no reason to offer even that bone as long as they continue to enjoy economic benefits to the exclusion of the others.

At this point, with neither an income flow nor marketable shares, the disfavored minority might seek judicial relief. Corporate law contractarians will generally respond that the minority must lie in the bed that they made. That is, the parties had the opportunity at the outset to protect their respective interests through shareholder agreements and provisions in the articles of incorporation. In this view, failure to take protective measures is the fault of those suffering the consequences. Accordingly, they should not look to courts for rescue from their own lack of foresight. Some courts have adopted that position, leaving the minority with no recourse.

Opposing the contractarian ideology is a viewpoint that appeals to the compassionate soul, namely that principals within a close corporation should follow a mutually deferential policy towards each other. Massachusetts courts currently are in the forefront of this perspective. A series of cases in that state apply the principle that shareholders in a

62. The Revised Model Business Corporation Act expressly sanctions such agreements. See REV. MODEL BUS. CORP. ACT § 7.32 (allowing shareholder agreements covering all aspects of their relationships if not contrary to public policy).

63. E.g., Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993) (observing that a minority shareholder had the opportunity to contract for certain protection, and that it "would do violence ... to corporat[e] law to fashion an ad hoc ruling which would result in a [corporate action] for which the parties had not contracted").
close corporation have fiduciary obligations equivalent to the high fiduciary duties owed by partners within a partnership.\textsuperscript{64} For example, in \textit{Wilkes v. Springside Nursing Home, Inc.},\textsuperscript{65} the fact pattern resembled the generic description set forth above. The court did not approach the permissibility of the plaintiff's dismissal as a director and officer and the cessation of salary payments to him as a question of statutory authority. Rather, asserting that the denial of employment could be "pernicious in some instances," the court determined that the majority had not met the burden imposed upon them to prove a legitimate business purpose for severing Wilkes from the payroll.\textsuperscript{66} The case was remanded for a finding of damages.\textsuperscript{67}

Most states allow minority shareholders a cause of action based upon "oppressive" conduct by directors or other shareholders.\textsuperscript{68} Statutory provision for this cause of action is commonly found within the judicial dissolution provisions. The "oppressive" conduct provision is perhaps the corporate code's most explicit recognition of equity's role in corporate affairs. Whatever "oppression" may be, it requires neither fraud nor illegality. It is directed to the "oppressed" shareholder and places the spotlight on the shareholder's interests rather than corporate goals, and it is not only the interest as a shareholder that may be affected. Cases involving oppressive conduct include corporate actions taken against shareholders in varying capacities such as director, officer, employee, or shareholder.\textsuperscript{69}

A family squabble in New Jersey illustrates the Solomonic manner in which some courts respond to charges of oppression. The story began with the corporation's founding father splitting his shares unequally between his daughters, Ruth and Judith.\textsuperscript{70} Ruth's husband ran the company.\textsuperscript{71} Judith was a somewhat passive director who received a substantial annual payment from the corporation.\textsuperscript{72} Later on, Judith's son and future daughter-in-law were employed by the company.\textsuperscript{73} In

\begin{itemize}
\item \textsuperscript{64} See, e.g., Donohue v. Rodd Electrotype Co., 382 N.E.2d 505 (1975).
\item \textsuperscript{65} 353 N.E.2d 657 (Mass. 1976).
\item \textsuperscript{66} Id. at 662-63.
\item \textsuperscript{67} Id. at 664.
\item \textsuperscript{68} The Revised Model Business Corporation Act contains such an authorization "in a proceeding by a shareholder if it is established that . . . the directors or those in control of the corporation have acted . . . in a manner that is illegal, oppressive, or fraudulent." REV. MODEL BUS. CORP. ACT § 14.30. Approximately 35 states have adopted a similar provision. Robert B. Thompson, \textit{The Shareholder's Cause of Action for Oppression}, 48 BUS. L. 699, 709 n.70 (1993).
\item \textsuperscript{69} Id. at 714.
\item \textsuperscript{70} Brenner v. Berkowitz, 634 A.2d 1019, 1021 (N.J. 1993).
\item \textsuperscript{71} Id.
\item \textsuperscript{72} Id. at 1021-22.
\item \textsuperscript{73} Id. at 1022.
\end{itemize}
time came the intra-family friction. Next came Judith’s removal as director, then the firing of her son and departure of daughter-in-law elect (who happened to be the company’s top salesperson). Judith sued under New Jersey’s “oppressive” conduct provision based on the loss of her and her family members’ positions. Adopting the “reasonable expectation” test used in many jurisdictions, the court determined that Judith had a reasonable expectation when she received her shares that she would remain a director and continue to receive annual payments. Thus, continuing payments to Judith were required. However, because her son and his fiance were later arrivals on the scene, Judith could have no reasonable expectation as to their continued employment. Having thus resolved the claims, the court used its bully pulpit to admonish Ruth’s faction (the majority) to assure that Judith received “financial benefits commensurate with her holdings.”

Whether that bit of dictum became an invitation for further litigation depends on the good behavior of Ruth, her husband, and their cohorts. What is clear, though, is that the Supreme Court of New Jersey, in keeping with many other courts, were prepared to roll up their sleeves, delve into the arcane battleground of internecine family disputes, and resolve the conflict through equitable remedies. Indeed, the decisions give hardly a passing glance at the statutory formulae under which majority shareholders elect the board, the board appoints officers and sets salaries, and minority shareholders, like children, are to be seen but not heard.

I. Shareholder Voting Rights

Shareholder voting rights are well defined in each corporate statute, subject to modification by the articles of incorporation. Unless voting rights are specifically granted, shareholders have no right to demand a vote as to a particular corporate matter. In general, shareholder voting is limited to the election of directors and to such major corporate actions as mergers, sale of all or substantially all assets, and dissolution.

Enter the courts. In at least two well-known areas, courts have intervened to require shareholder voting where the statute may indicate otherwise. One involves the sale of corporate assets, the other the de

74. See id. at 1021.
75. Id. at 1021, 1022.
76. Id. at 1021-22.
77. Id. at 1033-34.
78. Id. at 1034.
79. Id. at 1033.
80. Id. at 1034.
facto merger doctrine. In the former, the statutes uniformly restrict shareholder voting to those sales that involve “all or substantially all” of the corporate assets.81 When statutory framers want to use a majority concept, they certainly do so. Thus, the phrase “all or substantially all” appears to reflect a standard well above a majority percentage. Yet, Delaware courts have on at least two occasions noted that the percentage standard might not be the principal standard. In one case, where only twenty-six percent of the corporate assets were sold, the court approached the question of shareholder voting by asking whether the proposed sale was of assets “quantitatively vital” to the corporation, affecting its existence and purpose.82 In another instance, involving the sale of a subsidiary’s assets that represented fifty-one percent of the parent’s assets, the court required a shareholder vote on the basis of the “radical departure” that the sale would effect in the parent’s business.83 The statute was interpreted by these courts in a non-numerical manner, quite contrary to a plain reading. These cases reflect the judicial attitude that it is not right as a matter of principle for shareholders to be powerless in the face of major proposed transactions. If it is possible to interpret the statute to require shareholder voting, fairness dictates such an interpretation.

The de facto merger doctrine is similarly a judicial intrusion into the tidy world of black letter law. Statutory mergers uniformly require shareholder approval by the shareholders of the company that is being acquired.84 If management of the merging entities desire to avoid such a vote, perhaps because of appraisal rights or fear of rejection, the transaction might be structured to technically avoid the shareholder voting requirement. One possibility, for example, would be an upside-down transaction that technically turns the acquiring company into the acquired company, and vice versa, thereby perhaps avoiding a shareholder vote by the nominal acquiring company. Such technical evasions have not been accepted by some courts and have led to the so-called “de facto merger” doctrine. Under that doctrine, if the transaction is functionally one that, but for its technical arrangement, would have required a shareholder vote, that vote remains necessary.85 Compliance

83. Katz v. Bregman, 431 A.2d 1274, 1276 (Del. Ch. 1981). Interestingly, shareholders of a parent corporation ordinarily have no voting rights as to a subsidiary, yet this question was entirely avoided by the court. See id. at 1274-76.
84. E.g., DEL. CODE ANN. tit. 8, § 251(c) (1997). A vote by shareholders of the acquiring company often depends upon the nature of the consideration and changes, if any, to the acquirer’s articles of incorporation. E.g., id.
85. See, e.g., Rath v. Rath Packing Co., 136 N.W.2d 410, 417-18 (Iowa 1965) (holding
with the strict letter of the statute is of no avail if the courts conclude that the statute’s equitable purpose is being undermined.

Corporate counsel might well ask in frustration, how can I be assured that statutory compliance suffices to validate my client’s proposed action? By now it may be evident that there is no answer to that question. Corporate “natural law” will not be denied despite the clearest of statutory mandates.

J. Insider Trading

An axiomatic rule of corporate law is that insiders who purchase or sell their company’s stock based on confidential information act in violation of Rule 10b-5 and are subject to both civil and criminal sanctions. If we seek a rational basis for Rule 10b-5’s application to insider trading, the foundation principles are not readily apparent. It cannot be the effect of such trading on the market value of the stock, especially in the common instance where the stock is that of a publicly-traded corporation. The amount of shares traded by an insider is likely to be so small compared to the public float or even to the daily trading volume that market impact is negligible at best. Moreover, any impact will be in the direction that the stock ought to move if the confidential information were disclosed. Selling shares (because of confidential adverse information) puts a downward pressure on the stock price, while buying (on positive confidential information) creates an upward pressure, both being exactly the direction that the market would move with full information.

Nor can insider trading prohibitions be justified by any reliance on the part of the innocent traders on the other side of the transactions. The innocents were not impelled into the market by the insider, and the price at which they bought or sold the stock was no different than if the insider had not been trading at all. Assuming that the corporation was justified in not disclosing the confidential information, it made no difference to the innocents’ decisions or to their economic result whether the insider was buying while they were selling, or vice versa.

Moving up a notch, the argument is heard that the true problem with insider trading is that it mars the integrity of the market, as non-insiders will lose confidence in the market if they realize that there may be informational imbalances. First, this argument suffers from the fact that most traders already accept the fact that there are inherent, valid informational imbalances in the market. All traders realize, or should

that a reorganization leading to issuance of shares to third party corporation was a merger with such corporation and thus required two-thirds shareholder approval).
realize, that some are more adept at analyzing available information and have greater prediction capabilities than others. If that were not so, the entire industry of stock market analysts would be superfluous. (Some may suggest that is exactly the case, although near-universal reliance upon analytical gurus by mutual funds and others belies such skepticism.) Thus, traders do not expect that they know as much as everyone else; sometimes they think they know more, sometimes less. Moreover, it is difficult to accept the notion that the occasional, minuscule impact that insider trading might have on a particular stock would deter others from investing in that security (let alone the market generally), especially since that impact, if any, would move the stock in its proper direction.

Shred of conventional rationales, the insider trading doctrine rests ultimately on a fairness concept. It is simply unfair for insiders to gain advantages in the market by reason of their superior access to information. Insider trading is cheating, and cheating is unfair. Agencies and courts are not willing to countenance the exploitation of status that non-disclosure of material information brings. The insider trading prohibition is drawn from traditional agency law. The insider, as agent of the corporation, breaches a fiduciary duty not to profit by misusing or usurping confidential information belonging to the corporate principal. Fiduciary duties are founded on principles of trust and loyalty. The insider trading rules, cases, and commentaries ultimately reflect and boil down to these baseline "natural law" standards.

K. And the Mundane

Judicial invocation of fairness principles occurs even in somewhat ordinary factual circumstances. The Delaware case of Schnell v. Chris Craft Industries, Inc. is a good example. Facing an announced proxy fight with a group of dissident shareholders, the board of directors amended the corporate bylaws to move the annual shareholders' meeting date up by one month. The dissident shareholders complained that the earlier date seriously hampered their solicitation efforts.

86. See William R. Lucas et al., Common Sense, Flexibility, and Enforcement of the Federal Securities Laws, 51 BUS. L. 1221, 1237 (1996) ("Insider trading is about cheating; cheating a shareholder, an employee, a client, or even a friend.").
87. E.g., Securities & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968) ("Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or . . . remain uncorrected.").
89. Id. at 439.
90. Id. at 438-39.
directors argued that they "strictly complied" with the Delaware Corporation Law in changing the bylaw date. The supreme court, having found that the board utilized corporate machinery simply to perpetuate itself in office, answered the directors' argument of strict statutory compliance with the ringing pronouncement that "inequitable action does not become permissible simply because it is legally possible."

The *Schnell* court's declaration of equity's superiority over statutory law applies to an unlimited range of corporate actions. Corporate codes are replete with relatively mundane provisions, the application of which could be challenged on equitable grounds. For example, statutes permit shareholders to authorize "blank check" preferred stock for eventual issuance through board determination. Given certain circumstances, it would not be surprising to find a court holding that the "blank check" is not as blank as it appears. The directors' apparent carte blanche may be subject to claims ranging from self-dealing to unfair dilution of existing interests.

Dividends are a similar area nominally controlled by statutory provisions. Carefully drafted dividend provisions set forth financial criteria for board declarations. Despite the board's discretion to act within those explicit standards, there is no reason to doubt that courts may find equitable grounds to uphold challenges to distributions deemed contrary to fiduciary principles.

### III. Conclusion

Corporate law is not unique in recognizing an extensive role for equitable doctrine. What appears different about corporate law is its seeming commitment to and dominance by formalistic statutes and documents. The high stakes often at risk in corporate law issues cause the corporate bar and their clients to prefer a world of relatively certain doctrine. There is enormous client pressure to provide unambiguous opinions from counsel which in turn are often submitted to the clients' lenders, investors, merger partners, government agencies, and others. The corporate bar's desire for certainty leads to a continual tinkering with corporate statutes. Many of those efforts are aimed at clarification, such as recent amendments to the Revised Model Business Corporation Act that define the terms "director's conflicting interested transaction" and "required disclosures" for conflict of interest purposes. Such

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91. *Id.* at 439.
92. *Id.*
93. *See, e.g.*, REV. MODEL BUS. CODE ANN. § 6.02(a).
94. *See id.* § 8.60(1), (2).
efforts are valiant, and clarification efforts are appropriate, but they cannot cause us to forget Holmes' caution that "certainty is generally illusion, and repose is not the destiny of man." 95

This essay is not intended to suggest that corporate lawyers put down their Delaware advance sheets and pick up the collected works of Ronald Dworkin. On the other hand, it would not do lawyers any harm to develop an understanding of Dworkin's "rights" thesis. 96 Lawyers clearly appreciate changing doctrine. That is well illustrated by the attention given in recent years to the law and economics movement. Younger corporate lawyers are more likely to be mesmerized by the seeming certainty suggested by statutes, articles, bylaws, and shareholder agreements. Older lawyers may have witnessed enough of equity's interference with explicit statutory authority and carefully crafted agreements to be much more circumspect in relying upon explicated standards. Such lawyers can relate well to Philip Howard's description of "common sense" decisionmaking by government institutions: "The sunlight of common sense shines ... whenever principles control: What is right and reasonable, not the parsing of legal language, dominates the discussion." 97

Having come to the end of this short piece, it is my hope that the notion of corporate natural law does not strike the reader as foreign-sounding or oxymoronic as first appeared. Despite all the trappings of formalism, there is scarcely an area of corporate law that does not lend itself to the potential superiority of fairness principles over black letter law. However, appreciation of that fact is insufficient. Much more important (and here a study of jurisprudential scholarship may well be advisable) is an understanding of the parameters of fairness concepts, appropriate application of equitable doctrine, and the dynamic tension and opportunities created by interplay between the "is" and the "ought" of corporate law. How applicable are the words of Oliver Wendell Holmes:

[i]f the training of lawyers led them habitually to consider more definitely and explicitly the social advantage on which

95. Holmes, supra note 2, at 466.
96. Dworkin argues that law is not a collection of rules alone but is also endowed with controlling principles, the principles being especially important in hard cases where rules do not clearly resolve the disputes. See RONALD DWORKIN, TAKINGS RIGHTS SERIOUSLY 31-39 (1977). The governing principles are based upon perceived individual rights in a liberal sense, and judicial decisions involve the application and enforcement of those rights. See id. at 39-45.
97. PHILIP K. HOWARD, THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA 177 (1994) (arguing that there is far too little common sense decisionmaking in government as agencies regard themselves limited by rules and regulations).
the rule they lay down must be justified, they sometimes
would hesitate where now they are confident, and see that
really they were taking sides upon debatable and often
burning questions. 98

Debatable and burning questions will survive every effort at statutory
codification and reduction of corporate interests to written articles,
bylaws, and shareholder agreements. Fairness and equity doctrine will
so often influence these questions that the corporate lawyer’s province
necessarily extends well beyond the perimeters suggested by formal
documentation. The admonition to recognize and accommodate such
expanded horizons should be welcomed, not shunned, as it illuminates
the life and vitality of the complex world of human beings interacting
within the metaphysical entities we call corporations.

98. Holmes, supra note 2, at 468. Holmes generally has been treated as a legal positivist
because of his insistence upon the separation of law and morality. In this centennial year of the
Path of the Law article, it might be well to reconsider that characterization as perhaps too
narrow in light of Holmes’ continual emphasis upon the role of societal considerations in the
growth of legal principles.