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The Shareholder Primacy Norm

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I. INTRODUCTION

The structure of corporate law ensures that corporations generally operate in the interests of shareholders. Shareholders exercise control over corporations by electing directors, approving fundamental transactions, and bringing derivative suits on behalf of the

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corporation. Employees, creditors, suppliers, customers, and others may possess contractual claims against a corporation, but shareholders claim the corporation's heart. This shareholder-centric focus of corporate law is often referred to as shareholder primacy.

Although shareholder primacy is manifest throughout the structure of corporate law, it is within the law relating to fiduciary duties that shareholder primacy finds its most direct expression. Corporate directors have a fiduciary duty to make decisions that are in the best interests of the shareholders. This aspect of fiduciary duty is often called the shareholder primacy norm.[1]

Although the shareholder primacy norm has had myriad formulations over time, the one most often quoted by modern scholars comes from the well-known case *Dodge v. Ford Motor Co.*:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[2]

Legal scholars generally assume that the shareholder primacy norm is a major factor considered by boards of directors of publicly traded corporations in making ordinary business decisions and that changing the shareholder primacy norm would have an effect on the substance of those decisions. Stephen Bainbridge captured the prevailing sentiment exactly, asserting that "the shareholder wealth maximization norm . . . has been fully internalized by American managers."[3]

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1. The term "shareholder primacy norm" has come into wide use. *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C.L. REV. 1861, 1875 n.41 (1995); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 880 (1990). Occasionally, the term "shareholder wealth maximization norm" is employed instead. *See, e.g.*, Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993). Identifying this fiduciary duty as a "norm" has considerable jurisprudential support. For example, Hans Kelsen described legal norms as follows:

> The concepts of "duty" and "right" (or entitlement) are intimately connected with the functions of norms. "A norm commands a certain behavior" is equivalent to "A norm imposes a duty to behave in this way." "A person is 'duty-bound' or has a 'duty' to behave in a certain way" is equivalent to "There is a valid norm commanding this behavior." A duty is not something distinct from a norm: it *is* the norm in relation to the subject whose behaviour is commanded.

HANS KELSEN, GENERAL THEORY OF NORMS 133 (Michael Hartney trans., 1991). Although rarely analyzed, the distinction between the principle of shareholder primacy and the shareholder primacy norm occasionally emerges in corporate law scholarship. *See, e.g.*, John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1461 (1994) (referring to the "traditional shareholder primacy model" as including the right of a corporation's shareholders "to control its destiny, determine its fundamental policies, and decide whether to make fundamental changes in corporate policy and practice" and quoting *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919), as an "encapsulation of the shareholder primacy norm").

2. 170 N.W. at 684.

3. Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 717 (1996).

This Article challenges the received wisdom and argues that the shareholder primacy norm is nearly irrelevant to the ordinary business decisions of modern corporations. Furthermore, the shareholder primacy norm was not created to mediate conflicts between shareholders and nonshareholder constituencies of a corporation. Indeed, the origin and development of the shareholder primacy norm suggest that it was introduced into corporate law to perform a much different and somewhat surprising function—the shareholder primacy norm was first used by courts to resolve disputes among majority and minority shareholders in closely held corporations. Over time this use of the shareholder primacy norm has evolved into the modern doctrine of minority oppression. This application of the shareholder primacy norm seems incongruous today because minority oppression cases involve conflicts among shareholders, not conflicts between shareholders and nonshareholders. Nevertheless, when early courts employed rules requiring directors to act in the interests of *all* shareholders—not just the majority shareholders—they were creating the shareholder primacy norm.

Although first used to resolve minority oppression cases, the shareholder primacy norm was not confined to such cases. Because courts did not routinely distinguish closely held corporations from publicly traded corporations until the middle of this century, the shareholder primacy norm was employed without hesitation in cases involving publicly traded corporations.[4] Outside the takeover context,[5] however, application of the share-

4. *See* JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970, at 76 (1970):

> Both the set-pattern incorporation acts, which were standard as of the 1880s, and the enabling-act type of statute, which became standard by the 1930s, tacitly assumed that the corporation would be one with a substantial number of shareholders .... The record shows no significant attention given before the mid-twentieth century to the question whether a different corporate pattern might be more suited to the needs of a firm with relatively few investors, most of whom would usually be in continuing touch with its affairs, if not actively involved in operating it.

The first legislature to adopt a statutory provision aimed at addressing the special needs of closely held corporations was New York, which acted in the wake of *Benintendi v. Kenton Hotel Inc.*, 60 N.E.2d 829 (N.Y. 1945). North Carolina and South Carolina followed suit in 1955 and 1962 respectively. *See* F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 873-75 (1978). One of the first cases noting the importance of treating closely held corporations differently than publicly traded corporations was *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964). *See also* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975).

5. The shareholder primacy norm serves a different function in the context of takeovers than it does in the context of ordinary business decisions. Because takeovers usually are a terminal event for shareholders of the target corporation, the shareholder primacy norm protects rights that otherwise might be lost forever. As noted by the Delaware Supreme Court in *Paramount v. QVC*:

> Because of the intended sale of control, the [acquisition of Paramount by Viacom] has economic consequences of considerable significance to the Paramount stockholders. Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium. As a result, the Paramount stockholders are entitled to receive, and should receive, a control premium and/or protective devices of significant value. There being no such protective provisions in the Viacom-Paramount transaction, the Paramount directors had an obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available.

Paramount Comm. Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1994). For more on the shareholder primacy norm in the takeover context, see D. Gordon Smith, *Chancellor Allen and the Fundamental Question*, 21 SEATTLE U. L. REV. (forthcoming 1998).

holder primacy norm to publicly traded corporations is muted by the business judgment rule.[6] As a result, even though the shareholder primacy norm is closely associated with debates about the social responsibility of publicly traded corporations,[7] its impact on the ordinary business decisions of such corporations is limited.

Part I of this Article describes the prevailing view of the shareholder primacy norm in legal scholarship. It then challenges that view by examining the application of the shareholder primacy norm to modern, publicly traded corporations, arguing that the norm is nearly irrelevant to the ordinary business decisions made by boards of directors of such corporations. Part II argues that shareholder primacy applied to the earliest business corporations and describes its role. Part III shows how courts first enforced the shareholder primacy norm in the context of closely held corporations in actions that would be classified today as minority oppression cases. The Article concludes with an explanation of how the origin of the shareholder primacy norm reveals its irrelevance to modern, publicly traded corporations.

II. THE SHAREHOLDER PRIMACY NORM IN PUBLICLY TRADED CORPORATIONS

The shareholder primacy norm is considered fundamental to corporate law.[8] This section first describes the prevailing view of the shareholder primacy norm in legal scholarship. Then this section illustrates the error of that view by demonstrating the irrelevance of the shareholder primacy norm to corporate decision making in modern, publicly traded corporations.

A. The Shareholder Primacy Norm in Legal Scholarship

The assumption that the shareholder primacy norm is a major factor in the ordinary business decisions of boards of directors of modern, publicly traded corporations is pervasive in modern corporate law scholarship. The influence of the shareholder primacy norm seems so obvious that arguments among corporate law scholars typically leapfrog over descriptive aspects of the debate and rush straight to the normative question: *should* corporate law require profit maximization? Perhaps the most surprising aspect of this de-

6. The business judgment rule is essentially a presumption that directors did not breach their duty of care. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

7. For a recent example, see Marjorie Kelly, *Why All the Fuss About Stockholders?*, 11 BUS. ETHICS 5 (Jan./Feb. 1997):

> [Shareholders] also claim the more fundamental right to have corporations managed exclusively on their behalf. Corporations are believed to exist for one purpose: to maximize returns to shareholders. This message is reinforced by CEOs, *The Wall Street Journal*, business schools, and the courts. It is the guiding idea of the public corporation, and the law of the land—much as the divine right of kings was once the law of the land. Indeed, the notion of "maximizing returns to shareholders" is universally accepted as a kind of divine, unchallengeable truth.

8. *See, e.g.*, Kenneth B. Davis, *Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L. J. 7, 8 (1988) ("The bedrock principle of U.S. corporate law remains that maximization of shareholder value is the polestar of managerial decisionmaking.").

bate is that scholars on all sides seem to embrace the assumed power of the shareholder primacy norm.

The most frequent defender of the shareholder primacy norm in recent scholarship has been Stephen Bainbridge. In an article-length analysis of the normative implications of shareholder primacy, Bainbridge began with a descriptive assertion about the place of shareholder primacy in corporate law: "Despite a smattering of evidence to the contrary, the mainstream of corporate law remains committed to the principles espoused by the *Dodge* court."[9] In a later article, Bainbridge made the link between the legal norm and business practice explicit, asserting that "the shareholder wealth maximization norm ... has been fully internalized by American managers."[10] In fairness, Bainbridge recognizes that directors are not hell-bent on shareholder wealth maximization and sometimes consider the interests of other corporate constituencies.[11] However, in Bainbridge's opinion, that the shareholder primacy norm "matters" seems beyond question.[12]

Bainbridge is an unabashed proponent of the contractarian view of corporate law which dominated scholarship in the 1980s.[13] In recent years, contractarians have been subjected to a normative attack by a small group of self-proclaimed "communitarian" or "progressive" corporate law scholars. These scholars do not dispute the contractarians' descriptive claim that corporations are usually operated in the best interests of shareholders. What rankles the progressives is that the descriptive claim represents a state of affairs that they find repugnant. The primary item on the agenda of the progressives, therefore, has been to change corporate law in a way that accounts for the needs of nonshareholder constituencies. This agenda item has manifested itself most forcefully in the debate over nonshareholder constituency statutes.

David Millon often writes as if the shareholder primacy norm were a major factor considered by directors in making ordinary business decisions.[14] Millon believes "it is

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9. Bainbridge, *supra* note 1, at 1423-24. The "mainstream of corporate law" to which Bainbridge refers is the Delaware corporation statute and caselaw. *Id.* at 1424.

10. Bainbridge, *supra* note 3, at 717.

11. Bainbridge writes:

> In most situations, shareholder and nonshareholder constituency interests coincide. The tough cases, of course, are those in which the interests diverge. One suspects that, despite the shareholder wealth maximization norm, directors and officers often take nonshareholder constituency interests into account even in these cases. This is not particularly surprising because no one other than the occasional law and economics professor seriously expects managers to leave their ethical and moral concerns at home.

Bainbridge, *supra* note 1, at 1439.

12. *See infra* Part II.B.2.

13. For other examples of contractarian scholarship that assumes the influence of the shareholder primacy norm, see MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 97 (1995):

> [I]t is generally agreed that management's principal fiduciary duty is to maximize the return to the common shareholders .... It follows that the principle guiding management's investment decisions is to choose those projects that have an expected rate of return equal to or greater than the return demanded by the common shareholders ....

See also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36-38 (1991) (arguing that without the shareholder primacy norm, "[a]gency costs rise and social wealth falls").

14. *See, e.g.*, David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1374 (1993); *see also* Lynne L. Dallas, *Working Toward a New Paradigm, in*

still clear that shareholder primacy has served as corporate law's governing norm for much of this century."[15] Yet, Millon recognizes that corporate decision making is not based exclusively on shareholder primacy. He writes, "corporate law has always understood—though usually only dimly—that truly relentless pursuit of shareholder wealth maximization is inconsistent with actual business practice and socially unacceptable in any event."[16] Despite this recognition, Millon maintains that this governing norm heavily influences corporate decision making, as illustrated by the following:

> Shareholder primacy mandates that management—the corporation's directors and senior officers—devote its energies to the advancement of shareholder interests. If pursuit of this objective conflicts with the interests of one or more of the corporation's nonshareholder constituencies, management is to disregard such competing considerations . . . .
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> Efforts to maximize shareholder wealth are often costly to nonshareholders and often come at the expense of particular nonshareholder constituent groups. For example, a corporation may find that one of its several plants can no longer be operated profitably. Management's duty to the shareholders mandates that it consider closing the plant in order to avoid further losses. Doing so will result in lost jobs. Other members of the community in which the plant is located will suffer as well. Tax revenues will decline, as will charitable giving and other contributions of the corporation and its employees to the life of the community; established creditor, customer, and supplier relationships will be terminated, perhaps leading to further unemployment; and lost jobs will impose added strain on social services budgets. Shareholders gain (by avoiding losses) at the expense of these nonshareholders, many of whom have made nontransferable investments of human and financial capital with the reasonable expectation of a continued, long-term corporate relationship. Nevertheless, from a corporate law standpoint, none of these clearly foreseeable harms to nonshareholders are relevant to management's decisionmaking. Instead, management's duty is to focus solely on the interests of the corporation's shareholders, weighing the likely costs and benefits to them alone of closing the plant.[17]

PROGRESSIVE CORPORATE LAW 35, 46 (Lawrence E. Mitchell ed., 1995) (arguing that the emphasis on profit would lessen if "legal rules, social norms, or cultural values change"); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry Into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477, 501 (1995) (arguing that the shareholder primacy norm leads to corporate immorality); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 958 (1993) (arguing that the shareholder primacy norm "absolv[es] directors from their responsibility to act as moral agents").

15. *Id.*

16. Millon, *supra* note 14, at 1374.

17. David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 14, at 1 [hereinafter *Communitarianism*]. Somewhat surprisingly, Millon expressed doubts about the feasibility of nonshareholder constituency statutes, even though he has been one of their strongest proponents. *See id.* at 30 ("However attractive [the multi-fiduciary] model might be in theory, communitarian scholars have yet to show persuasively that it could function effectively in practice."); *see also* David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) [hereinafter *Redefining*].

Many who study corporate law do not identify themselves as either contractarians or progressives, but they still express faith in the shareholder primacy norm. The American Bar Association's Committee on Corporate Laws, for example, seems to find no divergence between the aspiration of shareholder fidelity and director behavior when it states that "directors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders when so doing."[18] Modern corporate law scholarship, therefore, seems to have achieved consensus on this fact: the shareholder primacy norm is a major factor considered by boards of directors of publicly traded corporations in making ordinary business decisions.

B. The Irrelevance of the Shareholder Primacy Norm in Publicly Traded Corporations

Whether the shareholder primacy norm is relevant to the ordinary decision making of boards of directors of modern, publicly traded corporations is an empirical question for which direct evidence is difficult, if not impossible, to obtain. The following analysis attacks the issue from three directions. First, this Article examines the use of the shareholder primacy norm in judicial opinions for evidence that the norm is enforced against directors.[19] Presumably, consistent application of the shareholder primacy norm by courts would cause directors to consider the norm when making decisions. Second, this Article describes the adoption of nonshareholder constituency statutes—which replace the shareholder primacy norm with a new norm allowing directors to consider the interests of other corporate constituencies—and examines the effects of these new statutes on courts' decisions.[20] Presumably, if the shareholder primacy norm is relevant to the ordinary decision making of boards of directors, a change in that norm would occasion some recognition in courts' decisions.[21] Third, this Article reviews studies of corporate deci-

18. Committee on Corporate Laws, A.B.A., *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2261 (1990) [hereinafter ABA, *Other Constituencies Statutes*].

19. *See infra* Part II.B.1.

20. *See infra* Part II.B.2.

21. Most nonshareholder constituency statutes are permissive; they do not *require* the board of directors to consider the interests of nonshareholder constituencies. *See, e.g.*, N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1997) (emphasis added):

> (b) In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:
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> (i) the prospects for potential growth, development, productivity and profitability of the corporation;
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> (ii) the corporation's current employees;
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> (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
>
> (iv) the corporation's customers and creditors; and
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> (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the

sion making by business management scholars for evidence indicating the effect of the shareholder primacy norm.[22] Taken together, these three sources of evidence do not definitively establish the irrelevance of the shareholder primacy norm with respect to ordinary decision making, but they create substantial doubt regarding its importance.

1. The Shareholder Primacy Norm in Judicial Opinions

Before examining the role of the shareholder primacy norm in judicial opinions, it is useful to have a more detailed description of the relationship between the norm and fiduciary duties generally. The shareholder primacy norm does not speak to the content of fiduciary duties beyond determining who is the beneficiary of such duties. Some applications of the fiduciary principle in corporate law do not require the identification of any particular corporate constituency as beneficiary, but only that the interests of "the corporation" in general must be served.[23] Indeed, courts traditionally have analyzed conflicts between the interests of managers and the interests of the corporation—which Lawrence Mitchell refers to as "vertical conflicts of interest"[24]—by examining the actions of the managers rather than by focusing on the interests of any identifiable beneficiary. For example, rules governing corporate opportunities, executive compensation,[25] and interested director transactions all prohibit certain managerial behavior without requiring specification of who is harmed. As Mitchell explained:

> What [the rules governing vertical conflicts of interest] suggest is that it is enough to prohibit directorial self-dealing to recognize that directors have no

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communities in which it does business.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.

For purposes of this paragraph, "control" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting stock, by contract, or otherwise.

Such statutes would not necessarily result in a change that would manifest itself in judicial opinions.

22. *See infra* Part II.B.3.

23. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 197-202 (rev. ed. 1967) (discussing a director's obligation to exercise "fidelity to the interests of the corporation").

24. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 591 (1992).

25. Claims for excessive compensation arguably implicate the shareholder primacy norm, although these often have the flavor of a duty of loyalty claim. In the well-known case of *Rogers v. Hill*, the court stated the standard for evaluating excessive compensation as follows: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority of stockholders have no power to give away corporate property against the protest of the minority." 60 F.2d 109, 113-14 (2d Cir. 1932). For a similar standard, see *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979). Even though excessive compensation has attracted much attention in the popular press and in law reviews, successful challenges of compensation decisions in publicly traded corporations are rare. *See* Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 214 (1996) ("While *Rogers* suggests that there is some outer limit to executive compensation in publicly held corporations, in fact the courts just do not reach the merits of a claim of excessive compensation.").

> legitimate financial interest in the property they manage that would permit them to use any portion of that property to further their own interests. Although logical, the correlative statement that these transactions should be precluded in the interest of the stockholders is not necessary: the older formulation focusing on the interests of the corporation is adequate. Thus, identifying the beneficiaries of the rule is, to establish this modest principle, of secondary importance.[26]

On the other hand, conflicts among different groups of shareholders or between the interests of shareholders and the interests of nonshareholder constituencies—which Mitchell refers to as "horizontal conflicts"[27]—require a rule identifying the beneficiary of managerial action.[28] As a descriptive matter, corporate law usually has identified common shareholders as the beneficiaries.[29] The normative question of whether shareholders *should* be the beneficiaries is beyond the scope of this Article. It is enough for present purposes to note that only horizontal conflicts of interest require specification of a beneficiary for director action and that the shareholder primacy norm usually performs this function in corporate law.

If fiduciary duties influence director action, the foregoing analysis suggests that directors take notice of the shareholder primacy norm, if at all, only in situations involving horizontal conflicts of interest. In situations involving vertical conflicts of interest, directors are concerned only with the prohibition against self-interested behavior. Whether shareholders or nonshareholder constituencies are the beneficiaries of that prohibition is of little import. Horizontal conflicts of interest are normally handled under the fiduciary duty of care. The duty of care as usually formulated requires a director to act in good faith, with ordinary care, and "in a manner [the director] reasonably believes to be in the best interests of the corporation."[30] The last component of the foregoing statement of the duty of care is the shareholder primacy norm[31] and "the best interests of the corporation" are generally understood to coincide with the best long-term interests of the shareholders.[32] If a director deviates from that standard by preferring the interests of a nonshare-

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26. Mitchell, *supra* note 24, at 596.

27. *Id.* at 591.

28. *See id.* at 590-94.

29. In some instances, directors may be required to act in the best interests of the creditors of the corporation. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. CIV.A.12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (stating that "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise"). For additional citations to such cases, see Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1512 n.88 (1993).

30. MODEL BUS. CORP. ACT ANN. § 8.30(a) (1996).

31. Most states with statutory statements of the duty of care require that a director perform his or her duties in a manner that he or she reasonably believes to be in the best interests of the corporation. MODEL BUS. CORP. ACT ANN. § 8.30, at 8-176.

32. *See, e.g.*, ABA, *Other Constituencies Statutes*, *supra* note 18, at 2255 ("With few exceptions, courts have consistently avowed the legal primacy of shareholder interests when management and directors make decisions."); Millon, *Redefining*, *supra* note 17, at 228 ("Corporate law has avoided such puzzles by, for the most part, equating the duty to the corporation with a duty to act in the best interests of its shareholders."); *see also* Mitchell, *supra* note 24, at 586. Mitchell states:

> Although the precepts phrasing suggests a distinction between the interests of the broader corporation and its stockholders as a subgroup, it is a distinction that has been slighted by the law.

holder constituency to the interests of the shareholders, the director technically violates the fiduciary duty of care.

This would be only a "technical" violation because, in duty of care cases, the universal application of the business judgment rule makes the shareholder primacy norm virtually unenforceable against public corporations' managers. The business judgment rule has various formulations,[33] but with respect to the shareholder primacy aspect of the duty of care, the deference embodied in the business judgment rule usually will be overcome only when the actions taken by directors cannot be "attributed to any rational business purpose."[34] Although the business judgment rule also inhibits enforcement of the shareholder primacy norm in closely held corporations,[35] it is nearly an iron-clad shield for directors of public corporations.[36] In discussing this point, Chancellor William Allen noted:

> Rather, the basic approach has been to equate the interests of the stockholders and the interests of the corporation, which have been identified at the lowest common denominator as stockholder wealth maximization.

Id. In a study of corporate governance in the United Kingdom, John Parkinson wrote the following:

> A requirement to benefit an artificial entity, *as an end in itself*, would be irrational and futile, since a non-real entity is incapable of experiencing well-being. Indeed, it is doubtful that an inanimate entity can meaningfully be said to have interests, or if it could, what they would be .... The correct position is thus that the corporate entity is a vehicle for benefitting the interests of a specified group or groups. These interests the law has traditionally defined as the interests of the shareholders. The duty of management can accordingly be stated as a duty to promote the success of the business venture, *in order* to benefit the members.

J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW 76-77 (1993).

33. For an excellent discussion of the various formulations of the business judgment rule and a proposal to abolish the rule, see Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1994).

34. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *see also* Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir. 1981); Hanrahan v. Kruidenier, 473 N.W.2d 184, 188 (Iowa 1991); *cf.* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 401(c)(3) (1994) (stating that a director fulfills the duty of care when he or she "rationally believes that the business judgment is in the best interests of the corporation") [hereinafter ALI PRINCIPLES]. In discussing *Sinclair*, legendary Delaware lawyer Samuel Arsht asserted that the "rational business purpose test was a correct articulation of one element of the business judgment rule. It should be assumed that a business objective or purpose is reasonable or rational only if its accomplishment is intended to serve the corporation's best interests." S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 107 (1979).

35. *See* O'Neal, *supra* note 4, at 884.

36. In an oft-cited article, Joseph Bishop wrote: "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). Bishop found only four such cases and commented, "to my mind none of these cases carries real conviction." *Id.* at 1100. Since Bishop's statement was published, other commentators have more or less confirmed his findings. *See, e.g.*, William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 922 n.126 (1993) ("I am aware of only five cases in the history of American corporate law that have held directors liable for breaches of the duty of care, four of which seem tainted by conflicts of interest."); 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, 591 n.1 (1983) ("Research reveals only seven successful shareholder cases [claiming a breach of the duty of care] not dominated by elements of fraud or self-dealing.").

> There is a theoretical exception to [business judgment protection] that holds that some decisions may be so "egregious" that liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction and, to my knowledge only the dubious holding in this Court of *Gimbel v. Signal Companies, Inc.*, (Del. Ch.) 316 A.2d 599 aff'd (Del. Supr.) 316 A.2d 619 (1974), seems to grant equitable relief in the absence of a claimed conflict or improper motivation. Thus, to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect.[37]

A recent New York case dealing with the business judgment rule illustrates the difficulty of prevailing on the rare claim that the directors violated the shareholder primacy norm. In *Stern v. General Electric Co.*,[38] Philip Stern sued General Electric, claiming that payments from the corporation to the "Non-Partisan Political Support Committee for General Electric Employees" did not benefit the corporation because funds from the Committee were used to support congressional incumbents regardless of their past positions on business issues.[39] Stern clearly asserted a business purpose claim that directly implicated the shareholder primacy norm. Although Stern survived a motion to dismiss,[40] the court ultimately granted summary judgment by applying the standards developed in two earlier cases—*Auerbach v. Bennett* and *Aronoff v. Albanese*.[41] A brief review of those standards reveals the substantial hurdles facing any shareholder who claims a violation of the shareholder primacy norm.

In *Auerbach v. Bennett*,[42] the New York Court of Appeals applied the business judgment rule to a decision of a shareholder litigation committee of the board of directors of General Telephone & Electronics Corporation to dismiss a derivative suit brought by one of the company's shareholders. On the issue implicated by the shareholder primacy norm—whether the suit was in the best interests of the corporation—the court had an expansive view of the business judgment rule:

> Derivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors. Necessarily such decision must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the

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[37] Gagliardi v. Trifoods Internat'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).

38. Stern v. General Elec. Co., No. 86 Civ. 4055 (MLJ), 1992 WL 8195 (S.D.N.Y. Jan. 14, 1992).

39. *See generally id.*

40. *Id.*

41. Stern v. General Elec. Co., 837 F. Supp. 72, 76-77 (S.D.N.Y. 1993), *aff'd*, 23 F.3d 746 (2d Cir. 1994), *cert. denied*, 513 U.S. 916 (1994).

42. 393 N.E.2d 994 (N.Y. 1979).

> corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.[43]

Aronoff v. Albanese also adopted a broad interpretation of the business judgment rule.[44] In that case, the court considered certain transactions between Hospital Building Corporation (HBC) and Pelham Bay General Hospital (PBGH).[45] Certain directors of HBC were also partners in PBGH.[46] According to the plaintiff, PBGH leased a hospital from HBC and received ten months of reduced rent and certain other benefits.[47] Although *Aronoff* involved issues of loyalty rather than care, the court offered an expansive view of the board's role in deciding its business purpose:

> The existence of benefit to the corporation ... is generally committed to the sound business judgment of the directors. The objecting stockholder must demonstrate that no person of ordinary sound business judgment would say that the corporation received fair benefit. If ordinary businessmen might differ on the sufficiency of consideration received by the corporation, the courts will uphold the transaction.[48]

These cases illustrate the extensive deference granted boards of directors to determine whether an action is in the best interests of the corporation.[49] Although it is possible for shareholders to prevail on claims that the board of directors violated the shareholder primacy norm, such cases are extremely rare, especially when they involve publicly traded corporations.

2. The Shareholder Primacy Norm in Incorporation Statutes

Fiduciary duties for directors were first developed by courts as a matter of common law. Only within the past few decades have those duties been defined in most incorporation statutes.[50] These statutory statements of the shareholder primacy norm have not

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43. *Id.* at 1000-01. Other courts have declined to apply the business judgment rule to decisions of special litigation committees. *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

44. 446 N.Y.S.2d 368, 371 (N.Y. App. Div. 1982).

45. *Id.* at 369.

46. *Id.*

47. *Id.*

48. *Id.* at 370-72 (citations omitted).

49. *See also* Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (holding that the decision not to install lights at Wrigley Field for night baseball games was not necessarily contrary to the best interests of the shareholders because "the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood" and because "the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating"); Hanrahan v. Kruidenier, 473 N.W.2d 184, 188 (Iowa 1991) (finding that the charitable donation of artwork in the liquidation of the Des Moines Register and Tribune Company had a rational business purpose because it resulted in an income tax deduction).

50. The Model Business Corporation Act first included a duty of care in 1974. At the time, the Committee on Corporate Laws noted:

> In recent years, a growing number of jurisdictions have introduced, in their business corporation acts, an affirmative statement of a standard of care for directors and, in many instances, officers. Recognizing this trend, it has been determined desirable to provide a standard in the Model Act which would promote uniformity in the development by statute of the basis on

added significantly to the common law treatment of the norm. Although subject to some variation, the basic statutory statement of the shareholder primacy norm requires directors to act in the best interests of the corporation, just as the common law rules did. Nevertheless, two developments in incorporation statutes have substantially altered the position of many statutes with respect to the shareholder primacy norm.

The first development occurred in the wake of *Smith v. Van Gorkom*, the well-known decision of the Delaware Supreme Court in which the court held directors liable for a breach of the duty of care in the context of a decision to sell the corporation.[51] Following this decision, many states passed statutes enabling corporations to adopt charter provisions to reduce or eliminate the liability of directors for a breach of the duty of care.[52] The charters of many publicly traded corporations now contain such a provision. To the extent the threat of suit for failure to pursue the corporation's best interests had any effect prior to this statutory development, the effect appears to be substantially diminished.

The second development has been the adoption of nonshareholder constituency statutes. In the late 1970s and early 1980s, many corporations adopted charter amendments allowing managers greater discretion to consider the interests of nonshareholder constituencies in the context of a corporate takeover.[53] In 1983, Pennsylvania adopted the first nonshareholder constituency statute, which allowed managers, "in considering the best interests of the corporation, [to] consider the effects of any action upon employees, suppliers, and customers of the corporation, communities in which offices or other establishments of the corporation are located, and all other pertinent factors."[54]

Nonshareholder constituency statutes have now been adopted in over half of the states.[55] Reaction to constituency statutes among commentators has been mixed,[56] but thus far the statutes have not generated lawsuits challenging ordinary business deci-

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which a director's performance shall be judged.

Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act, 30 BUS. LAW. 501, 503-04 (1975).

51. 488 A.2d 858 (Del. 1985).

52. Delaware was the first state to adopt such a statute. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990). "Delaware hoped to ease the [director and officer liability] insurance crisis by eliminating liability relating to duties typically covered by D&O insurance." *Id.* at 1160. Thirty-eight states currently have such provisions. MODEL BUS. CORP. ACT ANN. § 8.30, at 8-177 (1996).

53. A.A. Sommer, *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*. 16 DEL. J. CORP. L. 33, 39 (1991).

54. Act of Dec. 23, 1983, No. 1983-92, § 1(B), 1983 Pa. Laws 395.

55. Ronn S. Davids, *Constituency Statutes: An Appropriate Vehicle for Addressing Transition Costs?*, 28 COLUM. J.L. & SOC. PROBS. 145, 156 n.47 (1995) (listing various state statutes).

56. For arguments opposing nonshareholder constituency statutes, see generally ABA, *Other Constituencies Statutes, supra* note 32, at 2253; Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971 (1992); William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Sommer, *supra* note 53. For arguments supporting nonshareholder constituency statutes, see Mitchell, *supra* note 24; Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); Patrick J. Ryan, *Calculating the "Stakes" for Corporate Stakeholders as Part of Business Decision-Making*, 44 RUTGERS L. REV. 555 (1992); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991).

sions.[57] This may be partly because some of the statutes provide that nonshareholders have no cause of action based on the statutes, but it is probably also attributable to the fact that these statutes do not contemplate any significant change in the board's decision making process. As William Carney observed early in the debate over constituency statutes, "the results of corporate governance [under constituency statutes] would not differ significantly from what we now observe. Enlightened management . . . quite properly considers the interest of these constituencies when pursuing shareholder welfare."[58]

3. The Shareholder Primacy Norm in Modern Business Practices

Even if the shareholder primacy norm is unenforceable as a rule of law, it still may influence corporate decision making. As noted above, the influence of the shareholder primacy norm on ordinary business decisions is an empirical question not susceptible to a ready answer. Certainly, as noted in the American Law Institute's *Principles of Corporate Governance*, managers often make decisions that do not maximize value for shareholders:

> [O]bservation suggests that corporate decisions are not infrequently made on the basis of ethical considerations even when doing so would not enhance corporate profit or shareholder gain. Such behavior is not only appropriate, but desirable. Corporate officials are not less morally obliged than other citizens to take ethical considerations into account, and it would be unwise social policy to preclude them from doing so.[59]

A more complete picture of corporate decision making is required before one can assert the impotence of the shareholder primacy norm. A step in that direction is the important and oft-cited study of director behavior by Jay Lorsch and Elizabeth MacIver. Their study found widespread ambivalence toward the shareholder primacy norm among directors: "[D]irectors usually don't share a strong consensus about accountabilities to various constituencies and, therefore, about their purposes in serving. Further, the norm in most boardrooms is to avoid discussing such matters."[60]

Although directors believe that shareholders are their most important constituents, they factor other constituencies into their decisions.[61] Lorsch and MacIver found some

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57. Indeed, very few cases have been decided under nonshareholder constituency statutes. Those cases which have been decided under these statutes have been takeover cases. In the most recent case, involving a widely publicized battle between Norfolk Southern Corporation and CSX Corporation for control of Conrail Inc., Judge Van Artsdalen of the Eastern District of Pennsylvania upheld the use of Pennsylvania's nonshareholder constituency statute. For a description of the rulings, which are unreported, see Dennis J. Block & Jonathan M. Hoff, *Conrail/CSX: Pennsylvania Law on Different Track than Delaware*, N.Y.L.J., Feb. 27, 1997, at 1. For reported cases involving nonshareholder constituency statutes, see *Georgia-Pac. Corp. v. Great N. Nekoosa Corp.*, 727 F. Supp. 31 (D. Me. 1989); *Amanda Acquis. Corp. v. Universal Foods Corp.*, 708 F. Supp. 984 (E.D. Wis. 1989); *Keyser v. Commonwealth Nat'l Fin. Corp.*, 675 F. Supp. 238 (M.D. Pa. 1987); *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690 (E.D. Pa. 1986).

58. Carney, *supra* note 56, at 387; *see also* Orts, *supra* note 56, at 42 (stating that "the substance of the statutes simply reflects what many corporate directors and officers often have been doing anyway—conduct protected traditionally by the duty of care and the business judgment rule").

59. ALI PRINCIPLES, *supra* note 33, § 2.01 cmt. h.

60. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 38 (1989).

61. *Id.* at 38.

directors who "adhere to a strict belief in the primacy of the shareholder and decline to recognize that conflicts exist between their traditional legal perspective and that of other constituencies."[62] Such directors, however, were the "true minority."[63] The majority of directors felt themselves accountable to more than one constituency.[64] Most boards are comprised of directors who have different visions of the board's common goal, yet these visions usually are not explored by the group. In addition, those directors typically must attempt to supervise managers by creating well-articulated goals. The result is a complicated decision making process. Lorsch and MacIver conclude: "[The directors'] legal mandate often means little in the complex reality of governance."[65]

The Lorsch and MacIver study provides strong evidence of the impotence of the shareholder primacy norm. Other studies seem to support this hypothesis.[66] None of these studies prove that the shareholder primacy norm is impotent, but they suggest that the view of the shareholder primacy norm held by modern legal scholars—that it is a major factor considered by boards of directors of publicly traded corporations in making ordinary business decisions—may not accurately reflect reality.

III. SHAREHOLDER PRIMACY IN EARLY BUSINESS CORPORATIONS

If the shareholder primacy norm is irrelevant (or nearly so) to the ordinary business decisions of modern, publicly traded corporations, why is it considered to be a fundamental rule of corporate law? Moreover, does the shareholder primacy norm serve any function, other than in the rarified world of corporate takeovers? The answers to these questions emerge only from an examination of the origin and development of the shareholder primacy norm. That examination begins with the earliest business corporations in the United States.

Early business corporations in the United States were created primarily by special charters approved by state legislatures. Almost all business corporations that existed during the first years of the Republic engaged in activities such as insurance, banking, the construction of toll bridges, turnpikes, canals, and the provision of water, all of which were considered "activities of some community interest."[67] Willard Hurst called these corporations "public-utility-type enterprises."[68] Even the chartering of general business corporations, however, was justified on the grounds that these corporations served the public interest.[69]

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62. *Id.* at 39.

63. *Id.* at 39.

64. *Id.* at 43.

65. LORSCH AND MACIVER, *supra* note 60, at 50.

66. *See, e.g.*, JAMES C. COLLINS & JERRY I. PORRAS, BUILT TO LAST: SUCCESSFUL HABITS OF VISIONARY COMPANIES 67 (1st ed. 1994) (studying 18 "visionary companies" and finding that profit maximization was not a driving force; instead, most of the companies focused on some "core ideology," such as service to customers, concern for employees, quality products or services, or commitment to risk taking or innovation); HENRY MINTZBERG, POWER IN AND AROUND ORGANIZATIONS 278 (1983) (arguing that growth is often the most important organizational goal).

67. HURST, *supra* note 4, at 15.

68. *Id.* at 35.

69. *See* Currie's Admin. v. Mutual Assurance Soc'y, 14 Va. (4 Hen. & M.) 315, 347-48 (1809):

> With respect to acts of incorporation, they ought never to be passed, but in consideration of

Modern scholars often observe that the chartering of early business corporations in the United States was justified by reference to the public interest,[70] implying that those corporations were not expected to serve the best interests of the shareholders. This claim is credible because the shareholder primacy norm did not blossom until the middle of the nineteenth century. The implication is that these early corporations conducted business on different terms than modern corporations and that early corporate business decisions were more respectful of societal values. Short of conducting a detailed comparison of substantive business decisions, this claim is difficult either to substantiate or disprove. As a next best alternative, the following sections argue that the notion of "public interest," which justified the chartering of early business corporations, was consistent with the shareholder primacy norm and that early business corporations operated in a legal system and business culture that demanded shareholder primacy.

A. Early Business Corporations and the Public Interest

What was the public's interest in chartering business corporations? Early evidence regarding this question comes from a surprising source—the Supreme Court's opinion in *Trustees of Dartmouth College v. Woodward*.[71] Although *Dartmouth College* did not involve a business corporation, the Court considered the question of what constituted a "public good" in relation to private corporations. The Court's opinion did not distinguish among the different types of private corporations in providing an answer.[72]

> services to be rendered to the public . . . . It may be often *convenient* for a set of associated individuals, to have the privileges of a corporation bestowed on them; but if their object is merely *private* or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for privilege.

70. *See, e.g.*, Simeon E. Baldwin, *History of the Law of Private Corporations in the Colonies and States*, *in* 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 236, 251 (AALS ed., 1909) (first published in TWO CENTURIES' GROWTH OF AMERICAN LAW (1901)) ("The American corporation could only come into existence legitimately for the public good."); RALPH ESTES, TYRANNY OF THE BOTTOM LINE: WHY CORPORATIONS MAKE GOOD PEOPLE DO BAD THINGS 23 (1996) ("Investors were allowed a return as an inducement to fund the corporation, but providing a return to financial investors was secondary to the corporation's real purpose, which was to provide a *public* return, a public benefit."); Martin Lipton & Stephen A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 188 (1991) ("The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare."); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 207 (stating that "the typical corporation was chartered to pursue some sort of public function").

71. 17 U.S. (4 Wheat.) 517 (1819).

72. *See id.* at 659-61. None of the opinions in *Dartmouth College* explicitly address business corporations, an understandable omission given that Dartmouth College was considered a charitable corporation. A fair inference from all of the opinions regarding the public's interest in chartering corporations is that business corporations are treated similarly. Justice Marshall seems to include all corporations in his statement about corporate purpose and the public interest. *See infra* note 70 and accompanying text. Justice Washington claims to know of only "two kinds of corporations aggregate; namely, such as are for public government, and such as are for private charity," which he distinguishes "in order to prevent any implied decisions by this court, of any other case than the one immediately before it." *Dartmouth College*, 17 U.S. (4 Wheat) at 659. Of course, it is the private corporations to which this decision applies, and that group must include business corporations (which surely are not government corporations) even though Justice Washington is unclear on this point. Justice Story claims that "[i]t is unnecessary, in this place, to enter into any examination of civil corporations," a category that includes business corporations, but then proceeds to divide all corporations into

The narrower legal issue addressed by the Court was whether the Dartmouth College charter could be amended by a legislative act of the state of New Hampshire without impairing the obligation of a contract within the meaning of the United States Constitution. The contract at issue, of course, was the corporate charter itself. In considering whether a corporate charter was to be considered a contract for purposes of the Contracts Clause, both Justice Marshall and Justice Story revealed their views regarding the nature of the public interest required to justify the issuance of a corporate charter.

Justice Marshall attacked the question by asking whether the incorporators had given any consideration in exchange for the grant of a corporate charter. Justice Marshall had an expansive view of the consideration offered by the incorporators, stating: "The objects for which a corporation is created are universally such as the government wishes to promote. They are deemed beneficial to the country; and this benefit constitutes the consideration, and, in most cases, the sole consideration of the grant."[73]

Justice Story also addressed the issue of consideration, looking at various forms that might be rendered by incorporators. Among those was that the incorporators formed a contract because "this charter ... purports ... on its face, to be granted ... in consideration of the premises in the introductory recitals."[74] In the case of Dartmouth College, the introductory recitals of the charter stated:

> Dr. Wheelock had founded a charity-school at his own expense, on his own estate; that divers[e] contributions had been made in the colonies, by others, for its support; that new contributions had been made, and were making, in England, for this purpose, and were in the hands of trustees appointed by Dr. Wheelock to act in his behalf; that Dr. Wheelock had consented to have the school established at such other place as the trustees should select; ... that the trustees had finally consented to establish it in New Hampshire; and that Dr. Wheelock represented that, to effectuate the purposes of all parties, an incorporation was necessary.[75]

According to Justice Story, the actions contemplated by these recitals constituted consideration for the grant of the corporate charter. Such representations in a corporate charter were not unique to Dartmouth College or to charitable corporations generally. Indeed, the introductory recitals in the Dartmouth College charter were not significantly different than the introductory recitals of many special charters issued in that era, including charters issued to general business corporations. The following preamble from the charter of The Salem Iron Factory Company, a Massachusetts corporation formed on March 4, 1800, is illustrative:

> Whereas Ebenezer Beckford and others, herein after named, have associated themselves together for the purpose of establishing and carrying on the busi-

"public" and "private," thus sweeping business corporations together with charitable corporations. *Id.* at 668-71.

73. *Dartmouth College*, 17 U.S. (4 Wheat) at 637. Justice Marshall then proceeds to apply this general statement to "eleemosynary institutions," but this subsequent focus on such corporations should not detract from his general statement that *all* corporations ("universally") are chartered by government because they perform a function the government perceives as valuable and "wishes to promote." *Id.*

74. *Id.* at 685.

75. *Dartmouth College*, 17 U.S. (4 Wheat) at 685-86.

> ness of anchor-making, and other manufactures of iron, have at great expense purchased the mill-seats on *Water's-river* (now so called) formerly called the *Cow-house-river*, in Danvers, in the County of *Essex*, and have erected mills and other suitable buildings at said place, for the purposes aforesaid, and have petitioned the General Court, that they may be a body politic and corporate, with such powers, as may enable them, more conveniently and effectually, to execute the purposes aforesaid . . . .[76]

Using Justice Story's logic, it appears that Ebenezer Beckford and his co-incorporators proffered consideration sufficient to create a contract with the state of Massachusetts. They had purchased land, erected buildings, and presumably promised to operate an iron factory.[77] Just as Dr. Wheelock's promise to locate Dartmouth College in New Hampshire constituted consideration to the public for the grant of that corporate charter, Ebenezer Beckford's promise to operate a steel factory would seem to satisfy the public-benefit requirement and justify the issuance of a corporate charter.

In light of this analysis, the question asked above—What was the public's interest in chartering business corporations?—might be stated another way: What does the public receive in exchange for granting a corporate charter? The answer, it appears from *Dartmouth College*, is that the public receives the corporation itself!

Dartmouth College implies that early courts did not view the public good as conflicting with private gain.[78] Joseph Angell and Samuel Ames, who wrote the first American treatise on corporate law,[79] take the analysis one step further, suggesting that shareholder primacy is *essential* to serving the public good.[80] Following Marshall's lead, Angell and Ames tied the grant of special charters to the creation of a public benefit.[81] Indeed, they viewed public benefit as inherent in the concept of the corporation, stating that "the design of a corporation is to provide for some good that is useful to the public"[82] and that "nearly every corporation is public, inasmuch as they are created for the public benefit."[83] As to the nature of this public benefit, Angell and Ames asserted that the public benefits by encouraging investment in productive enterprises:

> It is frequently the principal object, in this and in other countries, in procuring an act of incorporation, to limit the risk of the partners to their shares in the stock of the association; and prudent men are always backward in taking stock when they become mere copartners as regards their personal liability for the company debts. *The public, therefore, gain by the acts incorporating trading associations, as by such means persons are induced to hazard a certain amount*

76. An Act to incorporate Ebenezer Bechford, Ch. LV (Mar. 4, 1800) (establishing an iron manufactory).

77. *Id.*

78. 17 U.S. (4 Wheat) at 562-70 (discussing generally the purposes underlying the grant of a charter).

79. *See* JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 7 (1832).

80. *Id.*

81. *Id.* (stating that "it has been generally the policy and the custom (especially in the United States) to incorporate all associations, whose object tends to the public advantage, in relation to municipal government, commerce, literature, and religion. The *public benefit* is deemed a sufficient consideration of a grant of corporate privileges.").

82. *Id.* at 8.

83. *Id.* at 21.

> *of property for the purposes of trade and public improvement, who would abstain from so doing, were not their liability thus limited.*[84]

Occasionally, the charters issued to corporations confirm Angell and Ames' view that the public interest was served primarily by the ability of corporations to encourage economic development or, in the case of public-utility-type enterprises, to promote the construction of infrastructure improvements.[85] Sometimes public-utility-type enterprises served the public interest by obtaining some infrastructure improvement while avoiding the need to impose taxes.[86]

General business corporations were not expected to produce infrastructure improvements, but were valued merely because they developed business. For example, the act incorporating the Hamilton Manufacturing Society, also a New York corporation, observed that the incorporators were pursuing a corporate charter "for the laudable purposes of promoting and extending the manufactory of glass . . . ."[87] Occasionally, corporate charters professed purposes that sounded almost altruistic. The charter of The New York Manufacturing Society stated a purpose that would please the most progressive corporate law scholars:

> Whereas James Nicholson and others, associated as a company under the style of the New York Manufacturing Society, for the laudable purposes of establishing manufacturies, and furnishing employment for the honest industrious poor, by their petition presented to this legislature, have prayed to be incorporated, to enable them more extensively to carry into effect their patriotic intentions.[88]

Early incorporation statutes also suggest that state legislatures viewed business corporations as a valuable means of promoting the public interest. In 1795, North Carolina adopted perhaps the first incorporation statute in the United States,[89] granting canal

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84. ANGELL & AMES, *supra* note 79, at 23-24 (emphasis added). Willard Hurst later echoed this idea, stating that fears of corporate power were outweighed by "practical acceptance of the corporate device as a socially useful instrument of economic growth." HURST, *supra* note 4, at 47.

85. *See, e.g.*, An Act for opening the navigation between Lake Erie and Lake Ontario, Laws of New York, Ch. 92 (Apr. 5. 1798) (establishing the Niagara Canal Company). The Niagara Canal Company, a New York corporation and a public-utility-type enterprise, was intended to promote economic development through infrastructure improvements: "*whereas* [a canal] would tend greatly to facilitate and advance the internal commerce of this State and promote the convenience and prosperity of the people thereof . . . ." *Id.*

86. For example, the preamble in the charter of The First Massachusetts Turnpike Corporation states:

> Whereas the highway leading through the towns of *Palmer* and *Western*, is circuitous, rocky and mountainous, and there is much travelling over the same, and the expen[s]e of straightening, making and repairing an highway through those towns, so as that the same may be safe and convenient for travellers, with horses and carriages, would be much greater than ought to be required of the said towns, under their present circumstances . . . .

An Act for establishing a Turnpike Gate, Ch. IV (June 11, 1796).

87. An Act to incorporate the stock holders of the Hamilton Manufactoring Society, Laws of New York, Ch. 68 (Mar. 30, 1797).

88. An Act to incorporate the stockholders of the New York Manufactoring Society, Laws of New York, Ch. 26 (Mar. 16, 1790).

89. In discussing the statute, Joseph Davis notes that "[n]o specific grant of corporate franchise is made, . . . and the companies formed under it are to be regarded merely as joint stock companies with one or two privileges (not even limited liability) commonly associated with corporations. Furthermore, it is doubtful if the companies were, strictly speaking, organized for profit." 2 JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 18-19 (1917).

builders the right of eminent domain under certain conditions and the power to "sue and be sued, plead and be impleaded, under the denomination of the canal company."[90] The statute's preamble defines the public interest:

> Whereas it has been demonstrated by the experience of the most improved and well cultivated countries, that opening communications by cutting canals, has been productive of great wealth and convenience: And whereas it has been represented to this General Assembly, that cutting canals . . . would greatly facilitate and encourage merchandize, and consequently contribute to the wealth and revenue of this state . . . and also be productive of the most salutary effects, by draining noxious marshes, swamps and low lands, which will promote health, reclaim immense quantities of our most fertile lands, and in a peculiar manner tend to the wealth and welfare of this state, which it is the most ardent desire of this legislature at all times to promote by every useful undertaking.[91]

That corporate charters and incorporation statutes often identified a public interest associated with the formation of the corporation does not, in itself, suggest that the corporations were operated on some basis other than shareholder primacy. Even the most ardent defenders of shareholder primacy would agree that the public benefits in all of the foregoing ways through the chartering of corporations. The next section examines the legal system and business culture in which early corporations operated and finds substantial evidence of shareholder primacy.

B. Evidence of Shareholder Primacy in Early Business Corporations

As discussed below, the shareholder primacy norm was not developed by courts until the 1830s, but evidence of shareholder primacy is abundant in early business corporations.[92] Early corporate charters,[93] general incorporation statutes,[94] judicial decisions, and legal commentary all reflect a commitment to shareholder primacy in the similar treatment of dividends and voting rules.[95] Moreover, judicial characterization of the

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90. *Id.* at 19.

91. *Id.* at 18.

92. *See infra* Part IV.A.

93. Secondary sources provide the evidence for some early charters, but most of the observations made below are based on a review of special charters issued in the Commonwealth of Massachusetts and the State of New York in or prior to 1800. Joseph Davis listed and classified the charters by industry in Appendix B of his important study of early corporations. DAVIS, *supra* note 89, at 332-45. The charters were located in Session Laws of American States and Territories, the Acts and Laws of Massachusetts, and the Laws of New York, respectively. Davis studied all charters issued in five industries: banking, inland navigation, toll bridges, turnpikes, and manufacturing. Unless otherwise noted, differences between charters for the public-utility-type corporations (the first four industries) and charters for general manufacturing corporations were trivial or nonexistent.

94. Secondary sources provide the evidence for some early incorporation statutes, but most of the observations made below are based on a review of the following incorporation statutes adopted prior to 1850: Laws of the State of New York, Ch. LXVII (Mar. 22, 1811); Public Statute Laws of the State of Connecticut, Ch. LXIII (June 10, 1837); Laws Made and Passed by the General Assembly of the State of Maryland, Ch. 267 (Mar. 28, 1839); Acts of the Seventieth Legislature of the State of New Jersey, p. 16 (Feb. 14, 1846); Laws of the General Assembly of the Commonwealth of Pennsylvania, No. 368 (Apr. 7, 1849).

95. These are not the only aspects of early corporate law that reflect adherence to shareholder primacy, but they are the most conspicuous. Other aspects of early corporate law include books and officer records re-

manager-shareholder relationship as one of trustee and *cestui que trust* reflects early acceptance of shareholder primacy. Finally, the development of derivative litigation by courts of equity suggests that courts at the time accepted the principle of shareholder primacy.

Early commitment to shareholder primacy is unsurprising given the universal assumption that shareholders collectively *became* the corporation. An early New York charter describes the transfiguration:

> That immediately from and after the filing and recording in manner aforesaid the list of subscribers to the western company, the persons therein named as subscribers, whilst they continue stockholders therein, and all others who shall continue stockholders therein, shall be and are hereby created and made a corporation and body politic in fact and in name . . . .[96]

This shareholder-centric world view also manifested itself in the detailed rules that governed corporations. For example, early corporate charters and incorporation statutes in the United States sometimes described the right of shareholders to receive dividends.[97]

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quirements. *See, e.g.*, Laws Made and Passed by the General Assembly of the State of Maryland, Ch. 267 (Mar. 28, 1839). Yet another aspect of early corporate law lies in the power of shareholders to have the final determination regarding bylaws. *See, e.g.*, Laws of the General Assembly of the Commonwealth of Pennsylvania, No. 368 (Apr. 7, 1849).

96. An Act for establishing the Western Inland Lock Navigation in the State of New York, Ch. 40 (Mar. 30, 1792). This formulation of the act of incorporation is far from exceptional. It appears to be the usual view of what was happening during formation of the corporation. *See, e.g.*, An Act for incorporating a bridge over the Charles River, Ch. XXI (Mar. 9, 1785) (stating that named persons, "so long as they shall continue to be proprietors in the said fund, together with all those who are, and those who shall become proprietors to the said fund or stock, shall be a corporation and a body politic . . . . "); An Act to incorporate the Bank of New York, Laws of New York, Ch. 37 (Mar. 21, 1791) ("That all such persons as now are, or hereafter shall be, stock holders of the said bank, shall be, and hereby are, ordained, constituted and declared to be . . . a body corporate and politic, in fact and in name . . . . "). The identity of shareholders and the corporation is evident in other charter provisions. For example, the special charter for the Niagara Canal Company provided for the levying of a toll, "which toll and the whole profits thereof shall belong to and be vested in the said corporation and *their* successors and shall be divided among *them* in proportion to *their respective shares* . . . . " An Act for opening the navigation between Lake Erie and Lake Ontario, Ch. 92 (Apr. 5, 1798) (emphasis added).

97. For examples of special charters. see An Act to incorporate Sundry Persons, Ch. V (June 18, 1799) (incorporating the President, Directors and Company of the Gloucester Bank); An Act to establish the Western Turnpike Road, Ch. 88 (Apr. 4, 1798) (stating that "the president and directors of the said corporation . . . shall make and declare a dividend of the clear profits and income (all contingent costs and charges being first deducted) amongst all the stockholders of the said corporation"); An Act to incorporate the President and Directors of the Nantucket Bank, Ch. XXXII (Feb. 27, 1795) ("The Directors shall make half yearly dividends of all the profits, premiums and interests of the Bank aforesaid."); An Act to incorporate Benjamin Greenleaf, Esq. and others, Ch. I (Feb. 1, 1794) (establishing a Woolen Manufactory and stating "[t]hat all dividends of monies arising from the profits of the said manufactory, shall be apportioned upon the several shares, equally"); An Act to incorporate the President, Directors and Company of the Bank of New York, Laws of New York, Ch. 37 (Mar. 21, 1791) (stating that "it shall be the duty of the directors to make half yearly dividends of so much of the profits of the said bank, as to them, or a majority of them shall appear advisable"). For examples of incorporation statutes, see Laws Made and Passed by the General Assembly of the State of Maryland, Ch. 267 (Mar. 28, 1839) ("That the president and directors . . . shall cause dividends of the net profits of the company, or so much thereof as they may deem it prudent to divide, to be declared and paid to the stockholders at such time and in such manner as the bye-laws may prescribe."); Laws of the General Assembly of the Commonwealth of Pennsylvania, No. 368 (April 7, 1849) ("Dividends of so much of the profits of any such company, as shall appear advisable to the directors, shall be declared in the months of June and

Because most corporations did not have access to public trading markets, the right to receive dividends was crucial to shareholders' ability to extract the value of their investments.[98] Special charters and incorporation statutes, however, usually did not grant that right substantially greater protection than it receives under modern incorporation statutes. In fact, dividends typically were declared by a majority vote of the shares voted at a shareholder meeting.[99] Nevertheless, Joseph Davis noted, "[i]t seems to have been expected that all of the net profits would be paid out regularly."[100] Joseph Blandi also noted that early Maryland charters typically required directors to distribute all profits.[101]

There are no eighteenth century cases relating to dividends,[102] but later cases reflect the general understanding that corporations would pay profits as dividends. In *Scott v. Eagle Fire Insurance Co.*, for example, the court held that if directors "without reasonable cause refuse to divide what is actually surplus profits, the stockholders are not without remedy, if they apply to the proper tribunal, before the corporation has become insolvent."[103] Also, the court noted in *Beers v. Bridgeport Spring Co.*, "[b]y an usage or

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December annually, and paid to the stockholders.").

98. Then, as now, shareholders did not have a legal right to profits of the business until dividends were declared by the board of directors. *See, e.g.*, Minot v. Paine, 99 Mass. 101, 111 (1868) ("The money in the hands of the directors may be income to the corporation; but it is not so to a stockholder till a dividend is made . . . .").

99. *See, e.g.*, Acts & Laws passed by the General Court of Massachusetts, Ch. I (Feb. 1, 1794) (establishing the Newbury-Port Woolen Manufactory and stating that "no dividend shall be made, but pursuant to a vote of the Corporation, passed at a meeting legally called"). The case law also recognized this rule. *See, e.g.*, Brightwell v. Mallory, 18 Tenn. (1 Yer.) 196, 197-98 (1836) ("The money in the [corporation] is the property of the institution, and to the ownership of which the stockholder has no more claim than a person has who is not at all connected with the [corporation].").

100. DAVIS, *supra* note 89, at 326. Davis also observes: "Few companies actually set aside any surplus, and dividends consequently commonly fluctuated with the annual earnings." *Id.*

101. *See* JOSEPH G. BLANDI, MARYLAND BUSINESS CORPORATIONS 1783-1852 at 69 (1934). Blandi quotes the following charter provision as an example:

> That it shall be the duty of the President and Directors of said company, on the first Monday of October in each and every year, to declare a dividend of the profits, and to pay over the same to the stockholders, in proportion to the amount of stock by them respectively held.

Id.

102. Samuel Williston, *The History of the Law of Business Corporations Before 1800, in* 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY, *supra* note 70, at 228.

103. 7 Paige Ch. 198, 203 (N.Y. Ch. 1838). A subsequent case citing *Scott* viewed director power more liberally. In *Barry v. Merchants' Exchange Co.*, the court stated:

> In the charter in question, the corporation is authorized to receive the rents and profits of their exchange, and divide the same amongst the stockholders, at such times as they may deem expedient and proper. It is thus left entirely to the discretion of the trustees.
>
> It is however said that this clause is mandatory, and that the permission to designate the times, for a division of profits, does not authorize a total omission to divide for a long period.
>
> I cannot take this view of the clause in the charter. Whether the first time to be designated for a dividend of profits, shall be one year or twenty, is left to the corporation to determine. Nor is there any serious danger of inordinate accumulation, or of the growth of any overshadowing monopoly, by leaving corporations to pursue their own course in this respect. Few men would care to forego the receipt of an income from their stock, during their lives or for any long period, in order that in the next generation, their heirs may participate in the management of some gigantic corporation.

1 Sand. Ch. 280, 304 (N.Y. Ch. 1844).

custom which is as well established as if it stood upon legislative enactment, corporations steadily earning profits are expected to divide a portion of the same."[104] The cases also show that dividends were based on stock ownership.[105] Nonshareholder corporate constituencies were not entitled to dividends unless they had contracted with a shareholder to receive the dividends in lieu of the shareholder receiving them.[106] Rules entitling shareholders to receive dividends and business practices dictating the payment of all profits to shareholders suggest that businesses were operated primarily for the benefit of shareholders. In other words, the principle of shareholder primacy was alive and well in early corporations.

A second important piece of evidence of shareholder primacy in early corporations is the exclusive right of shareholders to vote.[107] Special charters frequently provided for shareholder voting. Although the charters did not always specify the subjects on which shareholders were allowed to vote,[108] the usual focus of shareholder voting was the election of directors.[109] Early incorporation statutes also provided for the election of directors

104. 42 Conn. 17, 27 (1875).

105. This principle was perhaps so obvious as to be beyond comment, but it is easily perceived in cases dealing with the transfer of shares, when the dividend follows the shares. *See, e.g.*, Abercrombie v. Riddle, 3 Md. 320, 327 (1850) ("The stocks, it appears, were sold some short time before the declaration of dividends, and it is of course conceded that the title to the dividends subsequently declared passed by the sale and transfer of the shares to the purchaser."); King v. Follett, 3 Vt. 385, 388 (1831) ("A conveyance of stock ... conveys the right of receiving the dividends of the income of such stock, and of conveying the same right to others ....").

106. *See, e.g.*, Wheeler v. Perry, 18 N.H. 307 (1846) (involving dividends given by the testator of a will, who owned the shares); Clapp v. Astor, 2 Edw. Ch. 379 (N.Y. Ch. 1834) (involving the apportionment of dividends to be paid as employment compensation).

107. Early cases dealing with the granting of voting rights to shareholders are sparse. It is clear that nonshareholders can vote only under certain circumstances. *See, e.g.*, State v. McDaniel, 22 Ohio St. 354 (1872) (stating that bondholders were entitled to vote if the statutorily authorized reorganization agreement allowed such a transaction). A later case held that a corporation could not adopt a bylaw allowing bondholders to vote when the state incorporation statute required shareholders to vote. *See* Durkee v. People, 40 N.E. 626 (Ill. 1895).

108. The following provision from An Act to establish a Bank in Massachusetts typifies such an early voting provision:

> *And be it further enacted by the authority aforesaid*, [t]hat *William Phillips, Isaac Smith,* and *Jonathan Mason,* Esquire's, be empowered to call a meeting of the subscribers to the said bank, at such time and place as they may think convenient, by advertising the same in two of the *Boston* news-papers, fifteen days before the time of holding the said meeting, at which, or any future meeting of the stockholders, all matters shall be determined by the major votes of persons present at such meeting, who are stockholders, or who represent stockholders; the number of votes to be determined by the number of shares each voter holds or represents; save only, that nothing shall prevent stockholders from determining, that the holders of a certain number of shares shall be present, or represented at the transaction of any particular business.

An Act to establish a Bank in Massachusetts, Ch. II (Feb. 7, 1784).

109. *See, e.g.*, An Act to incorporate Sundry Persons by the name of the President and Directors of the Nantucket Bank, Ch. XXXII (Feb. 27, 1795).

> That for the well-ordering of the affairs of said Corporation, a meeting of the Stockholders shall be held at such place as the Stockholders shall direct, on the first Monday in *January* annually ... at which annual meeting there shall be chosen by ballot, twelve Directors, who shall continue in office the year ensuing their election.

Id.; *see also* An Act incorporating the Proprietors of Andover Bridge, Ch. XXXIV (Mar. 19, 1793) (stating that "the Proprietors, by a vote of a majority of those present, ... may elect such Officers, and make and es-

by shareholders.[110] Indeed, at least one early case stated in dictum that the election of directors was an inherent right of shareholders.[111] Interestingly, many early charters and statutes also required directors to be shareholders of the corporation,[112] thus ensuring (if

tablish such rules and bye-laws as to them shall seem necessary or convenient, for the regulation of said corporation"); An Act incorporating the Honorable John Worthington as a Proprietor of the Locks and Canals, on the Connecticut-River, Ch. XIII (Feb. 22, 1792) (stating that "the said Proprietors may also, at any legal meeting, . . . choose a Committee, for regulating and ordering the affairs and business of the said Corporation"); An Act to incorporate the President, Directors and Company of the Bank of New York, Laws of New York, Ch. 37 (Mar. 21, 1791) ("[T]he said election [of directors] shall be held and made by such of the said stock holders of the said bank, as shall attend [the meeting]."). An interesting variation on these formulations appeared in the charter for the Proprietors of the Newbury-Port Woolen Manufactory, which personified the corporation as follows: "the said *Corporation* shall have full power from time to time, at any legal meeting, to choose . . . such Officers, Directors, Agents and Factors, as to the said Corporation shall appear necessary or convenient for the regulation and government of the said Corporation . . . ." An Act to incorporate the Proprietors of the Newbury-Port Woolen Manufactory, Ch. 1 (Jan. 29, 1794) (emphasis added). The charter later clarifies that only the "proprietors" are entitled to vote. *Id.*; *see also* An Act to incorporate Ebenezer Beckford, Ch. LV (Mar. 4, 1800) (establishing the Salem Iron Factory Company).

110. *See, e.g.*, Laws of the General Assembly of the Commonwealth of Pennsylvania, No. 368 (Apr. 7, 1849) (stating that the directors were to be selected at the stockholder meeting); Laws Made and Passed by the General Assembly of the State of Maryland, Ch. 267 (Mar. 28, 1839) (stating that the directors were to be selected at the meeting of stockholders); Public Statute Laws of the State of Connecticut, Ch. LXIII § 6 (June 10, 1837) (stating that the "corporation, shall be under the care of, and shall be managed by not less than three directors, who shall be chosen annually by the stockholders"); Laws of the State of New York, Ch. LXVII (Mar. 22, 1811) ("[T]he election [of trustees] shall be made by such of the stockholders as shall attend [the meeting] for that purpose, either in person or by proxy.").

111. *See* Hughes v. Parker, 20 N.H. 58 (1849). Although the charter of the corporation involved in this case provided for the election of directors by "members," the court reasoned that the right to elect directors was inherent in the granting of the charter:

> The election of directors and other suitable officers or agents, for the direction and government of the affairs of the corporation, and the conduct of its business through the agency of such officers, pertain to the condition and nature of aggregate corporate bodies. The creation of this corporation by an act of the legislature, which should have contained no provisions whatever for the choice of directors, or for the management of its affairs through the agency of such, would have implied all that is expressly conferred by the provisions which the act contains, except so far as those provisions relate to the time, place or other modes to be observed by the corporation in the exercise of that inherent function.

Id. at 71.

112. For examples of early special charters requiring directors to be shareholders, see An Act to incorporate Sundry Persons, Ch. V (Jan. 27, 1800) (incorporating the Gloucester Bank); An Act to incorporate Sundry Persons, Ch. VIII (June 18, 1799) (incorporating the President, Directors, and Company of the Essex Bank); An Act to incorporate Sundry Persons, Ch. XXII (June 25, 1795) (incorporating the President and Directors of the Merrimack Bank and stating that only a member of the corporation who is a citizen or resident of the Commonwealth is eligible to be a Director); An Act to incorporate Sundry Persons, Ch. XXXII (Feb. 27, 1795) (incorporating the President and Directors of the Nantucket Bank and stating that "[n]one but a Member of said Corporation, being a Citizen of this Commonwealth, and resident therein, shall be eligible for a Director or Cashier"); An Act to incorporate the Bank of New York, Laws of New York, Ch. 37 (Mar. 21, 1791) (stating that directors "shall be stock holders"). For examples of early incorporation statutes which imposed the same requirement, see Laws of the General Assembly of the Commonwealth of Pennsylvania, No. 368 (Apr. 7, 1849) (stating that directors "shall be stockholders"); Laws Made and Passed by the General Assembly of the State of Maryland, Ch. 267 (Mar. 28, 1839) (same); Public Statute Laws of the State of Connecticut, Ch. LXIII (June 10, 1837) (same); Laws of the State of New York, Ch. LXVII (Mar. 22, 1811) (same). Absent a provision in the charter or incorporation statute, directors were not required to be shareholders. *See, e.g.*, Hoyt v. Bridgewater Copper-Min. Co., 6 N.J. Eq. 253, 274-75 (N.J. 1847). If the charter or incorporation

not by design, at least in effect) that directors would have some sympathy for shareholder concerns when making decisions regarding the corporation.

A final piece of evidence of shareholder primacy in early corporate charters comes from an interesting phrase that appeared in Massachusetts special charters establishing tolls. Such charters often specified that the tolls authorized in the charter were to be collected "for the sole benefit of the said Proprietors," that is, the shareholders.[113] This language was likely meant to clarify that the tolls were not for public use. It is, however, a peculiarly strong statement of the shareholder primacy norm for the time. The language offered an important clarification when the corporations were in the business of inland navigation because the special charters for such corporations often endowed the corporations with powers usually reserved to governments. These powers included the power to take land (in exchange for compensation), which was derived from the government's power of eminent domain.[114] Also, where the corporations were toll bridges or toll roads, the distinction between arms of government and private corporations might easily become blurred because toll bridges and toll roads often reverted to the public after a term of years.[115]

Shortly after 1800, the first cases suggesting the existence of the shareholder primacy norm began to appear. These early cases treated shareholders as the primary beneficiaries of director action and often referred to corporations as trusts with the shareholders as the *cestuis que trust*.[116] Again, the evidence is ambiguous because courts also treated creditors as the *cestuis que trust* when the corporation was insolvent.[117] Neverthe-

statute contained such a requirement, however, it was typically enforced. *See, e.g.*, Despatch Line of Packets v. Bellamy Mfg., 12 N.H. 205, 222 (1841).

113. *See* An Act to incorporate the Honourable John Worthington, Ch. XIII (Feb. 22, 1792) (incorporating the proprietors of the Locks and Canals on the Connecticut River); *see also* An Act for Incorporating James Sullivan, Ch. XXI (June 22, 1793); An Act incorporating Dudley Atkins Tyng, Esq. and Others, Ch. XVI (June 25, 1792) (rendering Merrimack-River passable with Boats, Rafts and Masts); An Act to incorporate Henry Knox, Ch. XLIII (March 8, 1792) (incorporating the Proprietors of the Massachusetts Canal); An Act incorporating certain Persons for the Purpose of building a Bridge over Charles River, Ch. XXI (Mar. 9, 1785) (stating that all revenues collected from the use of the toll bridge belonged to the proprietors of the corporation).

114. *See, e.g.*, An Act for incorporating the Honourable John Worthington, Ch. XIII (Feb. 22, 1792) (incorporating the Proprietors of the Locks and Canals on the Connecticut River and stating that "the said proprietors be, and they hereby are authorized and empowered . . . to take, occupy and enclose any of the lands adjoining such canals and locks, which may be necessary for building and repairing the same, for towing paths, and other necessary purposes").

115. *See, e.g.*, An Act establishing the Third Massachusetts Turnpike Corporation, Ch. XLIV (Mar. 9, 1797) (stating that the toll road reverts to the public after full compensation); An Act for establishing a Turnpike Gate, Ch. IV (June 11, 1796) (same); An Act incorporating certain Persons for erecting a Bridge over the Connecticut River, between Montague and Greenfield, in the county of Hampshire, Ch. XXIX (Mar. 6, 1792) (stating that the toll bridge reverts to the public after 50 years); An Act for incorporating certain persons for the purpose of building a Bridge over Merrimack River, Ch. XIX (Feb. 23, 1792) (stating that the bridge reverts to the public after 30 years); An Act for incorporating certain Persons for the Purpose of Building a Bridge over the Charles River, Ch. XXI (Mar. 9, 1785) (stating that the bridge reverts to the public after 40 years).

116. *See, e.g.*, Tippetts v. Walker, 4 Mass. (1 Tyng) 595, 596 (1808); Gray v. Portland Bank, 3 Mass. (1 Tyng) 364, 379 (1807).

117. *See, e.g.*, Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824); *cf.* Coons & Braine v. Tome, 9 F. 532, 534 (W.D. Pa. 1881) (holding that directors are "at least, *quasi* trustees for the creditors"); Jackson v. Ludeling, 88 U.S. (21 Wall.) 616, 624 (1874) ("Certainly [the directors] were the trustees of the stockholders,

less, this shift away from shareholder primacy was limited to situations in which the corporation was insolvent. The same norm adheres today, when the shareholder primacy norm is well established.

Perhaps the most important of the early cases relating to shareholder primacy is *Gray v. Portland Bank.*[118] In *Gray*, a shareholder sued to enforce a preemptive right to purchase shares of the Portland Bank, a Massachusetts corporation formed in 1799.[119] Although he was not one of the original organizers of the bank, the plaintiff became a shareholder upon incorporation, purchasing seventy of one thousand shares issued.[120] The bank's charter specified that each share of stock had a par value of $100 and permitted a total capital stock of not less than $100,000 and not more than $300,000.[121] In 1802, the shareholders voted to issue two thousand additional shares, thus bringing the total capital stock to $300,000. The plaintiff attempted to subscribe for 140 shares to retain his seven percent interest in the corporation.[122] The directors denied plaintiff's application, and the plaintiff sued.[123]

At trial, the plaintiff won a $1,500 verdict,[124] which the respondent appealed to the Supreme Judicial Court of Massachusetts. Three justices heard the appeal and decided the case unanimously in favor of the plaintiff. Two of the justices wrote opinions that revealed their conceptions of the shareholder primacy norm. Both justices strove to find a proper metaphor for the corporation in more familiar business forms, and the two possibilities that presented themselves were trusts and partnerships.

Justice Sewell embraced the notion of the corporation as trustee for the shareholders[125] and held that the corporation could not act except for the benefit of the existing shareholders. In addressing the charter provision specifying the range of permissible capital stock, Justice Sewell reasoned:

> That it shall not be less than one sum, and not exceeding a certain greater sum, is not a power granted to the trustee to create another interest for the benefit of other persons than those concerned in the original trust, or for their benefit in any other proportions than those determined by their subsisting shares.[126]

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and also, to a considerable degree, of the bondholders . . . . ").

118. 3 Mass. (1 Tyng) at 364.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 367-68.

123. *Gray*, 3 Mass. (1 Tyng) at 368. Although courts considered preemptive rights to purchase additional shares an inherent attribute of corporate stock until early in this century, preemptive rights are not essential to the shareholder primacy norm. The norm requires only that shareholders be the residual claimants against the assets of the corporation and that managers of the corporation have fiduciary duties to act in the interests of shareholders. It is possible, of course, that majority shareholders might authorize the purchase of additional shares as a method of diluting a minority shareholder. This form of minority oppression is covered below. *See infra* Part IV.C.

124. *Gray*, 3 Mass (1 Tyng) at 366.

125. *Id.* at 378-79 (considering the bank "to be a trust created with certain limitations and authorities, in which the corporation is the trustee for the management of the property, and each stockholder a *cestui que trust* according to his interest and shares").

126. *Id.* at 379.

Justice Sewell reasoned that by refusing the plaintiff's application for additional shares, the corporation impaired the plaintiff's rights as a stockholder.[127]

Justice Sedgwick viewed the bank as an incorporated partnership rather than a trust,[128] but agreed with Justice Sewell that the plaintiff had the right to participate in the issuance of additional shares in the same manner as he could participate in any other corporate project.[129] Again, the language used to reach the result suggests shareholder primacy:

> At the time of the vote to augment the capital of the bank, all the stockholders were *partners*. The augmentation was supposed to be, and intended for the profit of the joint concern; the capacity to augment was in virtue of their *joint* interest; and it could only be done by the will of the majority, and that in pursuance of their original association. The law, by which the partnership existed, and by which the united interest was regulated, was that alone by which the augmentation could be made. Whenever a partnership adopts a project, within the principles of their agreement, for the purpose of profit, it must be for the benefit of all the partners, in proportion to their respective interests in the concern. Natural justice requires that the majority should not have authority to exclude the minority.[130]

Although they took different paths, both Justice Sewell and Justice Sedgwick endorsed a notion of shareholder primacy. The common idea that unites their respective views is that the managers of the corporation were obligated to serve the interests of the existing shareholders ahead of other interests—namely, prospective shareholders or, as counsel for the plaintiff characterized them, the director's "favorites."[131] That notion of shareholder primacy had not yet evolved into the shareholder primacy norm, but it was not far from it. As Merrick Dodd observed, *Gray* "might possibly have been treated by the court as involving a breach of directors' fiduciary duties, but was, in fact, treated by it as relating to the property rights of shareholders rather than to the equitable duties of management."[132]

A final piece of evidence of shareholder primacy in early judicial decisions is the development of the mechanism of derivative litigation to enforce claims of the corporation against directors. Although derivative litigation was not employed prior to the 1830s,

127. Justice Sewell's approach to the case may not have required an assertion that the corporation was like a trustee and the shareholders like a *cestui que trust* because he based his ultimate disposition of the case more on contract analysis than anything resembling a fiduciary duty. In short, he concluded that the plaintiff was entitled to subscribe to the additional shares because the charter granted him that right. *Id.* at 379-80 (asserting that the legislature intended to protect the rights of the initial stockholders if the number of shares outstanding were subsequently increased).

128. *Id.* at 383 ("At the time of the vote to augment the capital of the bank, all the stockholders were *partners*.").

129. *Gray*, 3 Mass. (1 Tyng) at 383.

130. *Id.*

131. *Id.* at 374.

132. EDWIN MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 71 (1954).

in the same cases that first embraced the shareholder primacy norm,[133] Chancellor Kent suggested the procedure in an 1817 case:

> [T]he persons who, from time to time, exercise the corporate powers, may, in their character of trustees, be accountable to this court for a fraudulent breach of trust . . . .
>
> . . . .
>
> . . . Nor does the case, as charged, amount to a breach of trust, of which I am to take notice. There is no complaint, on the part of the stockholders, of misconduct, nor is the information founded on any thing of that kind. If there had been a prosecution instituted for a breach of trust, it would have been by bill, and against individuals by name, calling them to account for the use and benefit of the company at large.[134]

As evidenced by this passage, the basis for equity jurisdiction over disputes between minority shareholders and managers (usually the majority shareholders) was the law of trusts. It is important to note that treating directors as trustees of the shareholders is quintessential shareholder primacy. That shareholders were chosen to enforce claims of the corporation does not necessarily imply that corporations were to be operated primarily for the benefit of shareholders.[135] However, the use of the doctrine of trust as the legal hook shows that derivative suits and shareholder primacy are ineluctably intertwined.

The cumulative weight of the evidence regarding early business corporations suggests that shareholder primacy was a strong force in shaping corporate law and business practice. Corporate law of the nineteenth century contained provisions that implied skepticism of corporate power and a desire to protect nonshareholder constituencies, particularly creditors. However, these constraints on corporate action do not detract from the overwhelming evidence of shareholder primacy. Although creation of the shareholder primacy norm did not occur until the 1830s, the foregoing evidence shows that the groundwork for adoption of the norm was laid well before that time.

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133. *See* Bert S. Prunty, *The Shareholder's Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 988 (1957) (citing Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832), and Taylor v. Miami Exporting Co., 5 Ohio 162 (1831)), as the first cases employing the derivative suit in the United States). The court in *Taylor* hesitated but ultimately took jurisdiction, stating: "If this application was on the part of a creditor properly so called, there would hardly be a question that this Court had jurisdiction. I am not able to discover any good reason why the jurisdiction should be denied to a corporator against his trustee." 5 Ohio at 166-67.

134. Attorney General v. Utica Ins. Co., 2 Johns. Ch. 371, 389-90 (N.Y. Ch. 1817).

135. *See* Mitchell, *supra* note 24, at 603. Mitchell stated:

> Stockholders alone possess the means to assert these duties and redress their violation. This right has led to the conclusion that the duty is owed to the stockholders rather than the inverse: that stockholders are the only constituency that can enforce this duty because it is owed to them. That stockholders are the enforcers of the duty is not itself a necessary result of the existence of the duty, but rather is the product of nineteenth-century ownership concepts and the doctrinal confusion of different types of fiduciary duties owed by directors and controlling stockholders.

Id.

IV. THE SHAREHOLDER PRIMACY NORM IN CLOSELY HELD CORPORATIONS

During the early 1800s, businesses other than public-utility-type enterprises began to incorporate in greater numbers. However, most general businesses, prior to the second half of the nineteenth century, were organized as sole proprietorships or partnerships.[136] Those corporations that were organized during the earlier period rarely had securities traded in the public markets.[137] Even as the corporate form of organization came to be used more frequently for general business purposes, most corporations were closely held.[138] Thus, courts and legislatures developed most corporate law around these smaller corporations prior to the last decade of the nineteenth century. Despite the obvious importance of closely held corporations in the development of corporate law, modern scholarship relating to the shareholder primacy norm focuses almost exclusively on publicly traded corporations.

The failure of modern scholars to examine the shareholder primacy norm in the context of closely held corporations has led to a misunderstanding about the function of the shareholder primacy norm. That function takes on new dimensions when it is examined in the context of closely held corporations because such corporations generate different conflicts than publicly traded corporations. Traditionally, the only significant horizontal conflict in publicly traded corporations has been the conflict between shareholders and nonshareholders.[139] As discussed above, the shareholder primacy norm appears to be

136. "Until well after 1840 the partnership remained the standard legal form of the commercial enterprise . . . ." ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 36 (1977). "Until the 1840's . . . [i]n farming, lumbering, mining, manufacturing, and construction the enterprise remained small and personal. In nearly all cases it was a family affair. When it acquired a legal form, it was that of a partnership." *Id.* at 50; *see also* Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities 1887-1902*, 29 BUS. HIST. REV. 105 (1955) (discussing the early evolution of corporate organization).

137. Based on stocks quoted in the New York City press from 1792-1840, Walter Werner and Steven Smith determined that only banks and insurance companies had publicly traded shares of stock prior to 1824. *See* WALTER WERNER & STEVEN T. SMITH, WALL STREET 158-59 (1991). Thereafter, an increasing number of other businesses had share prices quoted, but only after 1837 did the total number of quoted shares exceed 100 companies. *Id.* Although stock quotations do not reveal the full extent of public trading, it is clear that the number of publicly traded corporations was very small in relation to the total number of corporations formed. *Id.* at 167-68 (noting that "considerable trading in the early New York securities markets occurred outside of the [New York Stock & Exchange Board]"). This does not necessarily imply that all early corporations had few investors. *See, e.g.*, ANGELL & AMES, *supra* note 79, at 121 ("The great number of members of which corporations aggregate usually consist, renders their undoubted right of contracting by vote, in general, extremely inconvenient . . . . ").

138. There is no standard definition of a "closely held corporation." The widely cited Massachusetts Supreme Court case, *Donahue v. Rodd Electrotype Co.*, stated: "We deem a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation." 328 N.E.2d 505, 511 (Mass. 1975). For purposes of this Article, however, a simpler definition from the leading treatise in the field will suffice: "the term 'close corporation' means a corporation whose shares are not generally traded in the securities markets." F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS: LAW AND PRACTICE § 1.02, at 7 (1996). Normally, corporations whose shares are not generally traded in the securities markets also possess the other *Donahue* attributes—a small number of stockholders and substantial majority stockholder participation in the management of the corporation. Nevertheless, the adopted definition focuses on public trading to simplify the identification of closely held business corporations.

139. Horizontal conflicts among active institutional investors or among holders of different classes of

largely irrelevant to corporate decision making, nevertheless, one suspects that most decisions are made in the interests of shareholders for reasons that have nothing to do with fiduciary duties. Similarly, in closely held corporations, conflicts between shareholders and nonshareholders typically are addressed by self-interest, not by the shareholder primacy norm. Majority shareholders (who usually manage closely held corporations) do not need to be motivated by the shareholder primacy norm to favor shareholders over nonshareholders.

A more significant horizontal conflict of interest in closely held corporations is the conflict between majority shareholders and minority shareholders.[140] Even though majority shareholders usually manage closely held corporations—and thereby occupy a vertical relationship to the minority shareholders—many conflicts in this setting are not resolved merely by prohibiting certain self-interested managerial behavior. The reason is obvious: majority shareholders have a *legitimate* interest in the property of the corporation. In other words, majority shareholders who manage a closely held corporation do not act solely on behalf of others, but also on behalf of themselves, and such self-interested behavior is proper, at least within limits.[141]

Apparently recognizing that a strict prohibition against managerial self-interest would be counterproductive in the context of a closely held corporation, nineteenth century courts attempted to establish the limits of managerial self-interest by creating the shareholder primacy norm and requiring managers to act in the interest of *all* of the shareholders. This application of the shareholder primacy norm seems incongruous today because minority oppression cases involve conflicts among shareholders, a problem that shareholder primacy would appear not to address. Indeed, the subsequent development of the doctrine of minority oppression shows that the shareholder primacy norm was not essential to resolving disputes between majority and minority shareholders in closely held corporations because the shareholder primacy norm is much broader than modern formulations of the minority oppression doctrine.[142] Nevertheless, the shareholder primacy norm was born and nurtured in minority oppression cases and only later made its way into cases involving publicly traded corporations.

A. The Birth of the Shareholder Primacy Norm

As noted above, cases of the early 1800s first suggested the existence of the shareholder primacy norm. These cases treated shareholders as the primary beneficiaries of director action and often referred to corporations as trusts, with the directors as trustees and the shareholders as the *cestuis que trust*. The language of trusts dominated corporate

common stock, such as dual class voting stock or targeted stock, may become more frequent in the future. *See, e.g.*, D. Gordon Smith, *Corporate Governance and Managerial Competence: Lessons From K-Mart*, 74 N.C. L. REV. 1037, 1051-54 (1996).

140. Lawrence Mitchell reasons: "The critical determinant of horizontal conflict is that it presents a case in which the fiduciary uses her legitimate, preexisting financial interest in the corporation in a manner that may lead her to realize a benefit disproportionate to those who own the same type of interest." Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, DUKE L.J. 425, 482 (1993).

141. Mitchell observes that these are the most difficult fiduciary duty cases, "precisely because of the inherent legitimate interest, a problem that does not exist in the vertical conflict cases." *Id.* at 486.

142. For a greater explanation of this point, see *infra* Part IV.E.

jurisprudence throughout the nineteenth century[143] and well into this century.[144] The trust metaphor was first applied in the 1830s by a minority shareholder in an attempt to hold a director personally liable for a breach of fiduciary duty.[145]

In *Taylor v. Miami Exporting Co.*,[146] the Ohio Supreme Court decided the first such case. *Taylor* involved claims by a shareholder (a bank) in the Miami Exporting Company that the managers of the company had mismanaged the business. The shareholder claimed that the manager, among other things, permitted a person to buy six hundred shares of stock on May 21, 1821, and then required the corporation to repurchase the shares for the purchase price two weeks later, on June 5, 1821. The transaction allegedly was made to determine the outcome of an election of directors, held between the initial sale and subsequent repurchase. Relying on the trust metaphor, the court placed the claim squarely within the law of trusts and in a court of equity:

> I look upon it as clear, that all corporations are trustees for the individuals of which they are composed, and that those who act for the corporation and conduct its affairs, are trustees for the corporation and can not appropriate the corporation funds to their individual advantage, to gratify their passions or to serve any other purposes than those for the general interest of the corporation and its creditors. And when a by-law or resolution is adopted for the personal

143. *See, e.g.*, Wheeler v. Pullman Iron & Steel Co., 32 N.E. 420 (Ill. 1892). The *Wheeler* court stated:

> [that the assets of trade corporations] belong to those who contributed to its capital and for whom it stood as representative in the business in which it was engaged, and are treated in equity as a trust fund, to be administered for the benefit of the *bona fide* holders of stock, subject to the just claims of creditors of the corporation.

Id. at 422. In *Butts v. Wood*, the court stated:

> The relation in which these [directors] stood, to the other stockholders, was that of trustees of the funds then in their hands, or in the treasury. And if they paid over these funds to a person upon a pretended claim, which they knew, or must be presumed to know, was wholly unfounded in law, it was clearly a breach of trust on their part. The relation between directors of a corporation, and its stockholders, is that of trustee and *cestui que trust*.

38 Barb. 181, 188-89 (N.Y. App. Div. 1862).

144. The trust metaphor was the focus of the well-known debate between Adolf Berle and Merrick Dodd in the early 1930s. *See* Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). Thereafter, use of the trust metaphor seems to have stopped completely. A search of 1996 cases in the WESTLAW Allcases Database revealed no cases using the trust metaphor, except in situations where the corporation was insolvent and courts held directors responsible as trustees for creditors. *See, e.g.*, Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 354 (N.D. Tex. 1996) ("Delaware law recognizes that when a corporation becomes insolvent, the assets of the corporation become a trust for the benefit of the corporation's creditors. The corporate directors then hold a fiduciary duty as trustees to protect the assets for the creditors.") (citations omitted).

145. *See* George D. Hornstein, *A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder*, 40 COLUM. L. REV. 220, 220 (1940) ("Little more than a hundred years ago a court of equity for the first time intervened in corporate management at the suit of a minority stockholder."); *see also* DODD, *supra* note 132, at 70 ("No case seems to have arisen in the United States during the period from 1800 to 1830 in which the principles of fiduciary law were applied to the directors or officers of business corporations.").

146. 5 Ohio 162 (1831).

> benefit of the individuals making it, chancery will control such exercise of power.[147]

In *Robinson v. Smith*,[148] a case that received more attention than *Taylor*, the New York Court of Chancery adjudicated shareholder breach of trust claims lodged against the directors of the New York Coal Company. The complaint arose because the company failed to pursue the business of coal mining—the purpose for which it was incorporated—and instead engaged in speculative investing and incurred a substantial loss of capital. The Chancellor reasoned:

> I have no hesitation in declaring it as the law of this state, that the directors of a moneyed or other joint-stock corporation, who willfully abuse their trust or misapply the funds of the company, by which a loss is sustained, are personally liable as trustees to make good their loss. And they are equally liable, if they suffer the corporate funds or property to be lost or wasted by gross negligence and inattention to the duties of their trust.[149]

Although the court ultimately allowed a demurrer because the plaintiffs did not allege that the corporation refused to sue,[150] an important threshold had been crossed. The shareholder primacy norm was born.

The shareholder primacy norm quickly gained universal acceptance. In the well-known case *Dodge v. Woolsey*,[151] the United States Supreme Court endorsed the shareholder primacy norm. *Dodge* involved a suit by a banking corporation's shareholder challenging the collection of a tax by the state of Ohio. The shareholder alleged that the tax was unconstitutional and claimed that the directors of the bank had failed to challenge the imposition of the tax. The court approved the shareholder primacy norm in the following language:

> It is now no longer doubted, either in England or the United States, that courts of equity, in both, have a jurisdiction over corporations, at the instance of one or more of their members; to apply preventative remedies by injunction, to restrain those who administer them from doing acts which would amount to a violation of charters, or to prevent any misapplication of their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares, as either may be protected by the franchises of a corporation, if the acts intended to be done create what is in the law denominated a breach of trust.[152]

147. *Id.* at 166. The judge envisioned a trust that serves both shareholders and creditors. Later in the opinion, he further expanded the responsibilities of directors, noting: "There is a vast amount of capital managed under various acts of incorporation, whose directors are under immense responsibilities to the public and to individual stockholders." *Id.* at 168. The judge ultimately overruled a demurrer after finding that the Court of Chancery properly had jurisdiction and that the named defendants were properly before the court as the persons who allegedly perpetrated the fraud on the plaintiff.

148. 3 Paige Ch. 222 (N.Y. Ch. 1832).

149. *Id.* at 231.

150. The court concluded that the corporation should be before the court, either as a plaintiff or as a defendant, and gave the plaintiffs leave to amend accordingly. *Id.* at 233.

151. 59 U.S. (18 How.) 331 (1855).

152. *Id.* at 341.

In subsequent years, courts continued to develop the trust metaphor in cases that today would be resolved by the invocation of the doctrine of minority oppression.[153] Given the contemporary views of the corporation described in Part III, it was inevitable that courts would be asked to confront this problem. Furthermore, it is understandable that courts would appeal to the notion of shareholder primacy for a solution.

B. The Development of the Business Judgment Rule

At approximately the time courts were developing the shareholder primacy norm, they were also developing the business judgment rule. The earliest rendering of the business judgment rule is usually traced to an 1829 Louisiana case, *Percy v. Millaudon*.[154] In *Percy*, three bank directors were sued in connection with embezzlement by the bank's president and secretary. The plaintiffs claimed that the directors' conduct was fraudulent. The court first sought to determine "the degree of care and diligence which the law required [of] the defendants, while exercising the trust of bank directors . . . ."[155] Although the court was unwilling to commit to a single standard of care that would apply in all circumstances, it applied a standard of ordinary care to the directors in this case.[156] The court then stated its early version of the business judgment rule—that directors are not liable for honest mistakes in judgment:

> [W]hen the person who is appointed attorney in fact, has the qualifications necessary for the discharge of the ordinary duties of the trust imposed, we are of the opinion that on the occurrence of difficulties, in the exercise of it, which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen.[157]

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153. The late Hodge O'Neal provided an abridged list of "the techniques used by controlling shareholders to eliminate minority shareholders from an enterprise or otherwise oppress them." F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121, 122 (1986/1987). The list read as follows:

> Majority shareholders may refuse to declare dividends and may drain off the corporation's earnings in a number of ways. Exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, high rentals for property the corporation leases from majority shareholders, and unreasonable payments to majority shareholders under contracts between the corporation and majority shareholders or companies the majority shareholders own are three major ways. Majority shareholders may deprive minority shareholders of corporate offices and of employment by the company or may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested. Majority shareholders may also organize a new company in which the minority will have no interest, transfer the corporation's assets or business to it, and perhaps then dissolve the old corporation; or they may bring about a merger under a plan unfair to the minority. These techniques, however, are merely illustrative of those to which resourceful squeezers may resort.

Id. at 125. Modern courts commonly treat each of these activities as a type of minority oppression. As is evident in the diversity of activities on this list, many nineteenth century cases relying on the shareholder primacy norm would today be treated as cases of minority oppression.

154. 8 Mart. (n.s.) 68 (La. 1829).

155. *Id.* at 73.

156. *See id.* at 74-75.

157. *Id.* at 77-78.

After *Percy*, courts refined the business judgment rule. By mid-century, the rule was stated in terms that would be very familiar to modern courts. For example, in the Rhode Island case of *Hodges v. New England Screw Co.*, the court stated: "We think a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake."[158]

The business judgment rule limited the scope of the fiduciary duties imposed on corporate directors as "trustees" for the shareholders. Although directors were required to act in the best interests of shareholders, the honest failure to do so would not subject the directors to liability. Early courts treated this development as a minor incursion into the shareholder's ability to constrain directors through fiduciary duties, but the business judgment rule has come to symbolize the futility of seeking to recover for violations of the duty of care. Hodge O'Neal criticized the "indiscriminate application of the business judgment rule to sustain action of directors in close corporations . . . ."[159] According to O'Neal, the usual justifications for the business judgment rule do not apply with full force to closely held corporations. O'Neal encouraged courts to "consider intervention to protect minority shareholders in a close corporation against oppressive action by the directors (for example, unfair dividend policies), even though fraud, bad faith or, for that matter, clear unreasonableness on the part of the directors cannot be shown."[160]

C. The Emergence of Minority Oppression

Since the earliest reported cases, courts have consistently held that the will of the majority of the shareholders governs business corporations in all actions within the bounds of the corporate charter.[161] As observed above, however, courts recognized the possibility that majority rule would lead to unfair results for minority shareholders, and they used the trust metaphor to impose on directors a fiduciary duty to serve *all* of the shareholders of the corporation, not just a select group.[162] The clash of majority rule and

158. 3 R.I. 9, 18 (1853).

159. O'Neal, *supra* note 4, at 884.

160. *Id.*

161. *See, e.g.*, Korn & Wisemiller v. Mutual Assurance Soc'y, 10 U.S. (6 Cranch) 192, 200 (1810) (acknowledging "the general principle, that the majority of a corporate body must have power to bind its individuals" in a suit involving a mutual insurance corporation); Gifford v. New Jersey R.R. & Transp. Co., 10 N.J. Eq. 171, 174 (1854) (employing the "well settled" principle "that acting within the scope and in obedience to the provisions of the constitutions of the corporation, the will of the majority, duly expressed at a legally constituted assembly, must govern"). The rationales for the majority rule were also widely acknowledged. The court in *Inhabitants of Waldoborough v. Knox and Lincoln R.R.* stated the case well:

> When there are differences of opinion, aggregate bodies of men must act by majorities, or they cannot act at all. It is true that this doctrine subjects the minorities to the will of majorities, but it is equally true that the contrary doctrine subjects majorities to the will of minorities; and since one side or the other must yield, it seems to us to be more in harmony with the principles of natural justice that it should be the minority.

24 A. 942, 942-43 (Me. 1892).

162. *See, e.g.*, Pratt v. Pratt, Read & Co., 33 Conn. 446 (1866). The court in *Pratt* stated:

> [T]hey must have applied to them principles making them accountable like all trustees, or the grievance would be intolerable, since otherwise a majority of the stockholders, acting through the directors, who would thus cease to be in fact what the law considers them, the agents of the

universal fidelity resulted in an accommodation in which courts allowed directors to implement the will of the majority subject to limitations imposed through the doctrine of *ultra vires* and prohibitions against fraud and illegality.[163]

Courts used this framework to adjudicate cases that today often would be resolved under the doctrine of minority oppression. For example, in *Fougeray v. Cord*[164] three equal shareholders in The Laurel Springs Land Company created a classic minority oppression situation. The case arose out of a dispute over eighty-five and one half acres of farmland owned by the corporation. The farmland was first identified by one of the shareholders (Fougeray) as a suitable site for development. Two shareholders (Cord and Korb) then purchased the farmland for $8,550. Next, Cord and Korb conveyed the land to the corporation, divided the land into lots, and proceeded to sell the lots. The sales were quite successful, yielding over $47,000 in the first year alone. Korb estimated that the remaining unsold lots would yield an additional $20,000. At the end of one year of operations, the corporation had an estimated surplus of nearly $37,000.

Shortly after the formation of the corporation, Cord and Korb began to explore possibilities for excluding Fougeray, who was not actively involved in the development of the property. They attempted to buy his share of the business, but he refused. They proceeded to call a special meeting of the directors— Fougeray did not receive notice of the meeting until after the fact—and voted themselves large salaries and commissions totaling over $16,000 in the first year. The court stated, "The fair inference from this conduct ... is that they then thought that such salaries and commissions would absorb the bulk of the profits and leave little or nothing to be divided with the complainant, and that they did not anticipate that the enterprise would be so successful...."[165] The court concluded that Cord and Korb were not entitled to the money they claimed.

At the first annual meeting of the corporation, Cord transferred one share of the corporation's stock to his father, whom Cord and Korb proceeded to elect as a director of the corporation in place of Fougeray. The two Cords and Korb then formed a new corporation called The Laurel Springs Land and Improvement Company, whose shares were

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> whole body of stockholders, and would become the private agents of the majority, might set the minority at defiance, and manage the affairs for their own supposed benefit and the benefit of the majority who appointed them.

Id. at 456; *see also* Jones v. Terre Haute & Richmond R.R., 57 N.Y. 196, 205 (1874) ("Unless in some way restrained by legislation the power to discriminate [among stockholders] would rest in the discretion of the directors and be liable to very great favoritism and abuse.").

163. *See, e.g.*, Dodge v. Woolsey, 59 U.S. (18 How.) 331, 343 (1855) (citing the treatise of Angell and Ames); Hand v. Dexter, 41 Ga. 454 (1871). The court in *Hand* stated:

> The majority of a corporation have a right to manage their affairs as they think fit, so long as they keep within their charter, and a Court of Equity will not interfere to prevent unwise or improvident acts; there must be some fraud or the infringement of the legal rights ....

Id. at 464. *See* also Wheeler v. Pullman Iron & Steel Co., 32 N.E. 420 (Ill. 1892). The court in *Wheeler* stated:

> The majority of shares ... or the agents by the holders thereof lawfully chosen, must be permitted to control the business of the corporation in their discretion, when not in violation of its charter, or some public law, or corruptly and fraudulently subversive of the rights and intent of the corporation or of a shareholder.

Id. at 423; *see also* Shaw v. Davis, 28 A. 619, 621 (Md. 1894) (stating that "if the act complained of be neither ultra vires, fraudulent, nor illegal, the court will refuse its intervention").

164. 24 A. 499 (N.J. Ch. 1892).

165. *Id.* at 502.

owned primarily by the younger Cord, and conveyed the farmland (except the lots already conveyed to third-party buyers) to this new corporation in exchange for $5,000. In addition, they conveyed all existing sales contracts to Korb, leaving the original corporation without most of its former property.

The court concluded that Cord's and Korb's actions constituted "fraudulent conduct" and "a piece of gross and bungling thievery."[166] To remedy these actions, the court compelled a dividend in kind (comprised of unsold lots and contracts for sale). This decision was based on the trust metaphor: "It is well settled that the officers of a corporation occupy towards its stockholders the relation of trustee and *cestui que trust*, and on that broad ground are liable to be called upon to account for their conduct in this court."[167]

Although many of the cases confronted by courts involved self-dealing by the majority shareholders, other cases revealed a more subtle form of prejudice against the minority. For example, in *East Rome Town Co. v. Nagle*[168] the majority shareholders passed a resolution to convert a bridge owned by the corporation from a toll bridge to a free bridge. The court held that the majority shareholders could not convert the bridge to a free bridge but must use the franchise for the profit of the corporation: "If the bridge franchise vested in the corporation by reason of the individuals to whom it was granted being afterwards incorporated, it is the duty of the corporation to use it in connection with the bridge, while it can be used profitably."[169]

In the late 1800s and early 1900s, courts began referring frequently to the concept "minority oppression."[170] Apparently, the term "minority oppression" sometimes in-

166. *Id.* at 504.

167. *Id.* For a case with similar facts and reasoning, see Meeker v. Winthrop Iron Co., 17 F. 48, 52 (W.D. Mich. 1883) (holding that a lease entered into at the behest of the majority stockholders was "inequitable, and a fraud upon the rights of the other stockholders").

168. 58 Ga. 474 (1877).

169. *Id.* at 478. In *Dodge v. Woolsey*, the Court stated the following regarding the failure of bank directors to challenge a state tax as unconstitutional:

> Now, in our view, the refusal upon the part of the directors, by their own showing, partakes more of disregard of duty, than of an error or judgment. It was a non-performance of a confessed official obligation, amounting to what the law considers a breach of trust, though it may not involve intentional moral delinquency .... It amounted to an illegal application of the profits due to the stockholders of the bank, into which a court of equity will inquire to prevent its being made.

59 U.S. (18 How.) 331, 345 (1855). As in *Nagle*, the behavior of the directors in *Dodge* does not smack of self-interest, but it nevertheless results in a cause of action for minority shareholders.

170. *See, e.g.*, Hayden v. Official Hotel Red-Book & Directory Co., 42 F. 875 (S.D.N.Y. 1890). The *Hayden* court held:

> [that a majority stockholder] cannot be permitted to exercise [the right to wind up the affairs and dispose of the assets of the corporation] in a manner inconsistent with good faith toward the minority stockholders; and if it is exercised oppressively, and they purchase the property of the corporation for themselves at an inadequate price, the transaction will not be permitted to stand.

Id. at 876; *see also* Inhabitants of Waldoborough v. Knox and Lincoln R.R., 24 A. 942, 943 (Me. 1892) ("The court will at all times protect a minority of the stockholders of a corporation against a fraudulent, collusive, or oppressive exercise of power by the majority."); Tanner v. Lindell Ry., 79 S.W. 155 (Mo. 1903). The *Tanner* court stated:

cluded *ultra vires*, fraud, and illegality, but courts also used the new term for situations that the traditional categories did not reach. Courts seemed unwilling to extend the concept of fraud to all instances of minority oppression but, nevertheless, courts wanted to offer relief from what appeared to be inequitable conduct.

It is important to note that *all* grounds for granting relief, including minority oppression, emanated from the shareholder primacy norm. This fact is illustrated in *Ervin v. Oregon Railway & Navigation Co.*, in which the court faced a fairly common example of minority oppression.[171] The court, however, was not quite prepared to label such minority oppression as "fraud."[172] *Ervin* involved the transfer of the assets of the Oregon Steam Navigation Company (OSNC) to the Oregon Railway and Navigation Company (ORNC), another corporation formed by Villard.[173] At the time of the sale, ORNC owned a majority of the shares of OSNC and controlled OSNC's management. The sales price of the assets was determined by two appraisers and was alleged by certain minority shareholders of OSNC to be well below the true value of the assets.[174] At a meeting of OSNC shareholders, however, the sale of OSNC's assets and the subsequent dissolution of OSNC were approved by an overwhelming majority of OSNC's shareholders, including ORNC.[175]

Villard, acting through ORNC, was careful to follow the requirements of OSNC's charter and the Oregon corporation statute in executing the transactions. As noted by the court:

> [Villard and his associates] had a right to dissolve the corporation and dispose of its property and distribute the proceeds. The minority cannot be heard to complain of this because the laws of Oregon permitted it, and because it is an implied condition of the association of stockholders in a corporation that the majority shall have power to bind the whole body as to all transactions within the scope of the corporate powers.[176]

Nevertheless, the court noted that the majority's power to control the corporation is limited.[177] In the case of a corporate dissolution, the majority must account to the minority for the fair value of the assets sold.[178] In disposing of the case on the merits, the court forged the link between minority oppression and the shareholder primacy norm:

> [The authorities cited] all recognize that the majority in interest have the right to rule within reasonable bounds and that whilst they have no right, arbitrarily or oppressively, to close out a corporation for their own advantage yet they are not compelled to continue an unprofitable business or to pay the minority more than their stock is worth for the privilege of closing it up.

Id. at 158.

171. 27 F. 625, 630 (S.D.N.Y. 1886).

172. *Id.*

173. *Id.* at 626-28.

174. *Id.* at 629.

175. The facts are stated at length in the second opinion in the case, *Ervin v. Oregon Ry. & Nav. Co.*, 27 F. 625, 626-29 (S.D.N.Y. 1886). The first opinion in the case, on demurrer, appears in *Ervin v. Oregon Ry. & Nav. Co.*, 20 F. 577, 580 (S.D.N.Y. 1884).

176. *Ervin*, 20 F. at 580.

177. *Id.*

178. *Id.*

> 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 relation occupied by the corporation toward its stockholders . . . . The corporation itself holds its property as a trust fund for the stockholders who have a joint interest in all its property and effects, and the relation between it and its several members is, for all practical purposes, that of trustee and *cestui que trust* . . . . Persons occupying this [community of interest] are under an *obligation to make the property or fund productive of the most that can be obtained from it for all who are interested in it*; and those who seek to make a profit out of it at the expense of those whose rights in it are the same as their own are unfaithful to the relation they have assumed, and are guilty, at least, of constructive fraud.[179]

The use of the term "constructive fraud" in the last sentence appears to be an attempt to hedge on the issue of fraud, even though the court finds the conduct clearly actionable. *Ervin* was cited in *Miner v. Belle Isle Ice Co.*,[180] the first case in which a court dissolved a corporation because of oppressive behavior by the majority shareholder.[181] In *Miner*, the court's language again revealed the connection between the shareholder primacy norm and minority oppression:

> The general rule undoubtedly is that courts of equity have no power to wind up a corporation, in the absence of statutory authority. This rule is, however, subject to qualifications. It has been held that, when it turns out that the purposes for which a corporation was formed cannot be attained, it is the duty of the company to wind up its affairs; *that the ultimate object of every ordinary trading corporation is the pecuniary gain of its stockholders*; that it is for this purpose, and no other, that the capital has been advanced; and if circumstances have rendered it impossible to continue to carry out the purpose for which it was formed with profit to its stockholders, it is the duty of its managing agents to wind up its affairs. To continue the business of the company under such circumstances would involve both an unauthorized exercise of the corporate franchises and a breach of the charter contract.[182]

The foregoing cases indicate that during the nineteenth century courts slowly changed their approach toward cases brought by minority shareholders. Having concluded that minority shareholders were beneficiaries in a trust relationship, courts were willing to override the binding effect of majority rule in certain circumstances. The most important of those circumstances for present purposes was fraud, which became an elastic concept in the hands of equity judges. Even as judges became less willing to attach the label of "fraud" to actions of majority shareholders, they continued to redress the concerns of minority shareholders, increasingly under the rubric of minority oppression.

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179. *Ervin*, 27 F. at 631-32. For more information on the obligation to maximize the gain to shareholders, see also Jackson v. Ludeling, 88 U.S. (21 Wall.) 616, 625 (1874) (discussing consent to the sale of mortgaged land by the board of directors, the Court stated, "It was their duty, to the extent of their power, to secure for all whose interests were in their charge the highest possible price for the property.").

180. 53 N.W. 218, 223 (Mich. 1892).

181. Hornstein, *supra* note 145, at 220 n.3.

182. *Miner*, 53 N.W. at 223 (emphasis added).

Throughout this period and into the twentieth century, one aspect of the jurisprudence of minority oppression cases remained constant—the use of the shareholder primacy norm to justify intervention on behalf of minority shareholders.[183] As the cause of action for minority oppression matured, the link to the shareholder primacy norm has largely disappeared.[184] However, the connection is still evident in the most famous shareholder primacy case, *Dodge v. Ford Motor Co.*[185]

D. Dodge v. Ford Motor Co. *Revisited*

The most quoted—at least by academics[186]—statement of the shareholder primacy norm is taken from *Dodge v. Ford Motor Co.*[187] One fact about the case that is rarely mentioned[188] is that it involved an oppression claim by minority shareholders (the Dodge brothers) in a closely held corporation (Ford Motor Company). The case involved a refusal by Henry Ford to pay dividends, which is the quintessential squeeze-out technique.[189] Although the bare facts of the case should be familiar to any law student in an introductory corporations class, the following description attempts to provide a fuller picture of the case, drawing not only from the opinion of the Supreme Court of Michigan but from other sources, in an effort to better explain the connection between the shareholder primacy norm and minority oppression.

The Ford Motor Company ("Ford Motor") was incorporated on June 16, 1903.[190] John and Horace Dodge were two of the original shareholders in Ford Motor,[191] having invested a total of $10,500 in promissory notes.[192] Their real contribution to the company

183. For cases illustrating this principle after the turn of the century and before *Dodge v. Ford Motor Co.*, see, for example, Stebbins v. Michigan Wheelbarrow & Truck Co., 212 F. 19, 28 (6th Cir. 1914) (holding that majority shareholders had a fiduciary duty to preserve the assets' value for minority shareholders in a case involving the transfer of assets between corporations at a price significantly below actual value); Jones v. Missouri-Edison Elec. Co., 144 F. 765, 771 (8th Cir. 1906) (holding that majority shareholders have a duty to "make the property of the corporation in their charge produce the largest possible amount to protect the interests of the holders of the minority of the stock" in a case involving a consolidation in which the interests of the shareholders of one company were substantially diluted); Glengary Consol. Min. Co. v. Boehmer, 62 P. 839 (Colo. 1900) (stating that "the legitimate exercise of corporate powers" requires management of the corporation to act "in the interests of all shareholders" in a case involving a challenge by minority shareholders to a lease of assets to the majority shareholder of a corporation).

184. *See generally infra* Part IV.E.

185. 170 N.W. 668 (Mich. 1919).

186. A search of the WESTLAW JLR database, covering selected journals and law reviews only as far back as the early to mid-1980s, revealed over 150 articles citing the case, while a search of WESTLAW ALLCASES and ALLCASES-OLD databases, covering both state and federal cases back to the time *Dodge* was decided, revealed fewer than 60 cases citing *Dodge*.

187. 170 N.W. at 668; *see also supra* note 2 and accompanying text.

188. *But see* Mitchell, *supra* note 24, at 601-02 (noting that the facts underlying *Dodge* justified treating the case in terms of self-dealing, but arguing that the court did not do so).

189. *See* O'Neal, *supra* note 153, at 125.

190. *Dodge*, 170 N.W. at 669.

191. The court noted that Ford originally subscribed for 255 shares, the Dodge brothers, Horace Rackham, and James Couzens each subscribed for 50 shares, and "several other persons" subscribed for the remainder. *Id.*

192. The court does not state the amount of the original investment. This number—and the fact that it was not all in cash—was provided in a biography of Ford by his assistant, Charles E. Sorenson. CHARLES E. SORENSON & SAMUEL T. WILLIAMSON, MY FORTY YEARS WITH FORD 166 (1956).

was an agreement to take what many regarded as the finest machine shop in Detroit and retool it to build the "unproven and untested Ford chassis" rather than supply parts for "the lucrative and sure-fire Oldsmobile account."[193]

At the time of the dispute between the Dodge brothers and Henry Ford, Ford Motor had evolved from "a mere assembling plant ... [to] a manufacturing plant, in which it made many of the parts of the car which in the beginning it had purchased from others."[194] During that time, the quality of its primary product—the Model T—had consistently improved while the price had declined. Originally selling for over $900,[195] the Model T was selling for $440 at the end of July 1916.[196] Regardless of the price, Ford Motor had never been able to meet fully the demand for the Model T.[197]

The Dodge brothers benefitted both as investors and as parts suppliers from the success of Ford Motor. However, after sitting on the board of directors for ten years, John Dodge resigned in August 1913 when he and Horace decided to stop supplying Ford Motor with parts and build their own automobiles to compete with the Model T.[198] Searching for capital to finance their new venture, the Dodge brothers offered to sell their shares of Ford Motor to Ford himself,[199] but Ford refused to purchase the Dodges' shares. Nevertheless, holding the shares provided the Dodge brothers with a constant source of funds—the Ford Motor dividends. Investors in Ford Motor received regular quarterly dividends equal to five percent monthly on capital stock of $2 million (*i.e.*, $1.2 million per year) plus a total of $41 million in special dividends from December 1911 to October 1915.[200]

The Dodges' decision to manufacture their own cars began a competitive feud with Ford, in which Ford attempted to deny the Dodges the capital they needed to thrive.[201] The feud came to a head in 1916. After announcing record profits of nearly $60 million,[202] Ford announced plans to discontinue the special dividends to shareholders. Ford instead planned to use the Ford Motor profits to expand manufacturing operations dramatically, nearly doubling the size of its Highland Park factory and constructing a giant manufacturing facility and iron smelting plant at a site on the River Rouge.[203] Ford also

193. CAROL GELDERMAN, HENRY FORD: THE WAYWARD CAPITALIST 81 (1981).

194. *Dodge*, 170 N.W. at 670

195. *Id.*

196. *Id.*

197. *Id.*

198. ROBERT LACEY, FORD: THE MEN AND THE MACHINE 167 (1986).

199. *Dodge*, 170 N.W. at 672. William Richards reported that the Dodge brothers offered to sell for $15 million in 1914, $25 million in 1915, and $35 million in 1916. WILLIAM C. RICHARDS, THE LAST BILLIONAIRE, HENRY FORD 51 (1948).

200. The monthly dividend was five percent on the capital stock of $2 million. *Dodge*, 170 N.W. at 670.

201. Among other things, Ford announced a Five Dollar Day—referring to the hourly wage to be paid to Ford workers, about double the previous average—in January 1914. LACEY, *supra* note 198, at 117. *The Wall Street Journal* criticized the plan as being nothing more than a method of reducing by $10 million the amount he would be forced to share with the Dodges. *Id.* at 168. Also in 1914, Ford "announced that if more than 300,000 Tin Lizzies were sold in a twelve-month period, every buyer would get a fifty-dollar check. When 308,313 were sold, more than $15 million in checks promptly went out in the mail." GELDERMAN, *supra* note 193, at 81.

202. *Dodge*, 170 N.W. at 670.

203. *Id.* at 673-74.

announced that the sales price of the Model T would be reduced again by eighty dollars.[204]

Originally, Ford planned to pursue the River Rouge project separate from Ford Motor. He purchased the land in his own name and told the *Dearborn Independent* in October 1915 that he would produce a tractor (to be called the "Fordson" after his son, Edsel) with "no stockholders, no directors, no absentee owners, no parasites."[205] Upon hearing rumors that Ford Motor would pursue the Rouge River project, John Dodge requested a meeting with Ford.[206] At the meeting, Ford revealed his intentions to expand Ford Motor. When Dodge suggested that Ford buy out the other shareholders to pursue his plans with his own money, Ford allegedly responded that "he had control and that was all he needed."[207]

On October 31, 1916, the directors of Ford Motor approved a $1 million contract for the fabrication and erection of blast furnaces at the River Rouge site—before they had even approved its acquisition![208] The board corrected the error three days later, passing resolutions authorizing Ford Motor to spend $23 million to expand the Highland Park facility and build the River Rouge project.[209] Immediately thereafter, the Dodge brothers sued.[210]

At the time of the suit, the Dodges owned ten percent of Ford Motor stock.[211] Ford owned fifty-eight percent of Ford Motor stock[212] and a handful of other people owned the remaining shares. Ford responded to the suit by calling E.G. Pipp, Editor in Chief of the *Detroit News*, to publicize his side of the story.[213] Pipp quoted Ford as saying, "I do not believe that we should make such awful profits on our cars. A reasonable profit is right, but not too much."[214] During the trial, the Dodges' attorney seized this language, forcing Ford to admit his view that corporations should be operated "incidentally to make money" because "[b]usiness is a service, not a bonanza."[215] This was enough for the lower court, which (1) ordered Ford Motor's directors to declare a dividend of over $19 million, (2) enjoined construction at the River Rouge site, (3) enjoined the purchase of additional fixed assets, and (4) enjoined the accumulation of liquid assets beyond an amount "reasonably required in the proper conduct and carrying on of the business and operations of said corporation."[216]

After the trial court issued its decision, but before the Michigan Supreme Court issued its decision on appeal, Ford resigned as president of Ford Motor and went to Cali-

204. *Id.* at 673.
205. LACEY, *supra* note 198, at 171 (citing DEARBORN INDEPENDENT, October 8, 1915).
206. *Id.*
207. *Id.* at 172.
208. SORENSON & WILLIAMSON, *supra* note 192, at 160-61.
209. *Id.* at 161.
210. Dodge v. Ford Motor Co., 170 N.W. 668, 670-71. Charles Sorenson later recalled, "I never could understand the Dodge attitude except to call it a selfish one." SORENSON & WILLIAMSON, *supra* note 192, at 161.
211. *Dodge*, 170 N.W. at 670.
212. *Id.* at 671.
213. GELDERMAN, *supra* note 193, at 75-77.
214. *Id.* at 83.
215. *Id.* at 84.
216. *Dodge*, 170 N.W. at 678.

fornia with his wife.[217] He announced plans to organize a new company to build cars to compete with Ford Motor.[218] The announcement created great excitement across the country, especially among Ford Motor shareholders. But, of course, that was exactly the point. The announcement was simply a "negotiating ploy" in preparation for Ford's move to buy out minority shareholders.[219] As Garet Garrett explains:

> News of [Henry's] thinking out loud in California caused a panic in the minds of the seven who had just got their big dividends back. If they had thought of selling out privately, now their market was ruined. Who would buy a minority interest in the Ford Motor Company with Ford threatening to become its competitor?[220]

Ford eventually succeeded in buying out all of the minority shareholders for $12,500 per share, except James and Rozetta Couzens, who received just over $13,000 per share.[221]

On appeal, the Michigan Supreme Court focused on two issues, both of which touched on the shareholder primacy norm: (1) whether the directors' failure to declare a special dividend requested by the Dodge brothers is "arbitrary action of the directors requiring judicial interference," and (2) whether the proposed expansion of Ford Motor's business to include iron smelting, using profits as capital, should be enjoined because it was "inimical to the best interests of the company and its shareholders."[222] The court declined to issue an injunction on the second issue, citing the business judgment rule and confessing that "judges are not business experts."[223] The first issue inspired the oft-cited statement of the shareholder primacy norm and is worthy of more detailed consideration here.

With respect to the dividend issue, the Dodge brothers had asked:

> for an injunction to restrain the carrying out of the alleged declared policy of Mr. Ford and the company, for a decree requiring the distribution to stockholders of at least [seventy-five] per cent of the accumulated cash surplus, and for the future that they be required to distribute all of the earnings of the company except such as may be reasonably required for emergency purposes in the conduct of the business.[224]

The court never used the words "minority oppression," but the analysis in the opinion leaves no doubt about its focus. As noted above, the doctrine of minority oppression de-

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217. LACEY, *supra* note 198, at 172.

218. The day after the announcement, the headlines in the *Los Angeles Examiner* read: "HENRY FORD ORGANIZING HUGE NEW COMPANY TO BUILD A BETTER, CHEAPER CAR." *Id.* at 173 (citing LOS ANGELES EXAMINER, March 5, 1919). The car was to sell for $250 to $350. When asked how the new company would affect Ford Motor, Henry Ford responded, "I don't know exactly what will become of that." *Id.* at 172-73.

219. *Id.* at 173.

220. GARET GARRETT, THE WILD WHEEL 119-20 (1952).

221. LACEY, *supra* note 198, at 176. James Brough reports that two years before selling for $12,500 per share, the Dodge brothers had rejected an offer for $18,000. Brough notes, "Henry's bombshell was having double impact, simultaneously softening up the sellers and driving down the price." JAMES BROUGH, THE FORD DYNASTY: AN AMERICAN STORY 102 (1977).

222. Dodge v. Ford Motor Co., 170 N.W. 668, 681 (Mich. 1919).

223. *Id.* at 684.

224. *Id.* at 673.

veloped because courts found the traditional grounds for imposing liability (*ultra vires*, fraud, and illegality) too restrictive. The *Dodge* court considered all of the traditional grounds before granting a remedy based on the shareholder primacy norm. With respect to *ultra vires*, the court reviewed the facts relating to the proposed smelting operation before stating:

> There is little, if anything, in the bill of complaint which suggests the contention that the smelting of iron ore as a part of the process of manufacturing motors is, or will be, an activity *ultra vires* the defendant corporation .... Restraint is asked, not because the smelting business is *ultra vires* the corporation, but because the whole plan of expansion is inimical to shareholders' rights and was formulated and will be carried out in defiance of those rights.[225]

The court then focused on the standard used to evaluate the decision of the Ford Motor board of directors to withhold special dividends and expand Ford Motor's operations. Quoting at length from various sources, the court identified the focal points of the standard as "fraud or misappropriation of the corporate funds"[226] and "fraud, or breach of ... good faith."[227] In addition, the court quoted from *Morawetz on Corporations* to the following effect: "The shareholders forming an ordinary business corporation expect to obtain the profits of their investment in the form of regular dividends. To withhold the entire profits merely to enlarge the capacity of the company's business would *defeat their just expectations*."[228] These passages reveal that the court was interested in reviewing not only the traditional bases for liability, but also other reasons that today would be considered under a claim of minority oppression.

Applying the legal standard to the facts of the case, the court noted Ford's position as the controlling shareholder: "Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor."[229] Then—*in the sentence immediately preceding the court's famous statement of the shareholder primacy norm*—the court referred to the special duties of a majority shareholder: "There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders."[230]

Lyman Johnson has implied that the statement of the shareholder primacy norm in *Dodge* developed out of whole cloth.[231] As shown above, however, the *Dodge* court had plenty of precedent for designating shareholders as the primary beneficiaries of corporate activity. The most likely explanation for the court's failure to cite authority for its statement is that the use of the shareholder primacy norm in minority oppression cases was so

225. *Id.* at 681.

226. *Id.* at 682 (quoting Hunter v. Roberts, Throp & Co., 47 N.W. 131, 134 (Mich. 1890)).

227. *Dodge*, 170 N.W. at 682 (quoting WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING CAPITAL STOCK § 545 (7th ed. 1913)).

228. *Id.* (emphasis added).

229. *Id.* at 683.

230. *Id.* at 684.

231. Johnson, *supra* note 1, at 874 n.41 ("Interestingly, the court failed to cite any authority for its statements, and one can rightly ask what the court looks to and relies on in making such important (normative) observations about the corporate institution.").

well established by 1919 as to be obvious. The court did not think it was enunciating a meta-principle of corporate law. Rather, the court thought it was merely deciding a dispute between majority and minority shareholders in a closely held corporation in the same way courts had decided such disputes for nearly a century. In short, *Dodge v. Ford Motor Co.* is best viewed as a minority oppression case. The language of the case convincingly establishes the link between the shareholder primacy norm and the modern doctrine of minority oppression.[232]

E. The Modern Doctrine of Minority Oppression

For all of the fanfare that has surrounded *Dodge v. Ford Motor Co.*, it has rarely been cited by courts faced with the issue of shareholder primacy. When it is so cited, however, the case usually involves a claim of minority oppression.[233] Unfortunately, in most modern cases the link between the shareholder primacy norm and the doctrine of minority oppression has been almost totally severed.

Lawrence Mitchell first observed this phenomenon, stating that the doctrine of minority oppression is "a doctrine unrecognizable as fiduciary duty, although still couched in that rhetoric."[234] The rift between fiduciary duty and the doctrine of minority oppression, which began in the common law, has been facilitated by the adoption of provisions prohibiting oppressive conduct by majority shareholders in most incorporation statutes.[235] Although many states permit a shareholder to petition for dissolution of the corporation on grounds other than oppression—including illegality, fraud, misapplication of assets, and waste—Robert Thompson notes that "[o]ppressive conduct by the majority or

232. The overlap between the shareholder primacy norm and minority oppression in *Dodge v. Ford Motor* is repeated in the well-known New York Supreme Court case, *Gottfried v. Gottfried*. 73 N.Y.S.2d 692 (1947). This case involved a claim by minority shareholders in two closely held corporations that the majority shareholders refused to declare dividends in an attempt to coerce the minority shareholders into selling their stock to the majority shareholders at a grossly inadequate price. The minority shareholders also alleged that the majority shareholders took excessive salaries, bonuses, and corporate loans and thus avoided personal hardship during the dividend drought. This claim portrays a classic "freeze out" strategy. The court held that the test of the legality of such a strategy is whether the majority shareholders acted in bad faith, and defined bad faith by referring to the shareholder primacy norm: "The essential test of bad faith is to determine whether the policy of the directors is dictated by their personal interests rather than the corporate welfare. Directors are fiduciaries. Their *cestui que trust* are the corporation and the stockholders as a body." *Id.* at 695. The court ultimately held that the dividend policy was motivated by many factors, not including bad faith. *Id.* at 700. However, the link between the shareholder primacy norm and minority oppression claims was evident in the court's opinion. *See generally id.*

233. For several notable cases, see *Miller v. Magline*, 256 N.W.2d 761 (Mich. Ct. App. 1977) (involving a claim that the refusal of majority shareholders to pay dividends was minority oppression); *Donahue v. Rodd Electrotype*, 328 N.E.2d 505 (Mass. 1975) (involving a claim that a repurchase of shares from a former controlling shareholder breached a fiduciary duty to minority shareholder); and *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (stating a claim that a majority shareholder's refusal to install lights in a major league baseball stadium was not based on consideration of the best interests of the corporation).

234. Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1715 (1990). Mitchell's claim that the doctrine of minority oppression is at odds with the historical understanding of fiduciary duty in closely held corporations is criticized below. *See infra* notes 238-248 and accompanying text.

235. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7.13, at 79 (2d ed. 1985).

controlling shareholder now . . . has become the principal vehicle used by legislatures, courts, and litigants to address the particular needs of close corporations."[236]

Whether the shift from the shareholder primacy norm to the doctrine of minority oppression has had any effect on the outcome of cases is a matter of some debate. When interpreting the meaning of "minority oppression" in statutes, most courts use one or more formulations of what constitutes oppressive conduct. These definitions are usually based on notions of fairness to minority shareholders. Thompson describes the three most common formulations as follows:

> Some courts describe *oppression* as "burdensome, harsh and wrongful conduct . . . a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." Other courts link the term directly to breach of the fiduciary duty of good faith and fair dealing majority shareholders owe minority shareholders, a duty that many courts recognize as enhanced in a close corporation setting . . . . A third view ties oppression to frustration of the reasonable expectations of the shareholders.[237]

These notions of fairness are derived by analogizing close corporations to partnerships.[238] They suggest that the modern doctrine of minority oppression originated in the aspect of fiduciary duties that requires good faith and fair dealing from the fiduciary. Certainly, modern formulations of the doctrine of minority oppression owe much to earlier partnership cases. But is the balancing of interests inherent in these standards really different from the analysis of minority oppression claims by early courts employing the shareholder primacy norm?

Lawrence Mitchell bemoans the tendency of modern courts to balance the interests of majority and minority shareholders.[239] Mitchell begins his attack on the doctrine of minority oppression with the following understanding of the "fiduciary principle": "The classic statement of the fiduciary principle is that, within the scope of the relationship, the fiduciary is to act in a disinterested manner in the beneficiary's best interests."[240] The fiduciary principle finds its most forceful expression in Judge Cardozo's oft-cited opinion in *Meinhard v. Salmon*,[241] which Mitchell calls "the oldest war-horse" for corporate fiduciary duties.[242] This is a surprising statement because *Meinhard* was written in 1928, nearly 100 years after the first cases employing the shareholder primacy norm. Although

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236. Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 708 (1993).

237. *Id.* at 711-12.

238. *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975). *Donahue* relied on Judge Cardozo's classic formulation in *Meinhard v. Salmon* of the fiduciary duty:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties . . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

164 N.E. 545, 546 (N.Y. 1928).

239. Mitchell, *supra* note 230, at 1677.

240. *Id.* at 1676.

241. 164 N.E. at 545.

242. Mitchell, *supra* note 234, at 1692.

Meinhard did not involve a closely held corporation, but rather a joint venture, it is often cited, even in cases involving corporations. One of these cases, *Donahue v. Rodd Electrotype Co.*,[243] serves as the starting point for Mitchell's analysis of recent jurisprudence of fiduciary duty in closely held corporations. Together, *Meinhard* and *Donahue* serve as a prototype for strict application of fiduciary duties in the closely held corporation.

Mitchell correctly identifies the central problem of strictly applying the fiduciary principle in closely held corporations—the inherent conflict of interest that confronts the manager of every closely held corporation because the manager is also a significant shareholder of the corporation.[244] Despite the obvious hazards in strictly applying the fiduciary principle to managers of closely held corporations,[245] Mitchell argues that balancing the relative interests of the shareholders is at odds with the whole notion of fiduciary duty:

> The concept of balancing is wholly inconsistent with the broad notion of fiduciary duty and its expression in *Meinhard* and *Donahue*. Balancing provides a complete shift in focus from the classic fiduciary examination of whether the action taken was in the beneficiary's best interests to a mode of analysis that centers on the fiduciary's interest. Thus, fiduciary conduct is now analyzed by examining whether the fiduciary had a motive other than to harm the beneficiary, rather than whether the fiduciary acted in the beneficiary's best interest.[246]

The primary problem with Mitchell's analysis is that the fiduciary world of *Meinhard* and *Donahue* which he describes had only a limited and transitory existence.[247] As suggested above,[248] since the first cases involving the adjudication of disputes between majority and minority shareholders, courts have required careful balancing to distinguish majority rule from minority oppression. The words have changed, but the balancing of interests—and the desire to achieve fairness—have remained constant.[249]

V. CONCLUSION

The thesis of this Article is that the shareholder primacy norm is nearly irrelevant with respect to conflicts of interest between shareholders and nonshareholders and is outmoded with respect to conflicts of interest between shareholders. In short, the share-

243. 328 N.E.2d 505 (Mass. 1975).

244. Mitchell, *supra* note 234, at 1690-91.

245. In the words of Mitchell, "The application of strict fiduciary standards to close corporations deprives controlling shareholders of the ability to manage the corporation—to use their own property—as they see fit." *Id.* at 1688.

246. *Id.* at 1708-09.

247. O'NEAL & THOMPSON, *supra* note 235, § 7.04, at 39 (noting that the *Donahue* standard has been applied in other jurisdictions, but often "tempered by the balancing test suggested in" *Wilkes v. Springside Nursing Home, Inc.*, and that "[s]ome courts have refused to apply the *Donahue* standard or have applied it in a limited fashion"). For an explanation of the balancing test, see *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

248. *See supra* Part IV.C.

249. In his excellent study of minority oppression, Robert Thompson goes one step further, arguing that the doctrine of minority oppression is not a diluted or perverted form of fiduciary duty, but rather is an enhanced fiduciary duty (relative to the prior standard), based in notions of fairness, that has "moved close corporation law more in the direction of partnership law." Thompson, *supra* note 236, at 706.

holder primacy norm may be one of the most overrated doctrines in corporate law.

Conflicts between shareholders and nonshareholders have attracted the attention of students of publicly traded corporations, particularly those interested in issues of corporate social responsibility. In this area of corporate law, the foregoing analysis suggests that the shareholder primacy norm was something of an interloper. It first appeared in cases involving closely held corporations, which today would be treated under the doctrine of minority oppression. But having once found a place in corporate jurisprudence, the shareholder primacy norm became a fixture and was applied to publicly traded corporations. Proponents of corporate social responsibility have seized upon the shareholder primacy norm in the belief that it is an important determinant of corporate decision making. The evidence, however, does not support that belief.

Conflicts among shareholders have long been analyzed under the doctrine of minority oppression rather than the shareholder primacy norm. Despite the link between the modern doctrine of minority oppression and the shareholder primacy norm, the shareholder primacy norm is broader than necessary to resolve problems of minority oppression in closely held corporations. The modern doctrine of minority oppression relies on notions of fairness, which implies equal treatment of shareholders. The shareholder primacy norm, however, implies not only that all shareholders will be treated equally, but that shareholders are to be preferred to other corporate constituencies. Therefore, the scope of the shareholder primacy norm exceeded its function, and courts eventually replaced it with the more narrowly tailored doctrine of minority oppression.

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