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No Power to be Disloyal (or, How Not to Write a Loyalty Opinion)

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NO POWER TO BE DISLOYAL (OR, HOW NOT TO WRITE A LOYALTY OPINION)

BY VAL RICKS*

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I. INTRODUCTION

Sometimes, courts find that a manager or director of a business entity was disloyal.¹ The fiduciary duty of loyalty is a lofty standard. A defendant does not have to stray far to offend “the punctilio of an honor the most sensitive.”²

Under such a standard, exonerating a defendant may be difficult, even when it is the right thing to do. A defendant who is not pure as the driven snow may still

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¹ *E.g.*, *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A.3d 839 (Del. Ch. 2012), *aff’d*, 59 A.3d 1206 (Del. 2012); *In re Southern Peru Copper Corp. S’holder Derivative Litig.*, 30 A.3d 60 (Del. Ch. 2011); *Johnston v. Pedersen*, 28 A.3d 1079 (Del. Ch. 2011); Wash. *ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 391 P.2d 979 (Wash. 1964); *see Wal-Mart Stores, Inc. v. Coughlin*, 255 S.W.3d 424 (Ark. 2007); *Labovitz v. Dolan*, 545 N.E.2d 304 (Ill. App. Ct. 1989).

² *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J).

not deserve liability. A judge with high standards may decline to approve of the defendant's conduct but still want to reach the right result. When courts decline to find disloyalty, they give various reasons: the disloyalty was waived,³ the conduct was ratified by an appropriate constituency,⁴ or the conduct was fair.⁵

But sometimes courts talk as if certain conduct is privileged, as if some right owned by the defendant trumped the duty of loyalty. Generally, it is a right given in the code without a hint that it relates in any way to the duty of loyalty.⁶ I find this talk troubling. The duty of loyalty is the bedrock of investor expectations. The duty requires that defendants act in good faith, i.e., that their actions serve a purpose of the entity and are not intentionally or in conscious disregard of the rights of investors.⁷ The duty demands that fiduciaries refrain from serving their own interests to the entity's detriment.⁸ Loyalty also ensures that corporate democracy, when in place, is not undercut.⁹ Without this guardian doctrine, those entrusted with the business of others could unjustly enrich themselves or squander assets with impunity. Methods of unfair opportunism available to insiders are endless. Only an open-ended duty could catch them all.

That is why talk of privilege or right to act notwithstanding loyalty is a concern. Nearly any absolute privilege to act, given the right circumstances, can be used disloyally. Courts' stating that a corporate actor—a partner, a LLC manager, a majority shareholder, or anyone—has a privilege to do any act notwithstanding the interests of investors is an invitation to those actors to use that privilege to cheat. Many fiduciaries, given long-term control of a business, can wait for or even slowly manufacture a circumstance in which the privilege can give them the unfair advantage they seek. And, if a right to cheat is attached to some corporate status, others will seek that status not for its inherent worth or the power it gives to serve others but for the power it gives to take from others, thus depriving investors of their fair return and the entity of its efficiency.

All this is true no matter what view of fiduciary duties one espouses. For instance, it is common to see fiduciary duties as contractual.¹⁰ Some might believe that loyalty is merely the default rule parties would have chosen but for the

³ See, e.g., DEL. CODE ANN. tit. 8 § 122(17) (West 2000); DEL. CODE ANN. tit. 6 § 17-1101(c) (West 2010); DEL. CODE ANN. tit. 6 § 18-1101(c) (West 2010); TEX. BUS. ORGS. CODE ANN. § 2.101(21) (West 2007); TEX. BUS. ORGS. CODE ANN. § 152.002 (West 2007); UNIF. P'SHIP. ACT § 103 (1997).

⁴ See, e.g., DEL. CODE ANN. tit. 8 § 144 (West 2010) (Delaware's so-called "safe harbor" statute); TEX. BUS. ORGS. CODE ANN. §§ 21.418 & 101.255 (West 2011) (Texas's attempt to create a true safe harbor); Rev. Model Bus. Corp. Act § 8.61.

⁵ See, e.g., *Cookies Food Prods, Inc. by Lakes Warehouse Distrib, Inc.*, 430 N.W.2d 447 (Iowa 1988).

⁶ That is true with respect to the three cases discussed in this article. See *Covalt v. High*, 675 P.2d 999 (N.M. Ct. App. 1983), *cert. denied*, 674 P.2d 521 (N.M. 1984); *North-West Transp. Co. v. Beatty*, [1887] 12 App. Cas. 589 (P. C.); *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996).

⁷ *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006).

⁸ E.g., *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, 30 A.3d 60 (Del. Ch. 2011).

⁹ E.g., *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127–32 (Del. 2003); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660–61 (Del. Ch. 1988); *Schnell v. Chris-Craft, Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971).

¹⁰ Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (1990).

transaction costs of bargaining.¹¹ I am a believer in contractual freedom and the general ingenuity of people to solve their problems by agreement, but I am skeptical of this justificatory move. It is possible that this method of analysis allows any (or nearly any) current state of the world to be justified. After all, this supposition that people have or would have agreed is largely a thought experiment engaged in by very creative people not bound by time, real world costs, heuristics, or prejudices. I never saw a client like that. For the contractarian view of fiduciary duties to generate a judicial conclusion that a right trumps a duty of loyalty, one would have to conclude that the investors agreed to allow the managers to do what would otherwise be a disloyal act. The trumping position itself allows the fiduciary a right to act in its own self-interest and opposed to the interests of investors. Given that the situation requires a trumping rationale, no explicit waiver of the duty of loyalty exists that covers the act, and no ratification has occurred. Moreover, the fiduciary's conduct is egregious enough that the court is hesitant to find it fair. The danger of present and future opportunism is obvious. Supposing that investors have agreed to this in advance is literally incredible.

Some believe that fiduciary duties are, and should be, not contractual but inherent and mandatory in certain relationships.¹² On this view, if fiduciary duties apply, no contractual arrangement can qualify them. This theory regards fiduciary duties as necessary to protect the weaker party in a relationship¹³ and third parties who deal with the fiduciary.¹⁴ With respect to the weaker party, Professor Gordon Smith's critical resources theory of fiduciary duties explains why.¹⁵ In this view,

¹¹ Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1996).

¹² See, e.g., Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 BOSTON U. L. REV. 1039, 1046 (2011) (“[T]here is a mandatory core . . . that cannot be overridden by agreement.”); Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L.J. 279 (2009); Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009); Daniel Kleinberger, *Seven Points to Explain Why the Law Ought Not Allow the Elimination of Fiduciary Duty Within Closely Held Businesses: Cardozo Is Dead; We Have Killed Him* (William Mitchell College of Law, Working Paper No. 61, 2006), available at <http://ssrn.com/abstract=948234> (last visited Feb. 14, 2013); Mark Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the “Manifestly Unreasonable” Standard*, 41 TULSA L. REV. 411 (2006); see also, e.g., *Labovitz v. Dolan*, 545 N.E.2d 304, 416–17 (Ill. App. Ct. 1989). The *Dolan* court opined, regarding a general partner's management discretion,

[T]hat discretion was encumbered by a supreme fiduciary duty of fairness, honesty, good faith and loyalty to his partners. Language in an agreement such as “sole discretion” does not metamorphose the document into an unrestricted license to engage in self-dealing at the expense of those to whom the managing partner owes such a duty. Defendants cite no authority, and we find none, for the proposition that there can be an *a priori* waiver of fiduciary duties in a partnership—be it general or limited.

Id. at 416–17. The court did not foreclose forever the possibility of an *a priori* waiver, see *id.* at 417, but the court's analysis strongly suggests that, if a duty of loyalty remained necessary at all to protect the parties, the court would find that it was not covered by whatever waiver had occurred.

¹³ See Sitkoff, *supra* note 12, at 1047.

¹⁴ See Miller, *supra* note 12, at 243.

¹⁵ D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002). Professor Smith claims his view is consistent with the notion that fiduciary duties are contractual. *Id.* at 1491–93. However, nothing in his view requires any connection between fiduciary duties and contract. If Smith is correct about fiduciary duties, it is not clear that the fiduciary duty, technically speaking, could ever be waived or modified; it would simply be displaced to the extent of

“fiduciary relationships form when one party . . . acts on behalf of another party . . . while exercising discretion with respect to a critical resource belonging to the beneficiary.”¹⁶ It is apparent in that description that fiduciaries, even those violating fiduciary duties, always claim as a factual matter to be acting according to right; the right gives them the discretion required under this definition of the duty. The fiduciary duty exists to rein in the fiduciary’s discretion *notwithstanding the fiduciary’s rights*. Thus, fiduciary duties, particularly the vital duty of loyalty, “protect[] beneficiaries against opportunistic behavior by fiduciaries.”¹⁷ This purpose and facet of fiduciary duties virtually requires condemnation of a right that allows a fiduciary to disregard loyalty. Only a cold and ineffective logic would free the fiduciary from the duty of loyalty for the exercise of some selective rights. To do so would invite opportunism and thus undercut the entire fiduciary enterprise as the theory describes it.

It is the thesis of this paper that no privilege to act disloyally exists: that a power to act never trumps the duty of loyalty. My method is to discuss three cases in which the privilege or power to act appears to receive judicial support. The paper shows why this strategy does not work. Such assertions have no support in logic (and usually not in law), provide a slippery slope at the bottom of which the duty of loyalty ceases to exist, often result in a decision being internally inconsistent, and fail to stand the test of time. I will do my best to unwind the harm these cases might cause. My hope is that those reading this paper will take its criticism to future cases so that this kind of argument can be defeated elsewhere in the law, and so that courts will not assert such things in the future. There is always a better, wiser course for the law.

II. *COVALT v. HIGH* (N.M. CT. APP. 1983)¹⁸

A. *The Case*

Covalt v. High reports a dispute between William High and Louis Covalt. High owned 75% of the shares of Concrete Systems, Inc. (“CSI”).¹⁹ Covalt owned 25% of CSI’s shares.²⁰ High was president of CSI, and Covalt was vice-president. Both received remuneration from CSI “in the form of salaries and bonuses.”²¹

the waiver or modification, and if it were displaced completely, then it never would have existed. Under Smith’s terms, a fiduciary duty exists if the relationship gives another party discretion with regard to a critical resource belonging to the beneficiary. *Id.* at 1402. A contract purporting to waive such a duty would either describe the required conduct, in which case there would be no discretion, or entirely undercut the idea that the resource was critical. There simply would be no fiduciary and no fiduciary duty. There can be neither waiver nor modification of something that does not exist. And if the premises of the fiduciary relationship remain to any extent, then presumably the duty remains, too, notwithstanding a contract, to the extent the relationship has not been displaced. Whether that technical argument is accepted or not, Smith’s description of the grounds of fiduciary duties lends nothing to the notion that those duties might be trumped by another right. Any other right would also undercut the premises of Smith’s description.

¹⁶ *Id.* at 1402.

¹⁷ *Id.*

¹⁸ *Covalt v. High*, 675 P.2d 999 (N.M. Ct. App. 1983).

¹⁹ *Id.* at 1000.

²⁰ *Id.*

²¹ *Id.*

In 1971, Covalt and High agreed to form a partnership. Covalt and High became equal partners.²² The partnership bought real property and built an office and warehouse. In 1973, CSI leased the building from the partnership for a five-year term. Substantial improvements that CSI made to the leasehold over the five-year term were to belong to the partnership at termination. The term ended in early 1978, after which CSI remained in possession as a tenant without a term.²³

Late in 1978, Covalt resigned his corporate position and went to work for a competitor of CSI. Covalt remained a partner with High in the partnership. Covalt soon wrote to High demanding that CSI's rent increase from \$1,850 to \$2,850. High responded that he would see if rent could be raised, but he took no action.²⁴

Covalt then sued High, alleging that High had breached his fiduciary duties as a partner. Covalt also sued CSI and High seeking dissolution of CSI. The two cases were consolidated. The trial court bifurcated Covalt's claim for loss of rental income from the other issues, partly because Covalt and High settled before trial all the remaining partnership issues by selling the partnership property and agreeing to a settlement of the partnership affairs.²⁵

At trial, High testified that CSI could not afford a higher rent. The trial court held, however, that this was incorrect, that CSI could afford to pay \$2,850, and that \$2,850 would have been a reasonable monthly rent.²⁶ The trial court then held that High had breached his fiduciary duty of "utmost fairness" to Covalt and ordered High to pay damages.²⁷ High appealed.

The court of appeals, which reversed, did not spend much time explaining the trial court's ruling. The court of appeals seemed not to want to recognize the fiduciary duty issue. When it recited the issue before the court, it omitted fiduciary duty, recasting the issue as if it were a management decision: "Can a partner recover damages against his co-partner for the co-partner's failure or refusal to negotiate and obtain an increase in the amount of rental of partnership property?"²⁸

When it came time to describe the fiduciary duties of partners, the court admitted,

[T]he formation of a partnership creates a fiduciary relationship between partners. The status of partnership requires of each member an obligation of good faith and fairness in their dealings with one another, and a duty to act in furtherance of the common benefit of all partners in transactions conducted within the ambit of partnership affairs. . . . "[A] partner must account for any profit acquired in a manner injurious to the interests of the partnership"²⁹

²² *Id.* at 1001 ("High paid Covalt . . . for his one-half interest as partner . . .").

²³ *Id.* at 1000.

²⁴ *Id.*

²⁵ *Id.* at 1000–01.

²⁶ *Id.*

²⁷ *Id.* at 1001.

²⁸ *Id.* at 1000.

²⁹ *Id.* at 1001 (quoting J. CRANE & A. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP § 68 (1968)). New Mexico law clearly provides that partners are fiduciaries. *See* Citizens Bank of Clovis v. Williams, 630 P.2d 1228, 1230 (N.M. 1981) ("It is true that partners occupy a fiduciary duty towards one another."); *Cave v. Cave*, 474 P.2d 480, 484 (N.M. 1970) (holding in particular that a managing partner owes the other partner a fiduciary duty (High was the managing partner, 675 P.2d at 1001));

But then the court proposed a competing principle: “Except where the partners expressly agree to the contrary, it is a fundamental principle of the law of partnership that all partners have equal rights in the management and conduct of the business of the partnership.”³⁰ Where the partners differ as to a matter, “the decision of the majority must govern.”³¹

Without any discussion of how the two principles relate to each other, the court declared that High’s right to equal management fully justified his refusal to raise the rent.³² A disagreement between partners is resolved by majority vote, the court said.³³ Of course, here there were only two partners. So the court turned to treatises naming a rule for deadlocked management:

If the parties are evenly divided as to a business decision affecting the partnership, and in the absence of a written provision in the partnership agreement providing for such contingency, then, as between the partners, the power to exercise discretion on behalf of the partners is suspended so long as the division continues.³⁴

The application of that principle in this case, the court said, was that “an act involving the partnership business may not be compelled by the co-partner.”³⁵ Citing an Idaho case in which partners disagreed over whether to hire a new employee but in which no partner had a conflict of interest and no allegations were made of breach of fiduciary duty, the court asserted that the rule was “mandatory.”³⁶

On that analysis, the court held “that one partner may not recover damages for the failure of the co-partner to acquiesce in a demand by the plaintiff that High negotiate and execute an increase in the monthly rentals of partnership property with CSI. Thus, there was no breach of a fiduciary duty.”³⁷ The *Covalt* decision has been cited for managerial rights trumping duty of loyalty.³⁸ The *Covalt* court

Rogers v. Stacy, 318 P.2d 1116, 1117 (N.M. 1957) (“A trust relation exists among partners.”).

³⁰ *Covalt*, 675 P.2d at 1002.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 1002 (citing NATHANIEL LINDLEY, ET AL. A TREATISE ON THE LAW OF PARTNERSHIP 354 (E. Scamell, 12th ed. 1962) (“[I]f the partners are equally divided, those who forbid a change must have their way.”) and J. M. BARRETT & ERWIN SEAGO, PARTNERS AND PARTNERSHIPS LAW AND TAXATION, ch. 5, § 7, at 484 (1956) (“If the partners are unable to agree and if the partnership agreement does not provide an acceptable means for settlement of this disagreement, the only course of action is to dissolve the partnership.”)).

³⁵ *Id.*

³⁶ *Id.* (citing *Summers v. Dooley*, 481 P.2d 318, 320 (Idaho 1971)).

³⁷ *Id.* at 1003.

³⁸ *E.g.*, *Mack v. Mack*, 613 N.W.2d 64, 68 (S.D. 2000); *Sanchez v. Saylor*, 13 P.3d 960, 977 (N.M. App. 2000); *Shuster v. Lyons*, Memorandum of Decision, 1997 WL 472419 *5 (Conn. Super. Ct., Aug. 7, 1997). The court’s reasoning is criticized in Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. L. REV. 955, 973 n.75 (1995) (“I find the decision mechanical and wrong-headed.”). Dickerson sees the court as balancing High’s duties to the corporation as against his duties to the partnership, *id.*, but this would be an obvious mistake. If High has put himself into a position in which he has conflicting duties, the presence of the conflicting duties is no reason to breach one of them. The *Covalt* court did not suggest it was balancing High’s duties. Though Dickerson thinks High breached his duty of loyalty, she recognizes that the decision may well rest on a kind of waiver, as the court also said and as I explain *infra* in the text following this footnote.

concluded this issue by suggesting that Covalt should have dissolved the partnership.³⁹

Perhaps feeling that it had not fully justified ignoring High's disloyalty, the court also tried another way. The court noted that conflicts of interest between Covalt and High existed from the time the partnership formed.⁴⁰ Even in 1973, the court said, both were "aware of the potential for conflict between their duties as corporate officers . . . and that of their role as partners in leasing realty to the corporation for the benefit of the partnership business."⁴¹ The conflicts continued, of course, after Covalt's resignation from employment at CSI. Then the court draws this conclusion: "Each party's conflict of interest was known to the other and was acquiesced in when the partnership was formed."⁴²

B. Analysis

i. Criticism

Covalt's reasoning about High's right to manage does not justify its conclusion that the duty of loyalty does not apply or was trumped. Most obviously, if High had a management right to decide what to do with the rent, then he had both the ability to decide not to raise it and the ability to raise it. In other words, the court translates High's right to disagree with Covalt into a disability: that High cannot act. But that neither follows from the premise, nor is this conclusion true. In fact, High's management rights gave him a choice whether to raise the rent. High's duty of loyalty is logically independent of his management right and can function consistently with it.⁴³ If High's duty of loyalty required him to raise the rent, it is no defense to say that he had a power to decide otherwise. His duty of loyalty required him to decide to exercise his management right in favor of the partnership and his partner.

Imagine the parade of horrors if what the *Covalt* court said was true. Every management act that was disloyal could hide behind a manager's right to decide. This would not necessarily be restricted to management deadlock. In a partnership, majorities rule in most cases. If two partners wanted to cheat a third, then so long as they made a decision, the other's recourse could only be dissolution as quickly as possible. If High had a management right to ignore what loyalty would otherwise require of a single partner in a deadlock, would he not have even more right if he were two of three partners? Under *Covalt's* reasoning, there could

³⁹ *Covalt*, 675 P.2d at 1003.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ For example, the power or right to manage and the duty of loyalty are expressed in separate code sections. See UNIF. P'SHIP ACT §§ 18(e) & 2; REV.UNIF. P'SHIP ACT §§ 401(f) & 404 (1997). The code does not purport to establish a hierarchy between them. They appear both to apply where their texts say they will apply, even when the two rules cover the same factual scenario. In fact, the two rules answer very different questions. One asks whether the partner has the authority, vis-à-vis the partnership, other partners, and in some cases a third party (see, e.g., UNIF. P'SHIP ACT § 9(1) ("unless the partner . . . has in fact no authority"); REV. UNIF. P'SHIP ACT § 301(1) ("unless the partner had no authority") (1997)), to do a certain act. The other rule asks whether in doing an act the partner was disloyal. The logic is just the same if two partners vote against one another.

be no disloyalty. Anytime action was taken pursuant to managerial decision, the action could not be challenged.

The source of the *Covalt* court's thinking on this issue may be the superficial notion that a disloyal act is not allowed because it is not authorized. Perhaps the court believed that, because High acted within his authorized management rights, loyalty was not an obstacle. This notion does not withstand scrutiny, however; it fundamentally misunderstands the relationship between management power and loyalty.

The partner has equal rights in the management of the partnership not because the other partner or partners have authorized them. The equal right in management is not given by the other partners like agency authority is given by principals. Instead, the equal right to manage follows from the partner's status as a co-owner of the partnership business.⁴⁴ As comments to the Revised Uniform Partnership Act put it, "A business is a series of acts directed toward an end. Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that they each have the power of ultimate control."⁴⁵ That is why what *Covalt* says about High's management rights is correct as a matter of management rights. High had management rights because he was a co-owner of the partnership; ownership gave High "the power of ultimate control."⁴⁶

This power of management is not obtained from the other partners, like the authority of an agent. It exists despite what the other partners do, unless a majority of the other partners decide otherwise, in which case the ownership of the partnership has spoken otherwise.⁴⁷ Both the rule cited in *Covalt* and the case *National Biscuit Co. v. Stroud*⁴⁸ illustrate the point. Stroud and Freeman's partnership operated a grocery store.⁴⁹ Stroud called Nabisco and told them he would not be responsible for any more bread ordered by Freeman.⁵⁰ Freeman thereafter ordered bread, and then the partnership dissolved.⁵¹ The court addressed whether Stroud was liable as a partner for the partnership's obligation to pay for the bread.⁵² While Freeman as a partner was generally an agent for the partnership's business,⁵³ the court had to ask whether this was the partnership's business. Though Stroud's action indicated it was not, Freeman's independent management right meant that it was, necessarily: "Stroud . . . could not restrict the power . . . of Freeman to buy bread for the partnership as a going concern, . . . because in the very nature of things Stroud was not, and could not be, a majority of the partners."⁵⁴ A right to manage, including a right to determine the direction of

⁴⁴ UNIF. P'SHIP ACT § 6(1); REV. UNIF. P'SHIP ACT § 202(a) (1997).

⁴⁵ REV. UNIF. P'SHIP ACT § 202 cmt, 1 (1997).

⁴⁶ *Id.*

⁴⁷ UNIF. P'SHIP ACT § 18(h); REV. UNIF. P'SHIP ACT § 401(j) (1997).

⁴⁸ *Nat'l Biscuit Co. v. Stroud*, 106 S.E.2d 692 (N.C. 1959).

⁴⁹ *Id.* at 693.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.* at 695 (citing North Carolina's analog to UNIF. P'SHIP ACT § 9(1)).

⁵⁴ *Stroud*, 106 S.E.2d at 695.

the business, is what defines a co-owner.⁵⁵

Whatever else we can say about High, then, we cannot say that he lacked the right and therefore the power to determine the direction of the business. He was, after all, a co-owner. However, in a partnership, that a person is an owner and has the management rights of an owner over a business does not mean that person has absolute power, because in a partnership there is more than one owner. The partners are “co-owners.”⁵⁶ Each has the same power. Obviously some limitations must be placed on that power. Two beings cannot have unbridled power over the same object any more than an unstoppable force can push aside an immovable wall or an omnipotent being can create a rock so large she cannot move it.

The code therefore mediates between the powers. The most obvious mediation is that, when a difference arises “as to ordinary matters connected with the partnership business[,] . . . a majority of the partners” resolves it.⁵⁷ If the matter is “outside of the ordinary course of business,” the management right to do the act exists “only with the consent of all of the partners.”⁵⁸

The other primary mediation made by the code between the partners’ power as co-owners is the duty of loyalty. Loyalty bridles ownership power; otherwise, no act of the partner done pursuant to the partner’s power to manage could be disloyal. Nearly everything a partner does is pursuant to the power to manage, and frequently these acts could be disloyal. Because the partner manages partnership property, the partner may change the locks (though this may exclude a partner). A partner may decide to hire a new employee (who may turn out to be the partner’s nephew). A partner may take the books home to examine them (which would deprive another partner of doing the same). A partner may sell partnership property, especially products the partnership sells in its business, and may set the price (though this sale may be to the partner for a bargain price). And a partner may buy property for the partnership’s business (though this may be from the partner at a price that is more than the property is worth). A partner as part owner and as manager has power to do each of these acts. If the partner acting as owner has power to act despite the disloyal harm she visits on her partners, then the duty of loyalty means nothing. If a partner who has ownership power to do all these things is freed from loyalty by virtue of that power, there is no duty of loyalty.

In fact, it is the power in the partner that makes the duty of loyalty vital. Recitation of even the most classic partnership cases proves the point. In *Meinhard v. Salmon*,⁵⁹ Salmon leased a building and then solicited Meinhard to put up money with a plan to renovate the building and sublease out parts as shops

⁵⁵ Against the suggestion that *High* and *Stroud* conflict because one says that in a deadlock the partners cannot act and the other says they can, I suggest that the partners’ status as co-owners meant that their management rights cannot be limited by the other partner. In *High*, the partner was minded to keep the rent the same. In *Stroud*, the partner was minded to order more bread. The management rules recited in the two cases give the partner power to do either, whichever and whatever he was minded to do. That is because a partner is a co-owner, not merely an agent of the partnership. I thank Gary Rosin for calling attention to the potential conflict.

⁵⁶ UNIF. P’SHP ACT § 6(1); *see also* REV. UNIF. P’SHP ACT § 202(a) (1997).

⁵⁷ UNIF. P’SHP ACT § 18(h); *see also* REV. UNIF. P’SHP ACT § 401(j) (1997).

⁵⁸ REV. UNIF. P’SHP ACT § 401(j) (1997).

⁵⁹ *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

to tenants.⁶⁰ The two were to split the profits at certain percentages over the years that remained on the lease.⁶¹ “Salmon . . . was to have sole power to ‘manage, lease, underlet and operate’ the building.”⁶² When the lease was about to end, the lessor proposed to Salmon another long-term lease during which the building would be torn down and a new one built in its place.⁶³ Salmon signed onto this new deal only through Midpoint Realty Company, which he solely owned.⁶⁴ He entered into this lease by himself, just as he had the first one.⁶⁵ But this time he failed to tell Meinhard anything about it.⁶⁶ When Meinhard later asserted an interest in the deal, Salmon refused him.⁶⁷

There was no question that the management authority was all Salmon’s. But that authority did not allow Salmon to ignore his duty to Meinhard. Cardozo reasoned:

Equity refuses to confine within the bounds of classified transactions its precept of a loyalty that is undivided and unselfish. Certain at least it is that a ‘man obtaining his locus standi, and his opportunity for making such arrangements, by the position he occupies as a partner, is bound by his obligation to his copartners in such dealings not to separate his interest from theirs, but, if he acquires any benefit, to communicate it to them.’

Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer. . . . For him and for those like him the rule of undivided loyalty is relentless and supreme Here the subject-matter of the new lease was an extension and enlargement of the subject-matter of the old one. A managing coadventurer appropriating the benefit of such a lease without warning to his partner might fairly expect to be reproached with conduct that was underhand, or lacking, to say the least, in reasonable candor, if the partner were to surprise him in the act of signing the new instrument. Conduct subject to that reproach does not receive from equity a healing benediction.⁶⁸

Management power is what gives the partner power to harm his fellow partner. Whether the source of the duty of loyalty is contractual or relational, the duty of loyalty exists so that this power is not misused.⁶⁹ To say that the power trumps the duty is like saying that the gas pedal trumped the brake and therefore no speeding tickets are allowed.

ii. Solution

High’s power to set rent could therefore not be grounds for him to ignore

⁶⁰ *Id.* at 545.

⁶¹ *Id.* at 545–46.

⁶² *Id.* at 546.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* at 548.

⁶⁹ *See, e.g.,* Labovitz v. Dolan, 545 N.E.2d at 308.

Covalt's interests. Fortunately, the court sensed as much and offered an alternative ground. At first, the court's other ground seems as ill-conceived as its first. The court says, merely, that each party was "aware of the potential for conflict between their duties as corporate officers . . . and that of their role as partners in leasing realty to the corporation for the benefit of the partnership business."⁷⁰ The conflicts continued, of course, after Covalt's resignation from employment at CSI. Then the court draws this conclusion: "Each party's conflict of interest was known to the other and was acquiesced in when the partnership was formed."⁷¹ As the court states it, this reasoning makes no sense. Acquiescence in a conflict of interest is not a waiver of cheating behavior.⁷² Business people acquiesce in conflicts because they trust the other party will not cheat, not because they have resigned themselves to become victims of whatever harm the other party inflicts.

Nevertheless, on the facts, the court is pointing in the right direction. The business structure High and Covalt built together included a partnership that owned property and was to distribute profits equally.⁷³ That partnership leased property to a corporation, shares of which High owned 75% and Covalt 25%.⁷⁴ Both were officers, and both received remuneration in the form of salaries and bonuses.⁷⁵ There is no reason that both Covalt and High could not be happy with this structure. In fact, there is no reason that they could not take home equal amounts of pay under this structure. There is no mention of dividends in the case; most likely the two principals drew profits from the business solely in the form of salary and bonuses. If their salaries and bonuses were equal, then the two made equal amounts from the corporation and partnership together, even though the two owned different percentages of stock. In that case, both were benefitting equally from the low rent.

On the other hand, equal pay seems unlikely. High was, after all, the higher officer and the owner of more shares. Covalt quit, not High, nor did Covalt appear able to force High out. If High's and Covalt's salary and bonuses differed in amount, it seems likely that High's exceeded Covalt's. If Covalt was taking home less in salary and bonuses from the corporation than High, then the below-market rent that the corporation paid actually benefitted High more than Covalt. This is

⁷⁰ *Covalt*, 675 P.2d at 1003.

⁷¹ *Id.*

⁷² For example, a lawyer may represent business people forming a business, even a partnership; two parties forming a contract; two spouses divorcing; a criminal defendant who is allowing another to pay for the representation; or an insured and an insurance company paying for the defense. The ethical lawyer obtains an informed waiver of the conflict from the two clients or potential clients. ABA MODEL RULES OF PROFESSIONAL CONDUCT 1.7(a), http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients.html (last accessed Oct. 17, 2011). But when the situation changes and the interests of the parties conflict so that "the representation of one client will be directly adverse to another client" or "there is a significant risk that the representation of one or more clients will be materially limited" by duties to anyone else, including the lawyer, then the lawyer must withdraw. *Id.* at 1.7(a) and cmts. ¶¶ 4–5, http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients/comment_on_rule_1_7.html (last accessed Oct. 17, 2011). Acquiescence in a conflict does not justify the lawyer's cheating one client for another, or for himself.

⁷³ *Covalt*, 675 P.2d at 1000.

⁷⁴ *Id.*

⁷⁵ *Id.*

true because the savings from paying a below-market rent were divided between the two unevenly, more to High than to Covalt. Covalt had thus already acquiesced in a departure from even-handedness, though perhaps he did not realize this.

Moreover, Covalt had to realize that, if he quit, he would immediately be cut off from what thus far had been, by agreement if not in fact, a fair division of profits for the business as a whole. The immediate cause of the unfair distribution, then, and Covalt had to know this, was Covalt's actions, not High's refusal to act. When Covalt quit, he necessarily gave up the salary and bonuses. This may well have rendered his stock worthless, without dividends. The result was that the benefit of a below-market rent went, or went more obviously, to High.

The court assessed Covalt's litigation position at this point. What the court saw then was that, for several years, Covalt was happy with what probably was a slightly unfair arrangement and with the knowledge that, if he resigned, an obviously unfair one would result. But it was one that happened by Covalt's own agreement. The greater unfairness that later came about occurred first of all because Covalt voluntarily caused it. There is no allegation that High forced Covalt out. It seems odd for Covalt to quit and then demand, for the first time, that High pay more. The rent that Covalt had approved before (perhaps even though unfair to him) was no longer acceptable to him, and the change that made it unacceptable was entirely his own action. Does Covalt's decision to decline the salary and bonuses that made the rental arrangement acceptable to him mean that High must re-arrange the rent, particularly if benefits from below-market rent were spread unevenly all along? Presumably the gains from the business were a package deal, and Covalt and High had their reasons for dividing them between partnership and corporation as they did. These reasons now no longer apply, because Covalt quit, but does that mean the court should remake the deal the way Covalt wants it?

The partnership was at will, apparently, and dissolution would have given Covalt his interest in the property, as later occurred.⁷⁶ Given Covalt's likely prior acquiescence and his creation of the situation that made the below-market rate intolerable to him, and the ease of dissolution, I am satisfied to interpret the court as saying it would not remedy a breach of duty even if one occurred—not because High had a management right, but because he did nothing disloyal, or nothing disloyal that the court could remedy in any way but to remake the deal Covalt himself had made and now regretted. Is that a waiver? I am comfortable with the idea that whatever rights Covalt may have had at one point to a fair rental rate are suspect because he cannot use the court to remake the business deal that Covalt and High had struck. I think the court reached the right result on this ground, though stated obtusely. In fairness, the deal between Covalt and High can only be seen by looking outside—by looking between—the strict legal categories of corporation, partnership, and contract. But there is no reason that deal should not govern. And this ground is much preferable, safer jurisprudentially, and more

⁷⁶ I infer this from the court's conclusion that Covalt should have dissolved the partnership. *Id.* at 1003. The parties, months after the split (but before trial), dissolved the partnership by agreement, and High paid Covalt \$170,000 in cash, plus installment payments the amount of which is not clear from the opinion. *Id.* at 1001.

logical than holding that management rights trump a duty of loyalty. *Covalt*, if it is to survive as a precedent, should be construed to mean only this.

III. NORTH-WEST TRANSPORTATION COMPANY, LTD. V. BEATTY⁷⁷

A. *The Case*

James Hughes Beatty was the sole owner of a steamship called “United Empire.”⁷⁸ Beatty was also a director of North-West Transportation Company, Limited (NWT), a Canadian joint stock company.⁷⁹

The bylaws of NWT specified that its board should have five directors, and that each director should hold five shares in the company.⁸⁰ Directors were elected at the annual shareholders meeting on the first Wednesday in February, at which meeting each share cast one vote per issue.⁸¹

The directors of NWT had the power to enact bylaws.⁸² But every board-enacted bylaw was enforceable only until the next annual meeting of shareholders, at which time shareholders would give these bylaws an up or down vote. Shareholders might also approve bylaws by special meeting, but board-enacted bylaws failing to receive shareholder confirmation ceased to have force.⁸³

NWT was organized for shipping. In late 1882, it lost one of its steamships, the “Asia.”⁸⁴ Another ship, the “Sovereign,” was considered unsuitable.⁸⁵ The “United Empire,” owned by Beatty, was under construction but nearly finished.⁸⁶

At the end of 1882, Beatty owned 200 shares of NWT, one-third of the total of 600.⁸⁷ On January 31, 1883, Beatty purchased 101 shares from S. Neelon, who was then a director.⁸⁸ Beatty therefore had more than half the shares. The next largest shareholder was Beatty’s brother Henry, with 120 shares.⁸⁹ Neelon had held third-most,⁹⁰ so Beatty now controlled far and away more shares than any other shareholder.

On the morning of February 7th, Beatty transferred five shares each to Rose and Laird, which qualified them to serve as directors.⁹¹ This reduced Beatty’s shares to 291, fewer than half.

The annual shareholders meeting for the year 1883 was held on the 7th of

⁷⁷ North-West Transp. Co. v. Beatty, [1887] 12 App. Cas. 589 (P.C.).

⁷⁸ *Id.* at 593.

⁷⁹ *Id.*

⁸⁰ *Id.* at 594.

⁸¹ *Id.* at 594–95.

⁸² *Id.* at 594.

⁸³ *Id.*

⁸⁴ *Id.* at 595.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 597.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

February after Beatty's transfer to Rose and Laird.⁹² At the meeting, Beatty, Rose, and Laird were elected directors.⁹³ Then a discussion took place regarding the "United Empire."⁹⁴ The shareholders resolved to hold a special shareholders meeting on the 16th of February for the purpose of voting on a bylaw for the purchase of the "United Empire" and also to consider whether to sell the "Sovereign."⁹⁵

In between shareholders' meetings, on the 10th, however, the directors met (in the absence of Brother Henry) and resolved by bylaw to purchase the "United Empire" for \$125,000.⁹⁶ An agreement between Beatty and NWT was recited to the board before the vote.⁹⁷ The agreement was later executed at the same meeting.⁹⁸

At the shareholders meeting on the 16th, the shareholders adopted the bylaw by a majority of votes.⁹⁹ Beatty, Rose, Laird, and William Beatty voted in favor, casting 306 votes.¹⁰⁰ Against the measure, Henry and three other shareholders cast 289 votes.¹⁰¹ Henry then sued to set the sale aside.

The suit twisted up through the courts, the Chancellor setting the sale aside, citing Beatty's conflict; the Court of Appeal of Ontario reversing, citing shareholders' rights; the Supreme Court of Canada reversing again; and the Privy Council in turn reversing the Supreme Court, thus affirming the transaction.¹⁰²

The Privy Council's reasoning focused on a shareholder's rights and downplayed a director's duty, which is why the case appears in this article. In upholding the transaction, the court said,

[T]he constitution of the company enabled the defendant J. H. Beatty to acquire this voting power; there was no limit upon the number of shares which a shareholder might hold, and for every share so held he was entitled to a vote; the charter itself recognised the defendant as a holder of 200 shares, one-third of the aggregate number; he had a perfect right to acquire further shares, and to exercise his voting power in such a manner as to secure the election of directors whose views upon policy agreed with his own, and to support those views at any shareholders' meeting; the acquisition of the *United Empire* was a pure question of policy, as to which it might be expected that there would be differences of opinion, and upon which the voice of the majority ought to prevail; to reject the votes of the defendant upon the question of the adoption of the bye-law would be to give effect to the views of the minority, and to disregard those of the majority.¹⁰³

The Council reasoned that "great confusion would be introduced into the affairs of

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.* at 595, 598.

⁹⁵ *Id.* at 595.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.* at 596.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 598.

¹⁰¹ *Id.*

¹⁰² *Id.* at 589–91, 599–600.

¹⁰³ *Id.* at 601 (original spelling retained).

joint stock companies if the circumstances of shareholders, voting in that character at general meetings, were to be examined, and their votes practically nullified, if they also stood in some fiduciary relation to the company.”¹⁰⁴ The Council’s statement of the rule also seems to favor shareholder rights:

The general principles applicable to cases of this kind are well established. Unless some provision to the contrary is to be found in the charter or other instrument by which the company is incorporated, the resolution of a majority of the shareholders, duly convened, upon any question with which the company is legally competent to deal, is binding upon the minority, and consequently upon the company, and every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject-matter¹⁰⁵ opposed to, or different from, the general or particular interests of the company.

The passage seems to say that a shareholder, perhaps even a majority shareholder but in any event a more or less controlling shareholder such as Beatty, has an absolute right to vote any way he wants, and that this trumps whatever duty of loyalty he may have to the company or the minority whether as director, officer, or shareholder. On these facts, it is difficult to read in any other way the court’s statement that “every shareholder has a perfect right to vote” however he may, “although he may have a personal interest in the subject-matter opposed to . . . the . . . interests of the company.”¹⁰⁶

In fairness, the Council also paid homage to the duty of loyalty:

On the other hand, a director of a company is precluded from dealing, on behalf of the company, with himself, and from entering into engagements in which he has a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound by fiduciary duty to protect . . .¹⁰⁷

But the Council wrote what it thought should happen if the right and duty conflicted, and it seems here that the right may trump: “Any such dealing or engagement may, however, be affirmed or adopted by the company, provided such affirmance or adoption is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards those shareholders who oppose it.”¹⁰⁸ The proviso in this sentence does not seem to apply to the transaction. Rather, it applies only to the vote (“such affirmance or adoption”), so that if the vote is done fairly, the vote appears to control notwithstanding unfairness in the transaction.¹⁰⁹ And when the court examined unfairness in the *Beatty* case, it examined facts surrounding the vote. It noted that Rose and Laird testified that there was no agreement or understanding between either of them and Beatty with regard to the purchase of the “United Empire.”¹¹⁰ They admitted that before Beatty transferred shares to them, they thought the purchase would be beneficial,

¹⁰⁴ *Id.* at 600.

¹⁰⁵ *Id.* at 593.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 593–94.

¹⁰⁹ See also *id.* at 600 (“In form and in terms they adopted it by a majority of votes, and the vote of the majority must prevail, unless the adoption was brought about by unfair or improper means.”).

¹¹⁰ *Id.* at 597.

“that they accepted the shares with the view of becoming directors,” and that Beatty knew of their opinions.¹¹¹ Rose said “he would not have joined the company” had not NWT intended to buy the boat.¹¹² None of these facts amounted to unfairness in the vote, and therefore the vote was effective to affirm the transaction.¹¹³ The only hint that the court is concerned with the fairness of the transaction comes early in the opinion, which mentions that “another steamer . . . was essential to the efficient conduct of the company’s business; that the *United Empire* was well adapted . . . and that the price agreed . . . was not excessive or unreasonable.”¹¹⁴ But these facts receive no further mention and appear to play no role in the court’s analysis.

B. Analysis

i. Criticism

The danger of the Privy Council’s rhetoric in *Beatty*, of course, is that the majority will be able to vote themselves unfair benefits—that NWT will pay too much for the United Empire. If the vote of the majority cannot be questioned, then that vote and the transaction it approves will stand even if Beatty caused NWT to pay too much for the boat. Declaring that the majority shareholder has a “perfect right to vote”¹¹⁵ for deals in his own favor might gut the duty of loyalty.

Beatty is a much-cited precedent, and sometimes it has been cited for this sort of overbalance toward a shareholder’s right to vote. In *Western Ontario Natural Gas Co. v. Aikens*,¹¹⁶ majority shareholders took company bonds in exchange for their shares as a step in financing a company expansion, then later presented this deal to all the shareholders for their approval, which was obtained.¹¹⁷ In response to the company’s complaint against the majority shareholders, the court quoted from *Beatty* the “perfect right to vote” language and found that there was no attempt to deceive the shareholders at the meeting.¹¹⁸

Perhaps the worst example of taking *Beatty* too far is *Whitlam v. Australian Securities and Investment Commission*.¹¹⁹ In this case, the director was given directions to vote shares by proxy and was accused of breaching that duty by failing to vote the shares at all.¹²⁰ The shares he failed to vote were sufficient to block a resolution whose claimed passage may well have occurred only because of

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *See id.* at 600.

¹¹⁴ *Id.* at 596.

¹¹⁵ *Id.* at 593.

¹¹⁶ *Western Ontario Natural Gas Co. v. Aikens*, [1946] 4 D.L.R. 647 (Can. Ont. Sup. Ct.).

¹¹⁷ *Id.* ¶¶ 13–27.

¹¹⁸ *Id.* ¶¶ 56, 59.

¹¹⁹ (2003) 57 NSWLR 559 (Austl.), available at <http://www.lawlink.nsw.gov.au/scjudgments/2003nswca.nsf/00000000000000000000000000000000/52db2c2ae9ffb98ca256d5c00024982?opendocument> (last accessed Apr. 13, 2012).

¹²⁰ *Id.* ¶ 45.

the director's failure.¹²¹ In discussing the issue, the court paid homage to the right to vote identified in *Beatty*:

Indeed, if the member directs the proxy/director to vote in a way that the director believes is not in the interests of the company, the director will generally, as the member's fiduciary, be obliged to vote in that way; and generally, this will not be in breach of the director's duties to the company. Even in voting their own shares, directors do not generally owe a duty to act in the interests of the company. In *North-West Transportation Co. Ltd v. Beatty* . . . the Privy Council found to be legitimate the narrow approval by shareholders of a contract between a director/shareholder and the company to buy a boat from him, in circumstances where most of the votes cast in favour of the resolution were those of the director/shareholder himself. The Court found that all shareholders, including a majority shareholder, are entitled to vote in the manner they wish, provided it is not unfair, improper, illegal, fraudulent or oppressive towards those shareholders opposing the resolution: see Ford, *Principles of Corporations Law*, 11th Ed. at 548. As there noted, that decision has not been departed from in Australia, although there may be circumstances in which a director/shareholder may come under a fiduciary duty to other shareholders (see *Brunninghausen v. Glavanics* (1999) 46 NSWLR 538), and there have been some statutory qualifications to the principle.

But the general principle is that directors voting their own shares can vote in their own interests, and are not bound by their duty as directors to act in the interests of the company as a whole. In our opinion, the position must be similar in relation to a director voting as proxy on the instructions of other shareholders, in the sense that the director can (and as a fiduciary should) vote as directed by those shareholders, and in doing so is not subject to a duty as director requiring that he or she vote in accordance with what he or she believes is in the best interests of the company. Thus, although there may be circumstances in which a director acting as proxy is discharging a director's duties, this is not necessarily the case.¹²²

The proposed analogy is striking: If the voting procedure itself is not unfair, the director can vote as the director wishes, just as the director as proxy may vote shares contrary to the interests of the entity and without fiduciary duties to anyone but the shareholder designating the proxy.

Under this rhetoric, the director is completely released from the duty of loyalty with respect to the substance of the vote. The director's right to vote appears to trump.

ii. Solution

The rhetoric of *Beatty* is merely that—rhetoric, it turns out.

Simply put, *Beatty*'s language just does not mean what it appears to mean. The rhetoric focuses on the director's voting rights only and fails to include the factual context of the case. That factual context severely limits *Beatty*'s reach. By focusing solely on the majority's right to bind, and describing the director's right to vote her own shares as a "perfect right," the court misleads readers into thinking it is asserting something absolute or unconditional.

In fact, the *Beatty* court resolved a very narrow issue, namely, whether an

¹²¹ *Id.* ¶¶ 18–31.

¹²² *Id.* ¶¶ 153–54.

interested director's vote in favor of a conflicted transaction violates a duty of loyalty when that transaction is fair. The trial court found the transaction in *Beatty* fair, a conclusion the Privy Council found on appeal to be "substantially admitted":

It is proved by uncontradicted evidence, and is indeed now substantially admitted, that at the date of the purchase the acquisition of another steamer . . . was essential to the efficient conduct of the company's business; that the *United Empire* was well adapted for that purpose; that it was not within the power of the company to acquire any other steamer equally well adapted for its business; and that the price agreed to be paid for the steamer was not excessive or unreasonable.¹²³

Because the transaction was fair, the question in *Beatty* was whether voting one's own interests was itself, regardless of the issue of fairness, a breach of loyalty. Putting the factual context back in shows just how little *Beatty* means: Interested directors may vote for a fair transaction without breaching the duty of loyalty.

This is not a controversial holding; it is now a widely adopted principal. Section 144 of Delaware's Interested Director statute holds flatly that a conflicted transaction is not void or voidable solely because the conflicted "director's or officer's votes are counted" in favor of the transaction if the transaction "is fair as to the corporation" when the meeting occurs.¹²⁴

*Oberly v. Kirby*¹²⁵ proves the point. Two directors of a non-profit corporation, the Kirby Foundation, also sat on the board of Alleghany Corporation.¹²⁶ Those directors voted to approve the redemption by Alleghany of Alleghany stock owned by the Kirby Foundation.¹²⁷ The redemption was challenged by the Delaware Attorney General.¹²⁸ The court, applying the same standards it applies to for-profit corporations,¹²⁹ held that the transaction was intrinsically fair, notwithstanding the conflicted votes.¹³⁰ The mere fact of the vote, therefore, was not disloyal.

The simple truth is that, in *Beatty*, the finding of fairness to the company essentially did away with the disloyalty claim. Voting for a fair transaction is not disloyal. This actually is all that the court said, despite its inflated language.

The other two cases that recite and purport to extend *Beatty*'s inflated rhetoric handle the exact same narrow issue. In *Aikens*, the court also found that the transaction itself, not just the vote, was fair,¹³¹ even though this factual issue was not relevant under any of the rules the court cited. In *Whitlam*, the court held

¹²³ *Beatty*, [1887] 12 App Cas 589, 596 (P.C.).

¹²⁴ DEL. GEN. CORP. LAW § 144(a)(1) (2012). The Delaware statute's language is widely adopted. See, e.g., D.C. CODE § 29-406.70 (2001); GA. CODE ANN. § 46-3-305 (1981); KAN. STAT. ANN. § 17-6304 (West 1972); LA. REV. STAT. ANN. § 12:84 (West 2010); MICH. COMP. LAWS ANN. § 450.2545 (2002); MO. ANN. STAT. § 351.327 (West 2001); OHIO REV. CODE ANN. § 1729.24 (West 2011); OKLA. STAT. ANN. tit. 18 § 1030 (West 2012); 15 PA. CONS. STAT. ST. § 1728 (West 2012); R.I. GEN. LAWS ANN. § 7-1.2-807 (West 1956); W. VA. CODE ANN. § 31D-8-860 (West 2012); see also TEX. BUS. ORGS. CODE § 21.418 (West 2011).

¹²⁵ 592 A.2d 445 (Del. 1991).

¹²⁶ *Id.* at 468–69.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at 466–68.

¹³⁰ *Id.* at 470–72.

¹³¹ *Western Ontario Natural Gas Co. v. Aikens*, [1946] 4 D.L.R. 647, ¶ 59–60.

that the pleadings did not raise the issue of whether the director had breached a fiduciary duty, so the recitation of the *Beatty* language in that case was entirely dicta.¹³²

A recent case, *In re Hillcrest Housing Ltd.*,¹³³ gets this same point, but the factual context is clear. The court explicitly addressed the narrow question of “whether directors are allowed to vote on a contract in which they have an interest.”¹³⁴ The court made it clear that whether voting on a conflicted transaction was disloyal would depend on the facts.¹³⁵ If disclosure was inadequate, the court implied that the mere act of voting might be disloyal.¹³⁶ That is how the court interpreted *Beatty*’s prohibition against a fraudulent vote,¹³⁷ but clearly hoodwinking shareholders into voting for a transaction in which a director is interested would be unfair in itself, and it would suggest that the transaction, which the director wanted to hide, was also unfair. In other words, the issue is the fairness of the transaction. If the transaction is fair, the majority shareholder is allowed to vote for it.

Conversely, if the transaction is not fair, the majority shareholder and director should have no rights. This is confirmed in the cases, too. When the factual context has changed, and there is no finding that the transaction is fair, courts quickly jettison *Beatty*. The now-aged case of *Cook v. Deeks*¹³⁸ is a good example. In *Cook*, as the more-recent *Brandley v. Hinman*¹³⁹ accurately reports, “[T]wo of three directors of a company negotiated for themselves a contract with another company which they had a duty to obtain for their company. They then used their controlling votes at a shareholders’ meeting to pass a resolution that the company had no interest in the contract.”¹⁴⁰ In holding that the directors breached their duty of loyalty, the court reasoned,

If, as their Lordships find on the facts, the contract in question was entered into under such circumstances that the directors could not retain the benefit of it for themselves, then it belonged in equity to the company, and ought to have been dealt with as an asset of the company. Even supposing it be not ultra vires of a company to make a present to its directors, it appears quite certain that directors holding a majority of votes would not be permitted to make a present to themselves. This would be to allow a majority to oppress the minority. To such circumstances the cases of *North-Western Transportation Co. v. Beatty* [and the like] . . . have no application.¹⁴¹

In other words, the issue is loyalty. Only when loyalty is not at issue may courts trumpet voting rights. No one has a right to be disloyal.

The *Beatty* case can be analogized to a line of Delaware cases (called

¹³² Whitlam v Australian Sec. & Invs. (2003) 199 ALR 674, ¶ 162–65.

¹³³ Hillcrest Housing Ltd. (1998) 165 Nfld. & P.E.I.R. 181.

¹³⁴ *Id.* ¶ 316.

¹³⁵ *Id.* ¶ 316–17.

¹³⁶ *Id.* ¶ 317.

¹³⁷ *Id.* ¶ 321.

¹³⁸ *Cooks v. Deeks*, [1916] 1 A.C. 554 (P.C.) (Ont.).

¹³⁹ *Brandley v. Hinman* (1993), 143 A.R. 81 (Can. Alta. Q.B.).

¹⁴⁰ 143 A.R. 81 ¶ 101.

¹⁴¹ 1 A.C. 554 ¶ 25.

informally the *Solomon* line) in which the courts have been more careful with their rhetoric. Consider the way the *Solomon*-line rule is phrased: “[A] controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock.”¹⁴² Here, too, as in *Beatty*, the court appears to have announced a right, as if one could be free from an obligation to be loyal. In the *Solomon* line of cases, loyalty is the issue, just as in *Beatty*. But in the court’s phrasing of the rule in the *Solomon* line, unlike in *Beatty*, the implicit conditional is made explicit. No doubt an exchange offer accompanied by trickery or coercion would be disloyal. But if there is no trickery and no coercion, so that minority shareholders are able to make what is probably as close to a market decision as could be made in this instance, then merely offering an exchange is not disloyal. And no doubt a vote for an interested transaction when the transaction is unfair is disloyal, but if there is no unfairness in the transaction because the transaction serves a corporate need, the board is informed in all material respects, and the price is fair, then voting for the exchange is not disloyal. *Beatty*’s perfect right to vote is just a contingent right, imperfectly expressed.

IV. THORPE V. CERBCO, INC. (DEL. 1996)¹⁴³

A. *The Case*

I confess to being a bit surprised by this case. I did not expect a rhetorical slip from this court on such a central issue. Nevertheless, I believe that is what *Thorpe* is.

“George and Robert Erikson were directors, officers, and controlling shareholders of CERBCO.”¹⁴⁴ The Eriksons owned 24.6% of CERBCO’s total equity, 56% of CERBCO’s total votes, and enough Class B shares to elect 75% of CERBCO’s board.¹⁴⁵ The Eriksons were in fact two of CERBCO’s four directors.¹⁴⁶ CERBCO was “a holding company with voting control of three subsidiaries.”¹⁴⁷

This case involved the business of one of these three subsidiaries, Insituform East, Inc. (“East”).¹⁴⁸ East’s business exploited technology obtained (licensed) from Insituform of North America, Inc. (“INA”) that allowed East to repair pipes without removing them.¹⁴⁹ In the fall of 1989, INA considered purchasing one of

¹⁴² *In re* Ocean Drilling & Exploration Co. S’holders Litig., CIV A. No. 11898, 1991 WL 70028, *334 (Del. Ch. Apr. 30, 1991); *see also* *Solomon v. Pathe Commc’ns Corp.*, 672 A.2d 35 (Del. 1996); *In re* Pure Res., Inc., S’holders Litig., 808 A.2d 421 (Del Ch. 2002); *In re* Siliconix Inc. S’holders Litig., No. CIV A. No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

¹⁴³ *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996).

¹⁴⁴ *Id.* at 437.

¹⁴⁵ *Id.* at 438.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

its licensees.¹⁵⁰ INA analyzed (in part through its investment banker, Drexel, Burnham) public information about East and prepared to make an offer.¹⁵¹ It arranged financing for an offer.¹⁵² INA's chairman, planner, and negotiator Krugman wrongly assumed, however, that East had a single class of shares.¹⁵³ East, like CERBCO itself, had a dual class and was controlled by CERBCO in much the same way the Eriksons controlled CERBCO itself, mostly through ownership of its Class B shares.¹⁵⁴

INA met with the Eriksons to discuss the acquisition.¹⁵⁵ Not knowing East's capital structure, or CERBCO's, presumably INA met with the Eriksons because they were directors of CERBCO.¹⁵⁶ In the meeting, the Eriksons proposed that INA, rather than buy East, instead purchase the Eriksons' interest in CERBCO.¹⁵⁷ The Eriksons led INA to believe that they would block a sale of East to INA.¹⁵⁸ With this new information, INA considered buying (1) all of CERBCO's interest in East or (2) most (and a controlling number) of the Eriksons' CERBCO Class B shares.¹⁵⁹

The Eriksons did not inform CERBCO's two outside directors of INA's interest.¹⁶⁰ Instead, they told them INA was interested in buying the Eriksons' shares of CERBCO.¹⁶¹ One of the two, Davies, suggested instead "that CERBCO sell East to INA, but Robert Erikson rejected this idea."¹⁶² Davies later asked in a CERBCO board meeting if "INA had ever been interested in buying East."¹⁶³ The Eriksons responded that INA had never made an offer and that, had INA done so, the Eriksons would have vetoed it.¹⁶⁴

The CERBCO board gave INA access to CERBCO's books and records, and consented to the Eriksons' use of CERBCO's lawyer as their personal counsel in negotiations with INA.¹⁶⁵ In March of 1990, the Eriksons and INA signed a letter of intent in which INA agreed to buy for \$6 million the Eriksons' controlling share of CERBCO. Thorpe, a CERBCO shareholder, made a demand in May that CERBCO sue the Eriksons over this.¹⁶⁶ Thorpe filed suit in August, alleging that

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² Thorpe v. CERBCO, Inc., CIV A. No. 11713, 1995 WL 478954, *3 (Del. Ch. Aug. 9, 1995), *aff'd in part, rev'd in part*, 676 A.2d 436 (Del. 1996).

¹⁵³ *Id.*

¹⁵⁴ See 676 A.2d at 438.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ See *id.* The text of the opinion has this in passive voice: INA "was led to believe." *Id.* But the Eriksons were the only persons named at the meeting from the CERBCO side. *Id.*

¹⁵⁹ *Id.* The court mentioned a third alternative but later affirmed that it was not a truly viable option. *Id.* at 438, 443.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 437, 439.

the Eriksons had breached their duty of loyalty.¹⁶⁷ Negotiations between INA and the Eriksons never led to a sale, however, and the letter of intent expired in September.¹⁶⁸ Apparently, one of the sticking points was indemnification for litigation costs, including for defense against Thorpe's claims and a pending SEC suit.¹⁶⁹

The Chancellor upheld Thorpe's corporate opportunity claim against motions to dismiss and for summary judgment.¹⁷⁰ At trial, the court found that the Eriksons breached their duty of loyalty by failing to inform the CERBCO board of INA's interest in East and by negotiating with INA in their own behalf.¹⁷¹ Nonetheless, the Chancellor awarded no damages because "the defendants['] actions were wholly fair. . . . First, no sale had occurred and therefore damages were speculative."¹⁷² Second,

§ 271 confers upon the Eriksons the right to veto any corporate change constituting the sale of substantially all of the corporation's assets. Under the facts of this case, any alternative transaction conceivably undertaken by CERBCO would implicate the provisions of § 271 and therefore be subject to disapproval by the Eriksons. [Therefore,] . . . the Eriksons could not be penalized for their breach¹⁷³

The Delaware Supreme Court framed its review of the Chancellor's decision by positing a conflict between controlling shareholders' "right to sell their shares" and their duty of loyalty.¹⁷⁴ Initially, the court seemed to give loyalty its due:

The shareholder vote provided by § 271 does not supersede the duty of loyalty owed by control persons, just as the statutory power to merge does not allow oppressive conduct in the effectuation of a merger. Rather, this statutorily conferred power must be exercised within the constraints of the duty of loyalty.¹⁷⁵

So the court affirmed the finding that the Eriksons were disloyal.¹⁷⁶ They should have told CERBCO of INA's interest, the court said, after which the Eriksons would have been free to compete with CERBCO for it.¹⁷⁷ Their failure to disclose was a disloyal omission.

That conclusion sounds as if a remedy is warranted, but not so fast, the court said. After finding a breach, the trial court had examined the transaction for fairness, but this court said instead that the corporate opportunity doctrine was a better analytical tool.¹⁷⁸ The court then explained that the corporate opportunity

¹⁶⁷ *Id.* at 440.

¹⁶⁸ *Id.* at 439.

¹⁶⁹ *Id.* at 439–40.

¹⁷⁰ *Id.* at 440–41.

¹⁷¹ *Id.* at 441.

¹⁷² *Id.*

¹⁷³ *Id.* at 441–42.

¹⁷⁴ *Id.* at 442.

¹⁷⁵ *Id.* (citing *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987)).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* at 443. In footnotes, the court explained that the fairness doctrine is something of a surrogate for measuring the value victim shareholders receive when the transaction was not disciplined by the market. *Id.* at 443 n. 8–9. Here, because the minority was not even offered a price and the

doctrine prohibits a director or officer from seizing an opportunity in which the corporation has an interest or reasonable expectancy.¹⁷⁹ The law prohibits this, the court said, because “the self-interest of the officer or director will be brought into conflict with that of his corporation.”¹⁸⁰ Here, “it is clear that the opportunity was one in which the corporation had an interest.”¹⁸¹

You might think, again, that would end the issue. After all, the Eriksons clearly tried to seize the opportunity. The interests of the Eriksons and the corporation clashed, and they chose themselves over the corporation. But here the court makes the analytical move that causes this opinion to be of interest:

Despite this fact, CERBCO would never be able to undertake the opportunity to sell its East shares. Every economically viable CERBCO sale of stock could have been blocked by the Eriksons under § 271. Since the corporation was not able to take advantage of the opportunity, the transaction was not one which, considering all of the relevant facts, fairly belonged to the corporation.¹⁸²

After affirming that CERBCO’s sale of the East stock would indeed have been the sale of all or substantially all of its assets, the court also reasoned, alternately,

Because the alternative transaction would have been covered by § 271, the Eriksons had the statutory right as shareholders to veto this transaction. Given their power, the Eriksons would obviously never allow CERBCO to enter a transaction against their economic interests. Damages cannot be awarded on the basis of a transaction that has a zero probability of occurring due to the lawful exercise of statutory rights.

. . . . Section 271 must . . . be given independent legal significance apart from the duty of loyalty. . . . [T]he Eriksons’ § 271 rights are ultimately responsible for the non-consummation of the transaction. Even if the Eriksons had behaved faithfully to their duties to CERBCO, they still could have rightfully vetoed a sale of substantially all of CERBCO’s assets under § 271. Thus, the § 271 rights, not the breach, were the proximate cause of the nonconsummation of the transaction. Accordingly, transactional damages are inappropriate.¹⁸³

This language appears to shrink in obvious ways the duty of loyalty as against the right of shareholders to vote for a sale of all or substantially all of the corporation’s assets. The foundation of the corporate opportunity doctrine is loyalty,¹⁸⁴ so if what would otherwise be a corporate opportunity is not one solely

Eriksons had no incentive to do anything but encourage INA to pay more, the fairness test was inapplicable, the court said. *Id.*

¹⁷⁹ *Id.* at 443.

¹⁸⁰ *Id.* (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939)).

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.* at 444.

¹⁸⁴ *See Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 964 (Del. 1980) (“[T]he law of corporate opportunity sets the parameters of permissible employee conduct consistent with an employee’s fiduciary duties to his employers of loyalty and fair dealing”); *Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939) (“The question is not one to be decided on narrow or technical grounds, but upon broad considerations of corporate duty and loyalty.”); *id.* at 511-13 (repeatedly examining the transaction at issue to determine the good faith (which is part of loyalty) of the defendant); *id.* at 515 (refuting an argument that the defendant had no duty and was therefore not disloyal); *Pfeiffer v. Toll*, 989 A.2d 683, 695 & n.10 (Del. Ch. 2010) (“*Guth v. Loft* remains the seminal Delaware decision

because the interested director could vote against it in her own self-interest under § 271, then the right trumps the duty. Worse yet is the idea that no harm is recognized under the duty of loyalty from blocking for self-interested reasons the corporation's taking advantage of a transaction. If one can do no disloyal harm by exercising one's right to vote, then the right trumps the duty.

Worst of all is that offensive sentence regarding § 271's independent legal significance. The doctrine of independent legal significance is a doctrine of statutory interpretation. In the context of rival statutory rights, it means that "action taken under one section of that law is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means."¹⁸⁵ The clear suggestion of the court is that actions taken under § 271 are "not dependent upon, nor to be tested by the requirements of" the duty of loyalty. Congratulations, Delaware fiduciaries! You are free to cheat so long as you can get what you want through your voting rights under a sale of all or substantially all assets.

In the end, the court imposed a damage award for the Eriksons' breach of loyalty nonetheless, for the \$75,000 the Eriksons received from INA for the letter of intent and for costs the corporation incurred "to accommodate the Eriksons' pursuit of their own interests prior to the deal being abandoned."¹⁸⁶ But the potential damage to doctrine was already done.

B. Analysis

i. Criticism

The *Thorpe* opinion can be criticized on several grounds.

First of all, the *Thorpe* opinion is internally inconsistent. The court said that the opportunity to sell East to INA was "one in which the corporation had an interest," but on the same page the court concluded that "the transaction was not one which . . . fairly belonged to the corporation."¹⁸⁷ On the one hand, the court said that "[t]he shareholder vote provided by § 271 does not supersede the duty of loyalty . . . [but] must be exercised within the constraints of the duty of loyalty."¹⁸⁸ On the other hand, the court said, "Section 271 must . . . be given independent legal significance apart from the duty of loyalty."¹⁸⁹ These are just contradictions.

The analysis also contains this kind of thinking. The court said that § 271 "must be exercised within the constraints of the duty of loyalty" and then gave no explanation for how the Eriksons' actions were so constrained.¹⁹⁰ Instead, the court talked as if the Eriksons' rights made a breach of loyalty with respect to the

addressing the duty of loyalty.") (listing numerous authorities tracing disloyalty in Delaware jurisprudence to *Guth*).

¹⁸⁵ *Orzeck v. Englehart*, 195 A.2d 375, 378 (Del. 1963).

¹⁸⁶ 676 A.2d at 445.

¹⁸⁷ *Id.* at 443.

¹⁸⁸ *Id.* at 442.

¹⁸⁹ *Id.* at 444.

¹⁹⁰ *Id.*

INA opportunity impossible.¹⁹¹ Seizing a corporate opportunity is a breach of loyalty, so the court's conclusion that § 271 makes what would otherwise be a corporate opportunity fair game flies in the face of the court's rhetoric about § 271 being subject to loyalty.

Nor does the court's assertion that the Eriksons should have told CERBCO about the INA offer¹⁹² make sense when juxtaposed with the court's later exoneration of the Eriksons because such a deal had "zero probability of occurring due to the lawful exercise of statutory rights."¹⁹³ According to the court's analysis, the Eriksons breached their duty of loyalty by failing to make a futile gesture. It hardly makes sense to chasten the Eriksons for not letting CERBCO compete with them if there was "zero probability" of CERBCO reaching a deal. Perhaps the court means to suggest that the likelihood of an INA deal changed over time, but if that is true, then at the time of the breach there was some probability of a deal occurring. However, if there was some probability at the time of the breach, then damages for taking it away should not be zero. That the probability later became zero is beside the point. So if the reasoning on liability is sensible, the reasoning on damages is not, or if the court's reasoning on damages makes sense, it's reasoning on liability does not.

The court's assertions about the role of the Eriksons' blocking power are made doubly odd by Chancellor Allen's decision that a trial was necessary to decide whether CERBCO's sale of control of East would be a sale of substantially all of CERBCO's assets that the Eriksons would have a right to vote against and thereby block. If the Chancellor of Delaware did not know before trial whether the Eriksons had a right to block such a sale, how could the Eriksons have known, asserted, and relied on such a right? And if they could not, then how does that right exculpate them after the fact for failure to disclose? In fact, the Eriksons acted disloyally but were later represented well by a lawyer who persuaded the court, after the fact, to find that the Eriksons were privileged to act as they did even though they could not have known it at the time. They were legally lucky, and that's all. That does not speak well for the court's analysis.

It's all a bit baffling, as the court explains it. Both courts seem to go to great lengths to split the Eriksons' conduct by hairs in order to exculpate them. It was wrong not to tell the CERBCO board about INA's interest, both courts agree. But neither court does more than mention in the facts that, when CERBCO director Davies inquired of the Eriksons "whether INA has proposed a bid to CERBCO for either CERBCO's Class B shares of East or all of the East shares owned by CERBCO,"¹⁹⁴ the Eriksons deliberately omitted the full story. Recall that INA initially approached the Eriksons with a proposal to do just that; that is how the deal was initially suggested to the Eriksons.¹⁹⁵ It would hardly make sense to hold

¹⁹¹ *Id.*

¹⁹² *Id.* at 442.

¹⁹³ *Id.* at 444.

¹⁹⁴ Thorpe v. CERBCO, Inc., CIV A. No. 11713, 1995 WL 478954, *5 (Del. Ch. Aug. 9, 1995), *aff'd in part, rev'd in part*, 676 A.2d 436 (Del. 1996).

¹⁹⁵ *Id.* at *3. INA believed that buying control of East was as simple as buying East's shares from CERBCO. It had Drexel, Burnham, Lambert & Co. analyze two possible acquisition scenarios, one in which INA bought 51% of East's single class of common stock, and one in which it bought 100% of

that the Eriksons had breached a duty of loyalty if that had not been the case. And yet the Eriksons replied to Davies that “INA had not and that INA was only interested in the Eriksons’ Class B CERBCO stock.”¹⁹⁶ This was at best a half-truth. To a fellow fiduciary, it was constructive fraud. This was not to abuse corporate processes in favor of their own transaction? Yet neither court so notes.

Logical oddities are apparent even in the macro sense in the Supreme Court’s opinion. A failure to disclose is a kind of disloyalty. Taking a corporate opportunity is another kind of disloyalty. Essentially, the Supreme Court here said that one kind of disloyalty would not be remedied with a transactional remedy because the defendants were not guilty of another kind of disloyalty. That’s not a coherent approach.

Chancellor Allen’s rhetorical strategy was, in contrast, logically unobjectionable: opine that a breach occurred but that transaction or rescissory damages were not warranted because the result was fair.¹⁹⁷ But Chancellor Allen also privileged the section 271 voting rights of the Eriksons while limiting the description of the Eriksons’ fiduciary duty as a controlling shareholder in order to find them in breach of loyalty but also find that they were privileged to vote against an INA transaction. Here is the limitation on the Eriksons’ fiduciary duty: “Even a large or controlling shareholder has a privilege to sell her stock for the best price available, at least where she does not utilize corporate processes or property to facilitate such sale.”¹⁹⁸ The Supreme Court made a similar move when it explained, near the end of its opinion on appeal: “While the Eriksons did have a duty to present that opportunity to CERBCO, they had no responsibility to ensure that a transaction was consummated.”¹⁹⁹ Neither explains how the Eriksons’ abuse of their directorial powers did not utilize corporate processes. There is a duty of loyalty, apparently, but if you are a stockholder, then at certain times you can just ignore it.

It also seems odd that a court famous for considering the possibility that people might always pay more for stock²⁰⁰ seems not to have considered that INA might actually pay enough for CERBCO’s East shares that the Eriksons would change their minds. No vote was ever taken and CERBCO was prevented by the Eriksons’ disloyalty even from bargaining. For the court’s argument from section

East’s shares. INA also arranged a \$10 million line of credit from a bank to finance an acquisition. So, with money already spent for analysis and financing arranged, INA appeared ready to proceed when its Chairman Krugman initially met with the Eriksons. *Id.* The Delaware Supreme Court put it more bluntly: “Krugman met with the Eriksons to discuss the possibility of INA’s acquiring East.” 676 A.2d at 438.

¹⁹⁶ 1995 WL 478954 at *5.

¹⁹⁷ *Id.* It is true, as the court noted, that “no price was ever received and the procedure amounted to a breach of the duty of loyalty,” 676 A.2d at 443, and as a result the entire fairness analysis was “enigmatic,” *id.*, but breach and fairness are two different concepts. Going one way with one and the other way with the other is not inconsistent. Saying that loyalty will be analyzed under the rubric of a disclosure obligation and under an opportunity doctrine to reach different results makes loyalty incomprehensible.

¹⁹⁸ 1995 WL 478954 at *7.

¹⁹⁹ 676 A.2d at 444.

²⁰⁰ *See, e.g.,* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1383 (Del. 1995) (rejecting a Chancery finding that an increase in director ownership would make a proxy contest less likely to succeed, with the recognition that directors as shareholders would themselves switch sides if they were offered enough money for their shares).

271 to hold water, then, it must work against any and all possible sales of substantially all of CERBCO's East shares. Otherwise, the argument could not be used a priori of any actual deal.²⁰¹ Yet it seems obvious that facts could exist that would press the conflict between loyalty and section 271 voting rights to an extreme and at some point make even a vote under section 271 an act of disloyalty in fact. Rejecting an offer of \$30,000,000 for East's shares in order to pressure INA to make a \$6,000,000 offer for the Eriksons' shares of CERBCO would just be bad faith. The Eriksons would make far more money with the \$30,000,000 offer, so factually its rejection in favor of an offer of far less for themselves alone would mean ill-will. Despite *Thorpe*'s rhetoric, I doubt the court would approve such a move. The court was right when it said that "the shareholder vote provided by § 271 does not supersede the duty of loyalty owed by control persons."²⁰² Section 271 does not really have independent legal significance.

The result of these rhetorical gymnastics is inconsistency. For failing to report to CERBCO a transaction that the court finds could not possibly have happened and the terms of which were completely unknown but that the Eriksons were completely justified in blocking but could not have known so at the time, the Supreme Court refused to require the Eriksons to pay CERBCO more than damages of \$75,000 plus reimbursement of certain other costs CERBCO incurred in connection with the negotiations between INA and the Eriksons.²⁰³

ii. Injustice?

Initially, I suspected the Delaware courts had allowed an injustice to be done to CERBCO's shareholders. After all, why engage in such arguments unless you have something to hide? But I do not think so now. I believe the opinion was just not well-considered.

First, fiduciary duties are a blunt instrument to handle a transaction that did not occur, because the remedies normally available do not address the corporate actor's bad acts or the harm done. Consider injunctive relief. Now that litigation has concluded and everything is out in the open, CERBCO is well aware of the corporate opportunity, and INA can do any deal it wants with CERBCO. There is no danger of the Eriksons hiding information now that it is all out in the open. There is no reason to think the Eriksons and INA are hiding a possible transaction in the background. Injunctive relief is therefore inappropriate.

How about a damage award? A constructive trust? Beyond the few benefits the Eriksons took during negotiations, I do not see any available measure of damages. Section 271 was not the only ground for the ruling. Chancellor Allen held that the damages sought by the plaintiffs were speculative.²⁰⁴ The plaintiffs proposed \$5.7 million in damages.²⁰⁵ This is the amount, plaintiffs claimed, of

²⁰¹ The *Thorpe* court examined the one other transaction it considered a "serious alternative." 676 A.2d at 443.

²⁰² *Id.* at 442.

²⁰³ *Id.* at 445.

²⁰⁴ *Thorpe v. CERBCO, Inc.*, No. 11713, 1995 WL 478954, at *10 (Del. Ch. 1995), *aff'd in part, rev'd in part*, *Thorpe*, 676 A.2d 436.

²⁰⁵ *Id.* at *6.

“the premium over market that the Eriksons would have realized in the possible sale of their CERBCO Class B Stock” and was, thus, “the amount *over the market price of CERBCO’s East common stock that INA would have been willing to pay CERBCO* for its East stock.”²⁰⁶ As Chancellor Allen noted, the leap from what the Eriksons would have received over market to what CERBCO would have received over market depends on assumptions, including that INA would have been willing to pay the same premium no matter what method of obtaining control it employed, and that CERBCO’s existing control over East (since CERBCO still owns it) need not be considered.²⁰⁷ But in the end the Chancellor found that “there is no testimony from which I am able to conclude that *any offer that INA might have made to CERBCO is better or worse than an offer that might be had now or in the future.*”²⁰⁸ A damage award would have been entirely speculative: “irrational,” Allen called it.²⁰⁹

This is apparent. If INA wanted to buy East from CERBCO, it certainly could have approached CERBCO at any moment and purchased it. This was still true even after its deal with the Eriksons fell apart. Nothing now prevents INA from making an offer to CERBCO. Nothing prevents INA from making an offer that not even the Eriksons could refuse. In other words, the opportunity still exists, now as much as it did earlier. So damages for lost opportunity would not be appropriate.

In fact, with the speculative nature of the plaintiff’s evidence in mind, one can, looking back on the *Thorpe* facts, construct an alternate rationale that fully justifies even the court’s use of section 271 as a ground for denying the plaintiff’s transactional damages, though it requires one more finding. One must engage in a kind of thought experiment, and progress backward in time from conditions following final judgment in the case. As the Chancellor noted, CERBCO still owns East. INA could still buy it. Of course, at this point after judgment, the material facts all being out in the open (this is the extra finding), the Eriksons could no longer be faulted for non-disclosure. If they withdrew from activity and played no role in the negotiations at all, so that a deal when reached was solely the result of a negotiation at arm’s length between INA and CERBCO, could the Eriksons veto it? I think it clear that they could. In that case, they are acting *fairly*. That is the key. It is not that they are acting solely in their right as stockholders, as if directors could cease being directors when they want to act as stockholders. Rather, they are at this point treating CERBCO fairly; their conduct is unimpeachable notwithstanding the conflict.²¹⁰

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.* at *10 (emphasis added).

²⁰⁹ *Id.*

²¹⁰ In that case, the Eriksons’ conduct would be like that of Curtiss-Wright in *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987). Curtiss-Wright Corporation, following a buying program lasting over a decade, owned 65% of Dorr-Oliver Incorporated. *Id.* at 842. It determined to merge with Dorr-Oliver, and the Dorr-Oliver board, after considering the proposal, voted for it. *Id.* at 84243. The Dorr-Oliver board was not independent of Curtiss-Wright; four or five of the seven-member board were Curtiss-Wright-affiliated. *Id.* at 843 n.4. After the merger was completed, a former Dorr-Oliver shareholder sued Curtiss-Wright, claiming that the majority shareholder, once it determined that Dorr-Oliver would be merged, should have staged an auction for the company under *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986). *Bershad*, 535 A.2d at 841–42. The court

But if we can construct such a hypothetical, we can also re-imagine the holding in *Thorpe*. Essentially, the reimagined holding is this (and this is a long sentence, so please read it carefully): Based on the evidence presented to the court about the parties' interests and bargaining positions, then even assuming (i) all the material facts were known to CERBCO's board, (ii) INA was interested in buying East from CERBCO, and (iii) INA made a play for East that resulted in a transaction that was presented to CERBCO's shareholders for a vote, the evidence does not support a finding that the Eriksons' veto of that deal would have been unfair. There may be some deal the veto under section 271 of which would have been unfair, but not one within the possibilities presented by the evidence in this case.

In other words, the shareholders of CERBCO were treated fairly, as Chancellor Allen in the end concluded. I believe they were, and this would have been the way to say it logically and plausibly, without setting up impossible contradictions in the law. So the result in *Thorpe* is not wrong, though much of its rhetoric is.

iii. Afterward

For what it is worth, later courts, and particularly the Delaware Chancery, appear to have recognized *Thorpe* for the troubled piece of writing that it is, though re-writing the *Thorpe* precedent through subsequent decisions is a rather inefficient method of judicial change.

First of all, the later Chancery Court was not so hesitant to condemn the Eriksons' conduct:

Thorpe involved a bidder who approached the management of Insituform East, Inc. desirous to purchase the company. In bad faith, management withheld this information from the outside directors, lied by saying that the bidder had not expressed interest in purchasing the company, threatened to block any sale of the entire company, and simply informed the board a bidder wished to buy the inside directors' controlling interest.²¹¹

Second, the courts have dropped some of the odd dichotomies. A federal court in Illinois recited that the Eriksons "breached their duty of loyalty to the corporation by usurping a corporate opportunity."²¹² No mincing between having

rejected this argument, citing the majority shareholders' right to

vote their shares in their own interest. They are limited only by any fiduciary duty owed to other stockholders. It is not objectionable that their motives may be for personal profit, or determined by whim or caprice, so long as they violate no duty owed other shareholders. Clearly, a stockholder is under no duty to sell its holdings in a corporation, even if it is a majority shareholder, merely because the sale would profit the minority.

Id. at 845 (citations omitted). The court found that Dorr-Oliver was "not for sale" because Curtiss-Wright had no interest in selling it; therefore, an auction would have been futile. *Id.* The court required Curtiss-Wright to act with fairness in the merger, however. *Id.* at 845-48. The court determined that Bershad had been treated fairly and dismissed Bershad's claims but remanded for disposition of the fairness claim with respect to other potential members of a plaintiff class. *Id.*

²¹¹ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 974 (Del.Ch. 2003).

²¹² *Christman v. Brauvn Realty Advisors, Inc.*, 80 F.Supp.2d 808, 814 (N.D.Ill. 1999).

an interest in the opportunity and whether it “fairly belonged” to the corporation.

The Delaware Chancellor similarly cut through the thicket of criss-crossed signals when deciding *In re Digex Inc. Shareholders Litigation*.²¹³ There, WorldCom was interested in buying Digex, Inc., but at the last moment transferred its interest to Digex’s parent corporation, Intermedia.²¹⁴ The Chancellor declared *Thorpe* instructive and announced that it would “guide this Court in determining whether the defendants have breached a duty of loyalty owed to the plaintiffs.”²¹⁵ Then the Chancellor recited all the Eriksons’ lack of candor. In noting how section 271 did not stand in the way of liability for the majority shareholder in *In re Digex*, the court judiciously quoted all of the language from *Thorpe* about how section 271 is subordinate to the duty of loyalty.²¹⁶ The court said nothing of section 271’s supposed independent legal significance, nothing about the absolute rights of shareholders to vote their own interests, and nothing about who owned the corporate opportunity.²¹⁷ It seems a somewhat convenient lapse of memory, but perhaps some things are better forgotten.

In another case, the Delaware Chancery turned *Thorpe* into an endorsement of damages for disloyal conduct, despite Delaware’s efforts to find reasons not to impose them on the Eriksons. In *In re Primedia, Inc. Derivative Litigation*,²¹⁸ shareholders alleged that “the controlling stockholder, through an investment vehicle that it managed and held an equity interest in, purchased large amounts of the corporation’s outstanding preferred stock at substantial discounts to par value.”²¹⁹ Then, by exerting influence over the corporation’s board, the stockholder caused the corporation to “call the preferred stock at its full redemption price years before the corporation was contractually obligated to do so.”²²⁰ In this, the controlling stockholder profited greatly to the exclusion of other common shareholders.

After determining that the plaintiff’s complaint adequately alleged a breach of the duty of loyalty, the court asked whether the complaint adequately alleged an injury to the corporation. In answering “yes,” the court relied on *Thorpe*’s wisdom as to damages for breach of loyalty:

If the plaintiffs ultimately prove such a breach of the duty of loyalty, this court should not unduly narrow the scope of their recovery. Even in a case where transactional damages are not present, a disloyal fiduciary may still be held liable for incidental damages. Concerns of equity and deterrence justify “loosen[ing] normally stringent requirements of causation and damages” when a breach of the

²¹³ 789 A.2d 1176 (Del.Ch. 2000).

²¹⁴ *Id.*

²¹⁵ *Id.* at 1192 (“As to this second theory, *Thorpe v. CERBCO* again is instructive. . . . The CERBCO Court found the Eriksons had breached their duty of loyalty to CERBCO. How the CERBCO Court reached that conclusion will guide this Court in determining whether the defendants have breached a duty of loyalty owed to the plaintiffs.”).

²¹⁶ *Id.* at 1192–93.

²¹⁷ *Id.*

²¹⁸ 910 A.2d 248 (Del. Ch. 2006).

²¹⁹ *Id.* at 250.

²²⁰ *Id.*

duty of loyalty is shown.²²¹

So, in the Chancery court's rhetoric, *Thorpe* no longer means hesitancy in imposing damages for breach of loyalty; *Thorpe* means "full speed ahead."

Finally, when the right of owners to trump the duty of loyalty was argued, the Chancery fled from *Thorpe*, distinguishing it as the harmless decision it should have been. *Auriga Capital Corp. v. Gatz Properties, LLC*²²² involved a power struggle between a LLC's majority owner and minority interests. The Gatz family owned farm property on Long Island that they wished to develop as a golf course.²²³ William Gatz approached Auriga Capital and others, and Auriga agreed to obtain financing and assist with construction.²²⁴ The parties formed a limited liability company, Peconic Bay, LLC ("Peconic"), to take a lease from the Gatzes, sublease the property to a golf course operator, and handle the resulting cash rent and other proceeds that would flow back to the investors and the lessors, the Gatzes.²²⁵ The Gatzes took a high percentage ownership in Peconic; they later purchased other owners' interests that gave the Gatz family veto rights to fundamental transactions such as subleasing the course long-term or selling Peconic.²²⁶

The course was constructed and subleased initially to American Golf Corporation.²²⁷ High expectations in the course's profitability did not materialize.²²⁸ Long before the sublease ended, William Gatz began to speculate that the course property might be worth more as a residential community than as a golf course. So rather than find a new operator or sell the course to someone who would maximize its value as a golf course, Gatz "did not search for a replacement management corporation, explore whether the LLC itself could manage the golf course profitably, or undertake to search for a buyer for the LLC."²²⁹ Instead, he tried to obstruct any movement that might allow the minority interests to profit from their investment; Gatz turned away potential buyers and conducted a sham auction in which the only real bid—a very low bid—came from the Gatz family interests.²³⁰ William Gatz tried to construct a circumstance in which the minority interests would be forced to sell out to the Gatz family at a low price.

Gatz's defense for this disloyal conduct was *Thorpe*-ish: "The manager's defense [was] that his voting power gave him a license to exploit the minority"²³¹ Or, as Gatz put it in his post-trial motion,

²²¹ *Id.* at 262 (quoting *Thorpe* 676 A.2d 436, 445 (Del. 1996)).

²²² 40 A.3d 839 (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

²²³ *Id.* at 844–45.

²²⁴ *Id.* at 45.

²²⁵ *Id.* at 845–47.

²²⁶ *Id.* at 846.

²²⁷ *Id.* at 847.

²²⁸ *Id.* at 859–60.

²²⁹ *Id.* at 842; *see also id.* at 860–62.

²³⁰ *Id.* at 860–75.

²³¹ *Id.* at 844; *see also id.* at 843 ("The first is that the manager and his family were able to veto any option for the LLC as their right as members. As a result, they could properly use a chokehold over the LLC to pursue their own interests and the minority would have to live with the consequences of their freedom of action.").

It is black letter law that Gatz Properties had no obligation to vote in favor of a new operator or operating the course itself. Gatz Properties had majority voting control, a right which was bargained for . . . and . . . [of] which all minority members were aware. . . . Controlling shareholders, while not allowed to use their control . . . to exploit the minority, are not required to act altruistically towards them. Gatz Properties, therefore, had the right to veto any transaction by a third party, a right which all parties knew about.²³²

Notwithstanding the clear invitation to make something of *Thorpe*'s twisted language, Chancellor Strine declined. His treatment of *Thorpe* in response to Gatz's argument attempts to put the case's rhetorical discrepancies in the past. Strine used *Thorpe* against Gatz: "Gatz, of course, had no duty to sell his interests. But the fact that he was not a seller does not mean that he had a free license to mismanage Peconic Bay so as to deliver it to himself at an unfair price."²³³ In other words, what the Chancery recognized of *Thorpe* is the good side of it, the side that gives loyalty its due. This is good news. While *Thorpe* survives on its facts and one side of its logic lives on, *Auriga Capital Corp.* gives hope that *Thorpe*'s contradictions and other troublesome rhetoric can someday be safely forgotten. I commend Chancellor Strine's treatment of the case. May all such attempts at claiming the duty of loyalty has been trumped be forgotten by later courts, and may no court attempt it again.

V. CONCLUSION

As this paper demonstrates, attempts to explain away disloyalty by claiming that otherwise disloyal fiduciaries were acting pursuant to a right that trumps loyalty are deeply flawed.

Where the argument is found, various kinds of faulty reasoning attend it. Most obviously, trumping arguments risk inconsistency. It is difficult to pay homage to loyalty, on the one hand, a move that comes in handy next time a court has to require damages of a cheating fiduciary, and on the other hand justify disregarding loyalty on the basis of a supposed right the fiduciary and others like it have always had. *Covalt*, *Beatty*, and *Thorpe* as opinions all suffer from this serious defect.

The rationale of trumping is conceptually antithetical to fiduciary duty itself. Fiduciary duty is necessary because the fiduciary has power by right. This is true no matter the source of the fiduciary duty, whether contract or relation. Under a contractual theory, the trumping exonerates what should be a breach of the contract, and, under a relational theory, the fiduciary is allowed to abuse the beneficiary. Yet the power of partners to manage and the power of majority shareholders to vote is the reason fiduciary duty is appropriate. There should be inconsistency in allowing the rights that require the existence of a fiduciary duty to trump the duty itself. Decisions ignoring this inconsistency are doomed to repeat it.

The trumping argument is also a slippery slope: Deciding that a right trumps

²³² Opening Post-Trial Brief of Defendants Gatz Properties, LLC and William Gatz, C.A. Auriga Capital Corp. v. Gatz Properties, LLC, 4390-VCS, 7 (Oct. 21, 2011) (citations omitted).

²³³ *Auriga Capital Corp.*, 40 A.3d at 878 & n.165.

loyalty invites fiduciaries to expand the exception with behavior that soon becomes opportunistic.

At worst, the trumping language is a kind of hyperbole. Inasmuch as later courts take it seriously, it has the potential to allow serious injustice. Inasmuch as later courts do not take it seriously, they still must respond to counsel's arguments trying to hide their clients behind it. Lower courts and even the deciding court itself may spend decades carefully cabining the hyperbole's effect by ignoring it and citing only the language of the trumping opinion that makes sense and is defensible. Lawyers practicing before the court may take decades to get the hint.

In the end, the final fault of the trumping rationale is that the true grounds for decision remain hidden. None of the results reached by the three opinions studied here are incorrect. But the rationale that justifies each result without confusion or controversy remains hidden because judges allowed the trumping argument to persuade them, or at least to allow them to stop thinking before articulating a less problematic ground for decision.

I believe these kinds of decisions are relatively rare. For the most part, judges do not engage in this kind of thinking. They never should.