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Note

Opportunity Lost: More of the
Same in Sale of Corporate Control
Cases


I. INTRODUCTION

In 1975 the market value of Laurel Harness Racing Association, Inc.'s common stock fluctuated between $7.50 and $10 per share. That year, Richard Hutchison, Jr., sold his common stock for $43.75 per share. Hutchison was able to obtain that inflated price because he sold more than just common stock; he sold the controlling interest in the corporation.

That transaction and others like it have prompted numerous commentators and courts to question the legal and equitable aspects of a controlling shareholder's right to receive a premium for his or her stock. Discussion has focused primarily on two issues: (1) whether the controlling shareholder when disposing of his or her interest has a fiduciary duty toward the minority shareholders; and (2) whether the controlling interest and the premium paid for

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2. Id. at 1261.
3. Id. at 1260.
it belong to the controlling shareholder, all the shareholders, or to the corporation.

Views on these issues cover a wide spectrum. At one extreme it is argued that the premium paid to the controlling shareholder is illegal per se. Professor Berle, an advocate of this view, premises his position on the rationale that control is a corporate asset, and as such, premiums paid for control belong in equity to all shareholders. Berle reasons:

By its corporation statute, the state grants each corporation capacity to choose a board of directors for management of its affairs. It directs exercise of that capacity through the stockholder's vote. By the certificate of incorporation, it gives the incorporators power to assign the vote evenly among all shares outstanding or evenly among all the shares of a specified class or classes. By statute in most states, and by general doctrine, the rights of each share of stock within each class must be identical. It is wholly impractical to require a unanimous vote to elect directors; consequently in all normal situations a majority is authorized to elect the directors prevailing over the votes of the minority. Essentially, this is nothing more than a device to assure continued management and functioning; it is a corporate power, though exercised by individual stockholders. It does not authorize or permit a management thus constituted to distinguish between majority and minority shareholders: management power does not include that privilege. The position of a majority shareholder, with his capacity to control, is thus not a "property right" in the same sense as is his right to participate in dividends, or in liquidation or the like. His control power is really adventitious, a byproduct of the corporate capacity to choose a board of directors by less than unanimity. This is why the control power--capacity to choose a management—is a corporate asset, not an individual one.

Another argument in this vein is that the premium is illegal because it constitutes a bribe. Professor Bayne bases this conclusion on the premise that a holder of the controlling interest is a trustee of the corporation. In this capacity, Bayne believes the holder should have a fiduciary duty to choose a successor with suitable moral integrity, managerial and organizational proficiency, social acceptability and health. The premium is viewed as a bribe paid by the buyer to induce the seller to breach his or her fiduciary duty, and thus should be disallowed.

A less extreme position is taken by Professor Andrews, who is not concerned with the payment of the premium itself. He feels that the controlling shareholder has the right to get whatever price he or she can for the controlling interest. However, the premium is acceptable to Andrews only as long as every shareholder is af-

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6. A. BERLE & G. MEANS, supra note 4, at 244; Berle, supra note 4, at 629.
8. Bayne, supra note 4, at 490.
9. Id. at 497.
10. Andrews, supra note 4, at 516.
11. Id. at 505.
forded an equal opportunity to sell his or her shares of stock, or a pro rata portion of them, on the same basis as the controlling shareholder. The rationale is that each stockholder is entitled to share proportionately in the profits of the enterprise; from the stockholder's point of view a sale of stock is one very important way of realizing a profit on his investment; profits from stock sales ought to be regarded as profits of the enterprise subject to equal sharing among shareholders just as much as profits realized through corporate action.

At the other end of the spectrum is the view held by a majority of the courts. The traditional rule has been that every stockholder, including a majority holder, is at liberty to dispose of his shares at any time and for any price to which he may agree without being liable to other stockholders... as long as he does not dominate, interfere with, or mislead other stockholders in exercising the same rights.

However, the trend today is to restrict this broad rule. The courts have refused to adopt the doctrines advanced by Berle, Baynes, or Andrews. Currently, the following rule prevails:

The right of control is ordinarily a right inherent in ownership or control of a majority of the stock, and if a purchaser pays a premium; i.e., a price greater than the fair value of the stock, merely for the right of control as an investment, with no foreseeable looting and no appropriation or frustration of a corporate business opportunity, and no inherent unfairness to the minority shareholders... the minority stockholders have no right to share in such premium...

Notwithstanding contemporary standards, courts have not produced any uniform guidelines in applying this rule.

The courts' refusal to adopt the Berle-Bayne approach that control premiums are per se invalid has left an analytical morass of hybrid theories that may be utilized to recapture a control premium. Each theory may seem justified by the facts of a particular case, but when considered collectively, they fall far short of forming a coherent body of law. The absence of a consistent framework has resulted in a series of obstacles for the unwary corporate planner as well as some tools for the wily corporate litigator.

The recent case of Clagett v. Hutchison exemplifies the haphazard analysis in the sale of control area. The United States Dis-
strict Court for the State of Maryland rejected the contention that
the leading theories are law. Instead of establishing a comprehensive test for determining the legality of a sale, the court employed a vague factual test, determining the case on the circumstances peculiar to the transaction involved.

II. FACTS

Between 1975 and 1977, a series of transactions occurred involving the controlling interest of Laurel Harness Racing Association, Inc. (Laurel). The first of these transactions was the 1975 sale by the major shareholder, Hutchison. That sale involved Hutchison receiving a substantial premium for his stock, and included offers by the purchasers on the same terms to minority shareholders designated by Hutchison. Within a year, the purchasers transferred an unspecified portion of their stock to a fourth party; the four controlled Laurel until 1977 when they sold their entire interests.

Laurel's minority shareholders sought to hold all parties involved in these transactions liable for damages allegedly sustained as a result of the sales. They sought compensation for the decrease in value of their common stock resulting from the purchasers' mismanagement of the corporation and diversion of corporate funds for their personal use. The minority interest holders alleged that Hutchison should be held responsible for the damage done by his purchasers in that he breached the fiduciary duties owed to them when the sale was made. The first of these duties, was to investigate the character, integrity, financial stability and managerial ability of his potential purchasers when it was apparent that the purchasers would defraud, loot, and mismanage the company. Furthermore, Hutchison was alleged to have breached his fiduciary duties by failing to afford the minority shareholders an equal opportunity to sell their interest to the purchasers on the same, or substantially the same, terms as he was offered. In addition, the minority shareholders sought to hold the purchasers liable for aiding and abetting Hutchison in the breach of those duties.

19. Id. at 1264.
20. See text accompanying note 1 supra.
21. 583 F.2d at 1261.
22. Id. The purchasers were Steven Sobechko, James Sobechko and Joseph Shamy.
23. Id. Daniel Rizk was the transferee of their stock.
24. Id.
26. 583 F.2d at 1260.
27. Id.
SALE OF CONTROL

The district court dismissed the complaint on the ground that it failed to state a claim upon which relief could be granted. The appellate court affirmed the decision, holding that on the facts of the case, neither of the plaintiffs' theories of recovery stated a claim upon which relief could be granted. With regard to the breach of duty to investigate the prospective purchaser, the court found that the circumstances surrounding the transaction were not sufficiently "suspicious" to give rise to a fiduciary duty. Furthermore, the court held that the laws of Maryland do not recognize a fiduciary duty which would require the seller to afford the minority shareholders an equal opportunity to share in the tender offer.

III. ANALYSIS

A. Fiduciary Duty to Investigate

The Clagett court, following the trend in sale of control cases, recognized that in certain sale situations the seller stands in a fiduciary relation to minority shareholders. If the seller is in a position to foresee the possibility that the subsequent purchaser might loot or defraud the corporation or the remaining shareholders, then under this view he must investigate the intentions of the purchaser. Additionally, the seller must refrain from completing the transaction unless a reasonable man would conclude that no fraud is intended or likely to result. In applying this rule the court was faced with the problem of determining when the seller is in a position to foresee the dishonorable intentions of the buyer. The test espoused by the court was a rule of reasonableness, i.e., would a reasonable person become suspicious when confronted with the circumstances of and surrounding the transaction?

The problem inherent in the use of the reasonable person standard is reflected in the court's opinion. The prime difficulty is in devising from the decision exactly what is required by the standard. In applying the test, the court was forced to rely heavily on the particular facts of the case, but in so doing, it did not set up any beneficial guidelines for those interested in selling control. There-

28. Id.
31. Id. at 1260.
32. Id. at 1263.
33. Id. at 1264.
34. Id. at 1262.
35. Id.
fore, unless every sale of control involved similar buyers, similar prices, a similar corporation, and a similar format to those in the Clagett case, the holding is of little predictive use. The corporate planner and future seller are left to conjecture whether even the common aspects of sale of control transactions would be considered suspicious by the courts. One has no manner of ascertaining whether the receipt of a premium makes the situation suspicious or not; nor is it evident whether the quickness with which buyers consummate the sale is a determinative factor. A comparison with some of the sale of control cases that have employed the reasonableness standard highlights this uncertainty. For example, in Clagett the fact that Hutchison received a premium of approximately $30 per share (300 percent of its worth) was not sufficiently suspicious to raise a duty to investigate. Yet another court has held that a $2.34 premium per share (188 percent of its worth) was highly indicative of the nature of the transaction, and that the duty to investigate was warranted.

In Clagett, the court concluded that a six to twelve month waiting period between the execution of the stock purchase agreement and the closing of the transaction "constituted a prudent business practice rather than 'suspicious' circumstances," whereas in Swinney v. Keebler Co., the haste with which the sale was completed was considered a prudent business act and not suspicious.

In conjunction with the problem of predictability is the added difficulty encountered with the rule's flexibility. Because the term reasonableness is vague by its nature, the court may use the term to reach any result it desires. This places an almost impossible burden on the parties involved. While some flexibility is desirable

36. The court held that the payment was justified as it was a payment for control. The court also stated that since the corporation was an on-going business likely to develop further, the payment of the premium was not suspicious. Id. at 1262.

37. [T]he inflated price paid by the Boston group for the banks' shares has already been considered as evidence that they were primarily interested in buying control, but I do not think it can be disregarded as being also some indication that they had an improper purpose in view. Why were the purchasers willing to pay so much for control? Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22, 26 (E.D. Pa. 1940). The reason the payment of a premium is deemed indicative of a potential looter, is that it is assumed the buyer will be under pressure to recoup his or her premium. If it does not appear that the profitability of the corporation will be greatly improved under his or her management, it is feared that the price will be recouped from the corporate treasury. See Hill, The Sale of Controlling Shares, 70 HARV. L. REV. 986, 1012-13 (1957).

38. 583 F.2d at 1262-63.


40. Id. at 579.
in order to allow courts to reach equitable decisions, the rule should not be so pliable as to allow courts to dictate another standard under the guise of reasonableness.

The Clagett court goes to extreme lengths to apply the reasonableness standard, yet reaches a decision heavily favoring the seller. In 1957, it was predicted by one commentator that "it would ordinarily take rather strong evidence to convince a judge that the seller was forewarned of such eventualities [i.e., looting]." The facts deemed "unsuspicious" in Clagett and those in Swinney v. Keebler Co. upon which Clagett relies, give truth to this prediction. Analyzing these two cases it would seem that despite the "reasonable" label, the test applied is one of actual knowledge; i.e., the seller will be held liable for failure to investigate and for selling control only when he or she has actual knowledge that the buyer intends to loot the corporation.

Swinney involved a sale of the controlling interest of Meadors, a candy factory, by Keebler Co. to Atlantic, a subsequent looter of that corporation. The trial court deemed seven circumstances surrounding the transaction as being sufficiently suspicious to warrant holding that the sellers, as reasonable persons, had a duty to investigate:

1. no one from Atlantic had any experience in the candy business,  
2. at the time the contract was executed no one from Atlantic had inspected the "Meadors operation,"  
3. by the time of the closing only Atlantic's accountant had examined Meadors to "any appreciable extent and he was interested principally in the books and inventory,"  
4. Meadors had no market of its own and the "profit as shown could not have been accepted at face value by an outsider,"  
5. prior to the closing Atlantic had no negotiations with Meadors' key employees concerning the continuation of the business,  
6. the sale was consummated with dispatch, and  
7. Atlantic had inquired as to availability of Meadors' funds for payment of the purchase price.

The appellate court reversed, finding that under the reasonableness standard these seven factors were not sufficiently suspicious to warrant investigation. This finding would only be accurate,

41. Professor Hazen stated that there are two advantages to the present unpredictable, case-by-case bases for determining sale of control cases: "The obvious advantage of such an approach is to allow the courts to achieve an equitable result in each case. Another advantage is that the corporate planner will have to scrutinize each transaction on its merits with an eye toward giving the minority a fair deal." Hazen, supra note 4, at 1041. See also Hill, supra note 37, at 987.
42. Hill, supra note 37, at 1013.
43. 480 F.2d 573, 579 (4th Cir. 1973).
44. Id. at 578.
45. In light of the facts and applicable law, plaintiffs' right to recover turns on whether Keebler had sufficient knowledge to foresee the likelihood of fraud so as to give rise to a duty to conduct a further
however, if the reasonable person was defined as an astute businessman familiar with sale of control transactions. The court emphasized that there were plausible business explanations for the way the transaction was carried out, and it gave the seller the benefit of the doubt that he considered these explanations. However, there were several other factors that the court failed to discuss which indicate that it was using a much lower standard than that of the reasonable person.

One commentator, in analyzing Swinney, pointed out the following factors which indicate use of a lower standard: (1) the court neglected to note that Meadors' major asset at the time of the sale was cash, and as such Keebler should have been more sensitive to the possibility of looting; (2) it viewed the seven factors individually, failing to give any weight to the overall picture; and (3) in down playing the significance of the seven factors, the court put great weight on the fact that Atlantic gave no indication that it planned to cease operation. Yet, this is a weak basis for decision since most looters continue operation in order to conceal their thievery.

In Clagett the plaintiffs alleged that there were four circumstances which should have given Hutchison notice of his buyers' motives: (1) a large premium was paid; (2) the transaction was delayed over six months after the conclusion of the sales contract; (3) the sales contract precluded any change in the company's financial situation during that period; and (4) it was arranged that not all shareholders would participate in the deal. The court

[Vol. 58:891

investigation and to satisfy itself, by the test of a reasonable man, that no fraud was intended or likely to result before it consummated the sale of control.

Id. at 578.
46. Id. at 578-80.
47. See 51 Tex. L. Rev. 1234 (1973).
48. Id. at 1237.
49. If the corporation's assets are found to be liquid in form, the courts' have tended to be more wary of the size of premium paid for the controlling interest, since the corporation is far more vulnerable to looters. As pointed out by one court:

No doubt, if this corporation had been an industrial, mining, or commercial enterprise, whose physical assets and business might have potentialities which a purchaser might believe he could develop if given control, the price would not mean so very much. It was, however, merely an investment company, and the ultimate assets—what was really being sold—were nothing but the ready equivalent of cash in marketable securities.

51. Id.
52. 583 F.2d at 1261.
noted that these facts alone would not make a reasonable person suspicious. But one has to wonder why someone was willing to pay 300 percent over the average market price; how that person planned to recoup his or her investment; and why he or she would be willing to pay a premium for minority shares? Even though there were plausible business reasons for the way the transaction was set up, they were unorthodox enough to warrant investigation. This is especially true if a person did not know of these reasons, and had a fiduciary duty to investigate due to the fact that the looting was foreseeable.

It should be noted that the court failed to adequately deal with the fact that the purchasers made offers to minority shareholders designated by Hutchison to buy at the same price. In disposing of this fact, the court merely stated that "selling one's own stock and including others in such a sale, is a private act, sanctioned in law, and not alone 'suspicious.'" This appears to be inconsistent with the earlier conclusion that the sale of control is not a private act, that it is an act subject to various limitations. The court seemed to ignore the fact that this was not just a sale of stock, but a sale of control.

Furthermore, the majority opinion in Clagett stated that the selection of certain minority shareholders to participate in the sale was not suspicious in itself. Contrary to the court's position, the selection was not the sole factor involved. The court's analysis failed to tie this fact in with the other three factors. If the court had viewed the transaction as a whole, it is probable that this one factor would have appeared more suspicious, as would the other factors. As noted by the dissenting judge:

[T]he conclusion that the premium simply reflected the price of control is dispelled by the allegation that the majority stockholder insisted that the purchasers acquire the stock of certain favored minority stockholders. Other stockholders, including the appellants, were not even told of the proposed transaction. The use of such leverage to favor one group of minority stockholders over another justifies the inference, at least at this stage of the proceedings, that the majority accurately foresaw that disaster was likely to befall the corporation.

The court's piecemeal analysis precluded finding any one of the factors suspicious. Thus, it is apparent that the only factor that

53. Id. at 1262.
54. Id. at 1263.
55. Id.
56. The court analyzed the other three points in connection with each other but failed to do this with the fourth point.
57. 583 F.2d at 1266.
58. The court's analysis of the facts, like that of the court in Swinney, consisted of giving plausible business explanations for the various factors of the transaction, and on this basis holding that Hutchison had no reason to be "suspi-
the court would have held sufficient to impose liability on the
seller would have been that of actual knowledge.

The standard of actual knowledge has been used in only one
sale of control case to date, Levy v. American Beverage Corp.59
Not only did that court deem that a seller is liable only if he or she
actually knew of the purchaser's mischievous intent, it also held
that, "[t]he law does not require one to act on the assumption that
a person with whom a business transaction, even of large amount,
is had, will commit a fraudulent or criminal act if given the oppor-
tunity to do so."60 As many commentators have indicated, the use-
fulness of this standard is best reflected in the statement, to
"require knowledge of intended looting on the part of the seller in
order to impose liability on him places a premium on the 'head in
the sand' approach to corporate sales."61

The inadequacy of the actual knowledge standard is found in its
basic inequity. Sale of control cases involve a conflict between two
policies. On one hand, it is desirable to have controlling sharehold-
ers able to freely sell their stock. However, this policy may conflict
with the protection the corporation and its minority shareholders
need from the injury which may result from sale of control transac-
tions.62 The best solution involves a compromise. The actual
knowledge standard does not go far enough in meeting the needs
of the minority shareholder. As pointed out by the district court in
Swinney, "The requirement of actual knowledge of the intended
looting, necessarily eliminating any standard of care, would, by
sanctioning the reckless or irresponsible sale of corporate control,
command persons having non-controlling interest in the corpora-
tion to the mercy of the holder of the controlling interest."63

This balance can be achieved by the reasonable person stan-
dard. Under it, restrictions are placed on the seller requiring him
or her to act with care while at the same time allowing a sale that
does not endanger the corporation. However, the balance is in a
vulnerable position since it allows the courts to use the actual
knowledge test in every way but name. In addition, the lack of pre-

60. Id. at 219, 38 N.Y.S.2d at 527.
Cir. 1973). See, e.g., Note, Corporations—Liability of Shareholder who Sells
Control to Looters, 39 Mo. L. Rev. 596, 600 (1974); 51 Tex. L. Rev. 1234, 1241
(1973).
63. 329 F. Supp. at 224. See also Leech, Transactions in Corporate Control, 104 U.
dictability may have a chilling effect on many sellers deciding whether or not to sell. This in turn, hampers the policy of free transferability. Handicapped by these difficulties, the effectiveness of the reasonableness standard is questionable.

A possible solution would be to impose upon the seller a higher standard of fiduciary responsibility. Such a standard would involve full disclosure of the sale of control, as well as a duty to investigate prospective purchasers in all sale of control transactions. Under this standard it would be unnecessary to determine whether the circumstances surrounding the transactions were "suspicious" enough to give rise to the duty to investigate.

The idea of imposing a duty to investigate in all sale of control cases was first offered by Professor Hill in 1957. Hill felt that due to the seriousness and complexity of such transactions, sellers out of their own interest tend to inform themselves of the credibility of the purchasing parties. Thus he saw the question as not whether the controlling shareholders should be compelled to investigate, but whether this investigation should be broadened to include the possible impact the transaction would have on the remaining shareholders. Since such inquiries are made anyway, he concluded the investigation could be extended to protect the interest of the minority without placing much of a burden on the seller.

Balance between the two desired policies is reflected in Hill's burden of proof rules. The rules are premised on the following assumptions:

- that the sale of control for personal profit is not presumptively wrong; that in the light of the foregoing premise and in the interest of avoiding uncertainties which themselves could cause undue restriction upon the transfer of control, doubtful cases should be resolved in favor of the sellers; and that information derived by the sellers from the inquiry they are charged with making is information peculiarly within their possession and should in fairness be produced by the sellers at the trial.

To supplement this duty, full disclosure of the tender offer to all the shareholders would be required before it is consummated. This would serve several useful purposes. First, it would provide a check for sale of control cases. Minority shareholders with the knowledge of who the purchasers were, could institute their own investigation. If the minority holders discovered that the buyer intended to loot or defraud the corporation, they could inform the seller and perhaps compel him to stop the sale.

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64. One court has called for such a high standard of duty. See Estate of Hooper v. Virgin Inlands, 427 F.2d 45, 47 (2d Cir. 1970).
66. Id. at 1025.
67. Id.
68. Id. at 1027.
Secondly, if the investigation was conducted by all the parties affected by the transaction rather than exclusively by the majority holder, it would allow for a more thorough investigation. The majority shareholder who is seeking to leave the corporation ordinarily limits the investigation to that which is necessary to protect his or her own security interest, and to negate any possible liability. On the other hand, the minority shareholders, who after the sale would still have an interest in the corporation, would look into the possible effects the new management would have on the corporation as well as on their own interests. From the various vantage points the circumstances may not only appear different, but certain circumstances might appear of more relative importance. This might also force the court to view the transaction not only from the point of view of the seller, but also from that of the corporation and the minority interest. It would allow the court to inquire more fully into the totality of the transaction, and to more zealously guard the balance between the two desired policies.

For example, in viewing the sale of control from only the sellers' point of view, the court in *Clagett* missed an extremely important effect the transaction would have had on the corporation. As the dissenting opinion pointed out, the corporation's state racing license, without which no race could be run, was dependent upon the competency and integrity of the owners. If the new management turned out to be corrupt or incompetent the license could be revoked by the racing commission. Thus, this factor should have been considered in the investigation before the majority shareholder was allowed to sell his or her interest. If both the majority and minority shareholders had investigated, all the relevant aspects of the deal could have been explored.

A third function of the full disclosure rule would be to give the minority interests a right to determine their own destiny. It would allow the minority shareholders to make an informed decision on whether or not they wished to remain in the corporation under the new management. With notice of a future sale, they could sell out before being subjected to any risks the prospective new management might occasion.

In addition, full disclosure of the tender offer would give the seller a possible defense if the minority shareholder failed to act or to investigate. If the minority shareholders have a substantial interest at stake, their failure to act could indicate their acquiescence in the deal. Thus, the shareholders would not be able to claim that they had been treated unfairly or that they were subjected to unfair surprise.

69. 583 F.2d at 1267.
Finally, the duty to disclose would serve as a check on those sales of control which are in reality a front for the sale of a corporate asset, a corporate opportunity or a corporate office. Disclosure of the terms of the sale contract would make the true nature of the sale apparent before it occurs. The shareholders could then seek to enjoin any improper sale. Furthermore, having to make a full disclosure of the terms or be liable for the failure to do so might make the seller more hesitant to sell anything more than actual control.

In the Clagett case the failure of the court to take advantage of the opportunity to impose a higher fiduciary duty on the seller of control is surprising, since Hutchison was president of the corporation at the time of the sale, a point which was not discussed by the court. While there is a controversy as to whether majority shareholders owe a fiduciary duty to the corporation, there is no such controversy when discussing corporate officers and directors, for it is well settled that

1. Directors and other officers must exercise the utmost good faith in all transactions touching their duties to the corporation and its property, and in their dealings with and for the corporation they are held to the same strict rule of honesty and fair dealings between themselves and their principal as other agents.

2. All their acts must be for the benefit of the corporation and not for their own benefit . . .

3. They are not permitted to profit as individuals by virtue of their position.

4. Any profits received by them from the company's property or business belongs to the company and they hold the same as trustees for the benefit of the corporation to its stockholders.

In Gerdes v. Reynolds, an early control premium case, the distinction was made between duties owed by one merely selling control, and one who was an officer selling control. The case involved a sale by the corporate officers to subsequent looters of the corporation. The contract of sale also included an agreement that the


73. It has been recognized by some courts that in certain situations the majority shareholders have the same fiduciary obligations as do the directors. See, e.g., Pepper v. Litton, 308 U.S. 295, 306 (1939); Southern Pac. Co. v. Bogert, 250 U.S. 483, 491-92 (1919); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). For fiduciary duties of officers and directors, see 3 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 850-860 (rev. ed. 1975).

74. 3 W. Fletcher, supra note 73, at 175-76 (footnotes omitted).

75. 28 N.Y.S.2d 622 (Sup. Ct. 1941).
sellers would resign their positions as directors, and would elect the buyers to fill their positions. The court held that the sellers, as majority shareholders, had not breached their fiduciary duty.

Moreover, since the new owners would be able to vote in whomever they chose, it held that the sale of the majority interest with a seriatum change in the board was not illegal as it was an inherent feature of the controlling interest.

However, the court held that they had breached their fiduciary duty as officers and were thus liable to the corporation. It held that directors and officers owed a fiduciary duty to the corporation, and they could not resign if they were aware that they would leave the corporation in improper care:

A man dealing with his own affairs may be as confiding and trusting as he pleases, and may be grossly negligent without being guilty of bad faith, but a fiduciary charged with the care of the property of others must be reasonably vigilant, and will not be heard to say that he did not know what the circumstances plainly indicated or that his faith in people was such that obvious opportunities for wrongdoing gave him no inkling that wrongdoing might be done . . . .

Even though the court in Clagett chose to use a reasonableness standard, it should have noted that Hutchison was an officer, and that as such he owed a greater degree of diligence to the corporation. Furthermore, the court should have placed greater emphasis on the effects of the transaction on the corporation, determining whether looting or fraud was foreseeable.

Speaking of the majority shareholders' fiduciary duties, the court stated:

The cases in which majority stockholders have been said to stand in a fiduciary relation to the minority have been cases in which the court was speaking of a matter of corporate management committed by statute directly to the stockholders rather than to directors . . . . or cases in which the majority have in fact assumed the management of the corporation's property or business . . . . or cases in which the majority have undertaken to act for the minority . . . . Such cases may not exhaust the entire list of situations in which the majority may be held to be fiduciaries, but certainly as to matters not relating to management of the corporation's business or property, and in the absence of any express undertaking, the stockholders do not stand in a fiduciary relation to each other . . . . Clearly, therefore, in the matter of selling their stock the holders of a majority thereof, whether one or a group, act for themselves alone and not as trustees, either technically or substantially, for the other stockholders, and no fiduciary duty is violated by such a sale, even though such sale ultimately bring about a change in the directorate.

Id. at 650 (citations omitted).

Id. at 650.

Id. at 659.

Id. at 653.
B. Equal Opportunity for Minority Shareholders

Once again exhibiting the contemporary trend in sale of control cases, the Clagett court dismissed the plaintiffs’ allegation that the defendants breached their fiduciary duty by failing to afford all the shareholders an equal opportunity to sell their shares. The ground cited was simply that the law of Maryland does not impose such a fiduciary duty.

This reluctance of the courts to accept the doctrine of equal opportunity is in line with their acceptance of the reasonableness standard for the duty to investigate. Like the reasonable person standard, the rejection of this rule allows the court to maintain a balance between the policies of encouraging free alienability of stock and of imposing restraints when the corporation would be endangered by the sale. The adoption of the equal opportunity rule would tip the scales against free alienability, for “the rule, if applied, would likely result in the stifling of many financial transactions due either to the purchaser’s inability to purchase the additional shares, or from a lack of inclination to purchase those shares.”

Failure to accept the doctrine is also indicative of the courts’ recognition that there is a difference between majority and minority stock. The majority’s stock is worth more because the dominant shareholders have the right to participate in the corporate profits as any other shareholders, and they have the power to increase those profits by implementing what they believe to be the best policies through their choice of management. In addition, people are willing to pay more for majority stock because it enables them to deal with an individual or small group, rather than a “multitude” of minority shareholders. Not only is there more certainty and convenience in dealing with smaller groups, it is also less expensive. Furthermore the minority shareholders are likely to sell for less, as it is more reflective of the value of their stock.

Finally, under the reasonable person standard, it is the selling shareholder that is given the duty to investigate. The premium, it could be argued, is compensation for those duties. As minority

80. 583 F.2d at 1264. See also text accompanying notes 10-13 supra.
81. 583 F.2d at 1264.
83. See also McDaniel v. Painter, 418 F.2d 545, 548 (10th Cir. 1969); Tyron v. Smith, 191 Or. 172, 178, 229 P.2d 251, 254 (1951).
84. Id. at 533.
85. Id. at 533.
shareholders are not so burdened, they would not be entitled to share in any of the premium.

In light of the fact that majority interests are inherently worth more than minority interests, the only justification for the use of the equal opportunity rule would be if it was effective against eliminating potential looters. Such effectiveness is highly questionable as one commentator has noted:

These problems [looting and corporate squeezes] result from abuse of the control position. They can arise at any time and do not require any transfer of control. Looting and corporate squeezing have naturally tended to occur, if at all, shortly after the transfers of control, when the power to accomplish them is first acquired. This would be equally so, however, with or without reference to any rules concerning transfers of control at a premium.87

The drastic approach of the equal opportunity rule, even if it were effective, would not be necessary if the more exacting fiduciary duty standard was applied.88 That alone should afford adequate protection.

Illustrative of the role the equal opportunity rule should play are three cases which held that the seller breached the fiduciary duty owed the corporation.89 In Perlman v. Feldmann,90 the court held that equal participation was necessary, since more than control of the corporation was sold.91 The court found that a corporate asset had been appropriated,92 an obvious violation of a fiduciary duty.

In Jones v. H.F. Ahmanson & Co.,93 the court held that the “comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders”94 in California. The court found that the controlling shareholders breached this fiduciary duty by freezing out the minority while taking advantage of a corporate opportunity to sell their interest.95 Thus, the court

87. Letts, supra note 82, at 646.
88. See text accompanying notes 78-84 supra.
91. Id. at 178.
93. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
94. Id. at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.
95. Id. at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604. See also Clagett v. Hutchison, No. HM76-1204, slip op. at 8 (D. Md. Jan. 20, 1977). The majority shareholders in order to take advantage of a bullish market for their type stock, formed a holding company to which they sold their stock and then the holding company went public. The minority shareholders of the closely held corporation,
held that under such circumstances the minority should be given a pro rata share of the profits.\textsuperscript{96}

In the third case, \textit{Donahue v. Rodd Electrotype Co.},\textsuperscript{97} it was held that there was a breach of fiduciary duty when the majority failed to offer the minority an equal opportunity to sell its shares due to the fact that the entity was a close corporation.\textsuperscript{98} By definition, a close corporation has (1) a small number of stockholders, (2) no ready market for its corporate stock, and (3) a substantial majority stockholder.\textsuperscript{99} Shareholders in such a corporation were held to owe a high fiduciary duty to each other \textit{in all} situations, a duty of utmost good faith and loyalty, similar to that one partner would owe another. The logical extension of this rule to the sale of control situation is that

the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price . . . . The controlling group may not, consistent with its strict duty to the minority, utilize its control of the corporation to obtain special advantages and disproportionate benefits from its share ownership.\textsuperscript{100}

Thus, courts which have applied the equal opportunity rule have done so as a remedy for breach of fiduciary duty,\textsuperscript{101} as a means to an end,\textsuperscript{102} and as a complement to the fiduciary standard.\textsuperscript{103} If the solution previously proposed\textsuperscript{104} is adopted by the courts, and majority shareholders are found to owe duties similar to those of officers and directors, the equal opportunity rule should be adopted to rectify the situation when the breach is found. It should be limited to that role, for as pointed out by the \textit{Clagett} court,\textsuperscript{105} it is otherwise contrary to corporate law, as it currently exists, and is unnecessarily cumbersome on one's right to free alienability of stock.

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not being able to sell to the holding company, were unable to take advantage of the public market. In finding that the majority had not acted in good faith or with fairness to the minority shareholders, the court awarded the latter damages amounting to the amount they would have realized had they been able to participate in such sales. 1 Cal. 3d at 117-18, 460 P.2d at 478, 81 Cal. Rptr. at 605-06.
\textsuperscript{96} 1 Cal. 3d at 119, 460 P.2d at 478, 81 Cal. Rptr. at 606.
\textsuperscript{97} 367 Mass. 578, 328 N.E.2d 505 (1975).
\textsuperscript{98} \textit{Id.} at 593, 328 N.E.2d at 515.
\textsuperscript{99} \textit{Id.} at 596, 328 N.E.2d at 511.
\textsuperscript{100} \textit{Id.} at 598, 328 N.E.2d at 518.
\textsuperscript{102} Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
\textsuperscript{103} \textit{Donahue v. Rodd Electrotype Co.}, 367 Mass. 578, 328 N.E.2d 505 (1975).
\textsuperscript{104} \textit{See} text accompanying notes 78-79 \textit{supra.}
\textsuperscript{105} 583 F.2d at 1264.
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IV. CONCLUSION

Clagett leaves both owners of controlling interests and owners of minority interests in a position worse than the one in which they were prior to the decision. It is undeniable that a majority shareholder is a fiduciary, but as pointed out by Justice Frankfurter: "[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?"106 Clagett fails to answer these latter questions; the court merely adds to the confusion that already exists. The court states that the standard to be applied in sale of control cases is reasonableness, but it uses the much lower standard of actual knowledge. Minority shareholders are led to believe that they can hold the control seller liable, only to find that it is nearly impossible to prove that the seller breached the duty owed them. The seller is no better off for there is always the possibility that the court might apply the standard it says it is applying. They might find themselves liable for situations in which they carelessly sold the interest; they might also find themselves liable in situations in which they took extreme precautions. Who is to say what is reasonable? To date, the courts have failed to establish any guidelines. Since the courts have refused to accept comprehensive rules suggested by legal scholars, they should come up with a scheme that will give some direction to those involved in sale of control transactions. The courts must seek to maintain a balance between free alienability of stock, and protection of the corporation. A good starting place would be for the courts to answer the questions concerning the control seller's fiduciary duty, and to develop a higher standard, imposing both a duty of full investigation and disclosure in every sale.

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