

THE ROLE OF THE STATE COURTS AFTER THE MODEL BUSINESS CORPORATION ACT

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The enactment of the Model Business Corporation Act would represent the most significant legislative development in the corporation law of Hawaii. There is, however, a judicial component to corporation law. State courts have played, and will continue to play, an important role in the development of corporation law.¹ One critical issue that must be analyzed subsequent to the implementation of the Model Act is how the state courts should interpret those sections of the Act which attempt to foreclose the courts' traditional common law role.² This article asserts that for

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¹ The courts, in comparison to state legislatures, have been almost solely responsible for the development of protective doctrines in corporation law. One need only look so far as the obvious examples such as the doctrine of "piercing the corporate veil," *see generally* *Pepper v. Litton*, 308 U.S. 295 (1939); *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967) *cert. denied*, 390 U.S. 988 (1968); *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); *Hamilton, The Corporate Entity*, 49 Tex. L. Rev. 979 (1971), or the obligation of majority shareholders to minority shareholders, *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Katzowitz v. Sidler*, 24 N.Y.2d 512, 249 N.E.2d 359, 301 N.Y.S.2d 470 (1969), or common law prohibitions on insider trading, *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), for examples of judicial creation of equitable doctrines. The legislatures have tended to enact provisions which lower the standards applying to corporate or management conduct. *See, e.g.,* HAWAII REV. STAT. § 416-35 (Supp. 1980) which adopts the least stringent standards in terms of indemnification of directors. Another example is section 35 of the ABA-ALI MODEL BUS. CORP. ACT (1979) [hereinafter cited as MBCA], which uses the lower of the two prevailing common law standards as to the duty of care of directors. *Hawes & Sherrard, Model Section 35—New Vigor for the Defense of Reliance on Counsel*, 32 BUS. LAW. 119, 120 (1976).

² Many sections in the Model Act attempt to codify and replace the common law. The sections dealing with fiduciary duties are of greatest concern to this article: section 35 (director's standard of care), section 41 (director's conflicts of interest with corporation; corporate opportunity) and section 80(d) (limitation of shareholder's remedy in a fundamental corporate change). Other sections of the Model Act seek to displace the common law: section 7 (replacing the common law doctrine of ultra vires), section 52 (shareholder rights to inspect corporate books and records at common law displaced), section 39 (removal of directors), section 38 (filling vacancies), section 34 (voting trusts and shareholder agreements, status unclear under common law), sections 26 and 26A (preemptive rights, sometimes allowed under common law), section 25 (liability of shareholders to pay the full consideration

various reasons,³ primarily the institutional inability of the legislature to perform its usual law-making function in the area of corporation law, state courts should disregard statutory corporate norms⁴ when necessary and equitable.⁵

Some of the most controversial provisions in the Model Act are those concerning the directors' and officers' fiduciary obligations toward the corporation and minority shareholders. It is generally recognized that the Model Act has followed the trend in lowering the standards of fiduciary duty.⁶ For example, section 35, relating to the "duty of care" of directors, adopts the lower of the two prevailing standards.⁷ Section 41 permits directors to contract with the corporation under any of three circumstances, one of these being a ratification by the shareholders notwithstanding that such shareholders themselves may be "interested" directors.⁸ Addition-

for shares), section 6 (right of corporation to acquire its own shares), and section 5 (indemnification of directors and officers, status unclear under common law).

³ See pp. 175-90 *infra*.

⁴ The term "statutory corporate norm" refers to the standards set forth in the statute. For example, section 35 states that directors shall perform their duties "with such care as an ordinarily prudent person in a like position would use under similar circumstances." Other examples of statutory corporate norms include section 35's command that the board of directors manage the corporation, and section 41 concerning a director's conflicts of interest.

⁵ Judicial doctrines that protect shareholder and corporate interests have been created under the courts' equitable powers. See *Pepper v. Litton*, 308 U.S. 295, 305-12 (1939); *Cranston v. International Business Machs. Corp.*, 234 Md. 477, 200 A.2d 33 (1964). Thus, the usual limitations on equitable relief, such as the availability of relief at law or the defenses of unclean hands or *in pari delicto* would apply.

⁶ Indications that the Model Act has followed the trend in lowering the standards of care are found in the following sections. Section 5, "Indemnification of Officers, Directors, Employees and Agents," follows almost verbatim the California and Delaware provisions which have adopted less stringent standards. See generally Heyler, *Indemnification of Corporate Agents*, 23 U.C.L.A. L. REV. 1255 (1976); ABA, Committee on Corporate Laws, *Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel*, 34 BUS. LAW. 1595 (1979). Section 41, "Director Conflict of Interest," has been described by Professor Hamilton of the University of Texas as "an abomination." See *TEACHERS' MANUAL to R. HAMILTON, CORPORATIONS* 136 (1976). See also Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME LAW. 201 (1977); 58 NEB. L. REV. 909 (1979). Section 53 adopts the lower of the American standards as the standard of care for directors. See, e.g., Hawes & Sherrard, *supra* note 1; ABA, Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAW. 947, 949-55 (1974). Section 27 gives the directors the power to change by-laws, formerly a right reserved to shareholders unless expressly stated otherwise.

⁷ See text accompanying note 15 *infra*.

⁸ Section 41 allows a contract between a corporation and its director if at least one of the following requirements are met: (a) the conflict is disclosed and the contract is approved by disinterested directors; (b) the conflict is disclosed and approved by a majority of all shareholders, whether or not they have a conflict of interest; (c) the contract is fair and reasonable. A disinterested minority would not be able to prevent a contract favored by an interested majority because only one of the requirements need be fulfilled. Thus, even though all of the disinterested directors vote against the contract, it could still be approved by a vote of the interested majority of shareholders. The application of this second provision was struck down as inherently unfair under the facts in *Remillard Brick Co. v. Remillard-*

ally, one of the most significant, new provisions is section 80(d), relating to the shareholder remedies in a fundamental corporate change. Section 80(d) makes the statutory appraisal remedy, absent unlawful conduct or fraud, the shareholder's exclusive remedy.⁹ The implementation of section 80(d), as an attempted legislative repeal, would cast doubt on the continued validity of *Perl v. IU International Corp.*¹⁰ In that case, the Hawaii Supreme Court held that, despite a purportedly exclusive appraisal remedy set forth in the statute, a shareholder can set aside a corporate transaction on the grounds that it lacks a justifiable "business purpose," or is not "entirely fair" to all shareholders.¹¹

The *Perl* decision points out that courts, in spite of the statutory norms set by the legislature, will develop and expand the requirements of fiduciary obligations toward noncontrolling shareholders.¹² Thus, these provisions bring into question the legitimacy of legislative attempts to displace and limit the courts' traditional equitable role of scrutinizing corporate transactions for fairness.¹³ This issue focuses on fundamental jurispru-

Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952). See note 23 *infra*. The usual rule has been to allow interested shareholders to vote. *Kentucky Package Store, Inc. v. Checani*, 331 Mass. 125, 117 N.E.2d 139 (1954). See generally Sneed, *The Stockholder May Vote as He Pleases: Theory and Fact*, 22 U. PITT. L. REV. 23, 52-54 (1960).

⁹ See Conard, *Amendments of Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80 and 81)*, 33 BUS. LAW. 2587 (1978).

¹⁰ 61 Hawaii 622, 607 P.2d 1036 (1980).

¹¹ *Id.*

The central question remaining in this case, then, is whether behavior short of fraud is actionable where the controlling statute states that, except for an action testing the sufficiency or regularity of the vote, appraisal is the exclusive remedy of any stockholder objecting to a merger.

Id. at 638, 607 P.2d at 1045.

In *Perl*, the Hawaii Supreme Court held that, despite the statute, a shareholder had a right to bring an action for a breach of fiduciary principles. The question is likely to be raised again if section 80(d) of the Model Act is enacted and such enactment is considered to be legislative evidence to limit a shareholder's remedies to an appraisal in the absence of fraud. See notes 67-82 and accompanying text *infra*.

¹² For a discussion of the development of judicial doctrines governing directors' dealings with their own corporation, see *New York Trust Co. v. American Realty Co.*, 244 N.Y. 209, 155 N.E. 102 (1926); Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966). As for the development of the director's duty of care, see *Bates v. Dresser*, 251 U.S. 524 (1920); *Hun v. Cary*, 82 N.Y. 65 (1880); *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940); *Selheimer v. Manganese Corp. of America*, 423 Pa. 563, 224 A.2d 634 (1966) (discussing the application of the statute in the context of the common law history). As for judicial doctrines insuring a shareholder an action in equity despite a statute purporting to make the appraisal remedy exclusive, see *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977).

¹³ The courts have been the institutions which have developed equitable doctrines to protect shareholders. See, e.g., *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955) (sale of control); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (majority shareholder's duty to the minority); *Cranson v. International Business Machs. Corp.*, 234 Md. 477, 200 A.2d 33 (1964) (corporation by estoppel); *Farris v. Glen Alden*, 393 Pa. 427, 143 A.2d 25 (1958) (de facto merger doctrine).

dential questions concerning the balance of power between the courts and the legislature and whether a state legislature has the power to completely foreclose a party's access to the judicial system.¹⁴

Moreover, the legitimacy of a legislative attempt to nullify the common law standards of fiduciary duty by enacting lower statutory standards is brought into question. For example, section 35 of the Model Act states that a director acting as an "ordinarily prudent person in a like position" insulates himself from a shareholder action for waste or breach of his duty of care.¹⁵ Such a section presents the question of whether the courts should be prohibited from holding a defendant to the higher standard.¹⁶

One might initially challenge any judicial deviation from the standards expressed in statutes.¹⁷ Ordinarily, the division between judicial and legislative functions can be expressed by the belief that the legislature makes the laws and courts merely interpret such laws.¹⁸ However, the courts' obligation to apply a statute as written is purely self-imposed. There is no institution which can compel the courts to read statutes as intended by the legislature.¹⁹ Granted, courts do not normally refuse application of statutes as written,²⁰ and compelling reasons are needed to

¹⁴ This is the problem presented by the "exclusivity" provision in section 80(d) and other state corporation codes which go even further in limiting the relief which a minority shareholder may obtain in state court. The most exclusive statutes preclude a resort to the courts where the cash-out remedy exists, absent "fraud or illegality." See, e.g., MASS. GEN. LAWS ANN. ch. 156B, § 98 (West 1970); TEX. BUS. CORP. ACT ANN. art. 5.12(G) (Vernon 1980). See notes 67-82 and accompanying text *infra*.

¹⁵ See MBCA, *supra* note 1, at § 35.

¹⁶ In regards to section 35, the higher standard would be "that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs." *Selheimer v. Manganese Corp. of America*, 423 Pa. 563, 224 A.2d 634, 640 (1966).

Another example of an attempted statutory displacement of a common law remedy is contained in section 41. See note 8 *supra*.

¹⁷ Traynor, *La Rude Vita, La Dolce Giustizia; Or Hard Cases Can Make Good Law*, 29 U. CHI. L. REV. 223 (1962):

It is easy to agree that the legislature is preeminently qualified to cope with such problems There are many such problems whose resolution entails extensive study or detailed regulation or substantial administration that a court cannot appropriately or effectively undertake. A judge must assume that in the main a legislature will take its share of responsibility for the liquidation of bad law.

Id. at 233.

¹⁸ Cf. W. FRIEDMANN, *LEGAL THEORY* 501-03 (5th ed. 1967) for a discussion of problems arising from legislative inaction and judicial reform.

¹⁹ The true lawmaker is the person who has the last word. Being the last word, there is no institution which can force the courts to interpret statutes as plainly written or intended. Levy, *Realist Jurisprudence and Prospective Overruling*, 109 U. PA. L. REV. 1 (1960). See *McBryde Sugar Co. v. Robinson*, 54 Hawaii 174, 504 P.2d 1330 (1973) (interpreting an 1848 statute that vests "ownership" of water in the state). But see *Robinson v. Ariyoshi*, 441 F. Supp. 559 (D. Hawaii 1977), *appeal docketed*, No. 78-2264 (9th Cir. Nov. 28, 1978) as an attempt to use the federal district courts as an institution to prevent an allegedly "new" interpretation of the 1848 statute by the Hawaii Supreme Court in *McBryde*.

²⁰ In interpreting a statute, courts are expected to apply the statute's plain meaning or

justify a court's refusal to apply the "plain meaning" of any statute.²¹

While this article argues that the courts should not always be bound by the Model Act's limitations, it should not be viewed as justifying the courts in totally disregarding the statute. Indeed, only when a court is convinced that, as applied to the facts, the statute will produce an inequitable result should it refuse to apply the statutory norms.

I. JUDICIAL DISREGARD OF CORPORATION STATUTES.

Given the "race of laxity"²² between the states regarding statutory standards of fiduciary duties governing corporations, it is not surprising that state courts have actively scrutinized corporate transactions for fairness. Particularly in regard to fiduciary obligations, it has been the state courts which have created and expanded the obligations of management and controlling shareholders to minority shareholders.²³ In adopting this interventionist role, the state courts have often been disdainful of applying statutory standards. On occasion, the courts have simply ignored a statute's clear language.²⁴ When statutes are not clear, courts have disre-

read the statute consistently with the legislature's intent. *Caminetti v. United States*, 242 U.S. 470, 485-86 (1917); H. HART & A. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW*, 1144-46 (Tent. ed. 1958).

²¹ See *Temple v. City of Petersburg*, 182 Va. 418, 423, 29 S.E.2d 357, 358 (1944): "If the language of a statute is plain and unambiguous, and its meaning perfectly clear and definite, effect must be given to it regardless of what courts think of its wisdom or policy. In such cases courts must find the meaning within the statute itself." See also *Caminetti v. United States*, 242 U.S. at 485-86: "Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them."

²² See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517 (1933) (Brandeis, J., dissenting):

Lesser States, eager for the revenue derived from the traffic in charters, had removed safeguards from their own incorporation laws. Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity. Incorporation under such laws was possible; and the great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation.

Id. at 557-60 (footnotes omitted).

²³ See note 12 *supra*. This is not to say that the state legislatures have been totally inactive. See, e.g., N.C. GEN. STAT. § 55-35 (1975) that requires of the management "that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions."

²⁴ The "plain meaning" rule was explained in *Caminetti v. United States*, 242 U.S. 470, 485 (1917): "[T]he meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, . . . the sole function of the courts is to enforce it according to its terms." An example of a state court ignoring a statute's apparent plain meaning is *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (1952). In that case, the court was required to interpret a California statute that allowed a director to enter into a contract with his corporation if there was either (a) ratification by a disinterested board after disclosure; (b) ratification by the shareholders, whether

garded norms of statutory interpretation to avoid inequitable results.²⁵ One example of this judicial unwillingness to follow familiar rules of stat-

or not interested, after disclosure; or (c) the contract was just and reasonable. The "plain meaning" of the statute was that a contract was valid if it met any of the three criteria. The California Supreme Court, protecting the minority shareholders from an unfavorable contract, held that the third part of the statute—fairness—was required in all contracts. In explaining its decision, the court stated: "But neither section 820 of the Corporations Code nor any other provision of the law automatically validates such transactions simply because there has been a disclosure and approval by the majority of the stockholders. . . . Even though the requirements of section 820 are technically met, transactions that are unfair and unreasonable may be avoided." *Id.* at 418, 241 P.2d at 74. The court did not state its grounds for refusing to apply the "plain meaning rule." Either the court reasoned that the legislature actually intended the statute to be construed contrary to its clear meaning, or, as urged in this article, the legislature did not have the power to nullify common law doctrines of fiduciary duty.

Exclusivity statutes are another example of statutes which have been interpreted contrary to their plain meaning. For example, Pennsylvania's exclusivity provision states that "rights and remedies . . . , shall be limited to the rights and remedies prescribed under this section, and the rights and remedies prescribed by this section shall be exclusive." PA. STAT. ANN. tit. 15, § 1515K (Purdon 1967). Despite this language, Pennsylvania law has been interpreted as allowing a shareholder to attack a merger for fraud. *Miller v. Steinbach*, 268 F. Supp. 255, 268-71 (S.D.N.Y. 1967). Moreover, Hawaii's exclusivity provision reads:

The rights and remedies of any stockholder to object to or litigate as to any such merger or consolidation are limited to the right to receive the fair market value of his shares in the manner and upon the terms and conditions provided in sections 417-19 to 417-30 except suits or actions to test the sufficiency or regularity of the votes of the stockholders

HAWAII REV. STAT. § 417-29 (1976). However, indicative of a judicial attitude encouraged by this article, the Hawaii Supreme Court in *Perl v. IU Int'l Corp.*, 61 Hawaii 622, 607 P.2d 1036 (1980), allowed a suit to challenge a merger for fairness despite the clear prohibition on such actions in the statute.

²⁵ Of course, since for every rule of statutory construction, there is an equally persuasive countervailing rule, see Llewellyn, *Remarks on the Theory of Appellate Decisions and the Rules or Canons About How Statutes Are to be Construed*, 3 VAND. L. REV. 395 (1950), one person's "norm of statutory construction" is another person's exception to the rule. This conflict is found in the "de facto" merger doctrine. Under the Delaware cases, a corporate transaction that complies with the appropriate sale of assets provision will not be recharacterized as a "de facto" merger. Instead, Delaware courts hold that the sale of assets and the merger provisions are of equal dignity. See *Orzeck v. Englehart*, 41 Del. Ch. 223, 192 A.2d 36 (1963); *Hariton v. Arco Elec., Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (1963); *Heilbrunn v. Sun Chem. Corp.*, 38 Del. Ch. 321, 150 A.2d 755 (1959). On the other hand, the Pennsylvania Supreme Court in *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958) held a sale of assets to be a "de facto" merger, thereby giving the minority shareholders the protections they would have received under the merger provision.

The statutory norm employed by the Delaware courts was that two sections of the same statute should be construed independently. In other words, the existence of the two different provisions meant that mergers were governed by the merger provision and sales of assets, regardless of their similarity with a merger, were governed by the sale provision. However, those courts following the "de facto" merger doctrine could cite with equal force the maxim that: "'One part [of a statute] must not be so construed as to render another part nugatory, or of no effect.' *People v. Burns*, 5 Mich. 114." *City of Grand Rapids v. Crocker*, 219 Mich. 178, 183, 189 N.W. 221, 222 (1922). A "norm of statutory construction" is truly a relative standard.

utory construction is the evolution of the "de facto" merger doctrine.²⁶ Moreover, even where the statute explicitly or implicitly commands a result, the courts have created doctrines that avoid such results. For example, the "piercing the corporate veil" doctrine holds that notwithstanding actual compliance with statutes that create a corporation and give it limited liability, the courts may ignore the effect of such statutes to "pierce" the shield of limited liability in certain circumstances.²⁷

More specifically, it is where statutes have set standards for fiduciary conduct that the courts have "rewritten" statutes to give them a different meaning. Thus, in *Remillard Brick Co. v. Remillard-Dandini Co.*,²⁸ the California Supreme Court interpreted a disjunctive statute concerning director's contracts as a conjunctive statute to protect the minority shareholders. In other cases involving alleged unfair treatment of the corporation and minority shareholders, statutory compliance has not barred a judicial inquiry into fairness. Mergers,²⁹ stock repurchases,³⁰ the issuance of shares³¹ and step transactions such as redemptions followed by liquidations,³² are not immune from judicial attacks simply because the parties complied with the applicable corporate statutes. If the transaction results in a breach of a fiduciary duty, the courts have set the transaction aside.

One reason why courts have taken this activist role is that the primary function of corporation statutes is to create or "enable" the legal fiction of a corporation and its various concomitant powers to exist.³³ Since the

²⁶ Under the "de facto merger" doctrine, fundamental changes, such as the sale of substantially all the assets of a corporation, which have the effect of a merger, must comply with the statutory requirements for mergers. *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958). For a decision holding the doctrine inapplicable, see *Hariton v. Arco Elec., Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (1963). See generally Folk, *De Facto Mergers in Delaware: Hariton v. Arco Electronics, Inc.*, 49 VA. L. REV. 1261 (1963).

²⁷ The intent of the Model Act's drafters was that sections 56 "Effect of Issuance of Certificate of Incorporation" and 146 "Unauthorized Assumption of Corporate Powers" would combine to displace the judicially created doctrines of "corporation by estoppel" and "de facto corporation." Under these sections, corporate existence commences only when the certificates are issued by the state. Prior to that, there is no corporate existence, de facto or otherwise. 2 MODEL BUS. CORP. ACT ANN. § 56, ¶ 2 (2d ed. 1971) [hereinafter cited as 2 MBCA ANN.]. See *Robertson v. Levy*, 197 A.2d 443 (D.C. 1964). Therefore the question is raised as to whether a court may "pierce" the corporate shell and deny that it exists in order to hold shareholders liable. *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

²⁸ 109 Cal. App. 2d 405, 241 P.2d 66 (1952). See generally note 8 *supra*.

²⁹ *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Perl v. IU Int'l Corp.*, 61 Hawaii 622, 607 P.2d 1036 (1980); *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958); *Matteson v. Ziebarth*, 40 Wash. 2d 286, 242 P.2d 1025 (1952).

³⁰ *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Williams v. Nevelow*, 513 S.W.2d 535 (Tex. 1974).

³¹ E.g., *Katzowitz v. Sidler*, 24 N.Y.2d 512, 249 N.E.2d 359, 301 N.Y.S.2d 470 (1969).

³² E.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Miller v. Steinbach*, 268 F. Supp. 255 (S.D.N.Y. 1967).

³³ See generally Katz, *The Philosophy of Mid Century Corporation Statutes*, 23 L. & CONTEMP. PROB. 177 (1958); Latty, *Why Are Business Corporation Codes Largely Ena-*

statutes are primarily "enabling" and not regulatory, they should not be construed so as to preempt the common law.³⁴

A second reason for this interventionist posture is the United States Supreme Court's position that corporation law is substantially a state concern.³⁵ In recent years, the Supreme Court has curtailed the development of Rule 10b-5 as a source of a federal common law of corporations. Thus, in *Santa Fe Industries v. Green*,³⁶ the Supreme Court held that Rule 10b-5 should not be extended to cover breaches of fiduciary duty; this was an area traditionally regulated by state law.³⁷ Moreover, in determining the existence of implied private remedies under the federal securities acts, the Court has held that an important consideration is whether the remedy sought is traditionally provided by state law.³⁸ If so, a cause

bling?, 50 CORNELL L.Q. 599 (1965).

³⁴ The corporation is a legal fiction; its characteristics and powers granted by state statute. Thus, simply because a statute grants the corporation some power, it should not be considered as the only applicable "law." In other words, the absence of explicit statutory language as to whether equitable doctrines should apply, should not be interpreted as negating such common law equitable doctrines. For example, in *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), the defendants relied, in part, on a defense that the redemption followed by a liquidation complied with the corporation codes. But the statute in that case allowing a corporation to redeem its stock and allowing a corporation to liquidate, was read as merely granting a corporation the power to effect those transactions. Such enabling provisions should not be interpreted as implicitly negating the application of common law equitable doctrines. The failure of the legislature to include a remedy in a statutory scheme that purports to be regulatory has justified the refusal to imply remedies that are not consistent with legislative intent. See *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979). Thus, where provisions have an enabling purpose, as do many in corporation codes (amendment of the articles, repurchases of stock, mergers and other fundamental corporate changes), such provisions should not be viewed as though they were regulatory, thus raising an inquiry as to whether they displace "implied" remedies under the common law.

³⁵ "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Cort v. Ash*, 422 U.S. 66, 84 (1975). See also *Burks v. Lasker*, 441 U.S. 471 (1979).

³⁶ 430 U.S. 462 (1977).

The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. . . . Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.

Id. at 478-79.

³⁷ See generally *Campbell, Santa Fe Industries, Inc. v. Green: An Analysis Two Years Later*, 30 ME. L. REV. 187 (1979).

³⁸ *Cort v. Ash*, 422 U.S. 66, 84-85 (1975): "We are necessarily reluctant to imply a federal right . . . where the [state] laws governing the corporation may put a shareholder on notice that there may be no such recovery."

This same deference to states is evidenced by the Supreme Court's consistent approval of the apportionment method selected by the state in its corporate tax scheme. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). "Although the adoption of a uniform [tax] code

of action is not likely to be implied from the federal statutes.³⁹ The state courts must act to fill the void.

In determining whether a state court may disregard a statutory standard, the initial question is one of legislative intent; did the legislature, in enacting this provision, intend to preempt common law standards or remedies? In this regard, the Model Act is a "mixed bag." Some sections are aimed at prohibiting the courts from applying common law standards. Other "enabling" provisions show no intent of barring judicial scrutiny.⁴⁰

would undeniably advance the policies that underlie the Commerce Clause, it would require a policy decision based on political and economic considerations that vary from State to State." *Id.* at 279. See also *Exxon Corp. v. Department of Revenue*, 477 U.S. 207 (1980).

³⁹ If one views a corporation and shareholders' rights in a corporation as a creation of state statute, then the Supreme Court's deference to state law in determining the shareholders' rights is consistent with its deference to state law in determining the scope and nature of other state-created rights. For example, in determining whether a nontenured teacher had a "property" interest in continued employment for the purposes of the fourteenth amendment, the Supreme Court stated in *Board of Regents v. Roth*, 408 U.S. 564, 577 (1971): "Property interests, of course, are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law—rules or understanding that secure certain benefits and that support claims of entitlement to those benefits." See also *Perry v. Sindermann*, 408 U.S. 593, 602-03 n.7 (1971): "If it is the law of Texas that a teacher in the respondent's position has no contractual or other claim to job tenure, the respondent's claim would be defeated." One must question, however, the appropriateness of the Court's similar treatment of corporation and other areas of state law. Unlike traditional areas of state law, e.g., real property law, the state legislatures cannot truly formulate sound policies to regulate corporations. They lack the meaningful ability to choose corporate policy. As asserted later, this argues for an expanded role for the state courts in setting forth a common law of corporations. See note 53 and accompanying text *infra*.

⁴⁰ Within the Model Act, there are also those sections that contain both enabling and regulatory components. For example, section 5, relating to indemnification of directors and officers, enables the corporation to indemnify in situations prohibited under common law. See *New York Dock Co. v. McCollom*, 173 Misc. 106, 16 N.Y.S.2d 844 (1939) (corporate indemnification of officer who successfully defended himself in a derivative action held to be *ultra vires*). At the same time, the Model Act provides that the court, at its discretion, may nullify any such indemnification upon a finding of negligence or misconduct.

This duality is further evidenced in the combined application of sections 56 and 146 which create or "enable" the existence of a corporation. See *Robertson v. Levy*, 197 A.2d 443 (D.C. 1964). See generally note 25 *supra*. At the same time, the commentary indicates that the sections, read together, were designed to eliminate the common law doctrines of corporation by estoppel and de facto corporation. 1 MODEL BUS. CORP. ACT ANN. § 46, ¶ 2 (2d ed. 1971) [hereinafter cited as 1 MBCA ANN.].

However, if the intent was to eliminate these two judicial doctrines, arguably there should have been similar intent to eliminate the "piercing the corporate veil" doctrine. See note 27 *supra*. The commentary to the Model Act does not address this point and no commentator or court has interpreted these sections as intending to displace this latter doctrine. Similarly, it is not clear whether section 50, in setting forth the make-up of executive management, attempted to implicitly set or reject any common law standards relating to officers' duty of care. See 2 MBCA ANN., *supra* note 27, at § 50, ¶ 2. Kentucky and Minnesota do provide by statute that officers must exercise their duty in good faith and with diligence, care, and skill. *Id.* ¶ 3.03(9). Confusion is one of the unfortunate by-products of these types of provisions.

Examples of intentionally preclusive sections—section 35,⁴¹ setting forth the duty of care, and section 41,⁴² establishing the conditions under which directors may contract with their corporations—have already been discussed.

Examples of the enabling type of provision are those allowing the by-laws to fix the date of the annual shareholders' meeting and granting the board of directors the power to change the by-laws.⁴³ Such enabling provisions should not be read as immunizing every attempt to set the date of annual meeting from judicial scrutiny. Thus, in *Schnell v. Chris-Craft Industries, Inc.*,⁴⁴ the by-laws set forth the date of the shareholders' annual meeting. State law allowed the directors to amend the by-laws. To block a shareholders' attempt to stop the re-election of incumbent management, the board of directors amended the by-laws to advance the meeting date. Since the advancement would have prejudiced the attempt to remove the incumbents, the shareholders sought injunctive relief in state court. Defendants pointed out that they complied with the Delaware statutes allowing the annual meeting to be fixed by the by-laws and the directors to amend the by-laws. The Delaware Supreme Court, however, disagreed with the reasoning and held the meeting must occur on the date originally set in the by-laws. In response to the defendants' argument, the court stated: "Management contends that it has complied strictly with the provisions of the new Delaware Corporation Law in changing the by-law date. The answer to that contention, of course, is that inequitable action does not become permissible simply because it is legally possible."⁴⁵ This article urges a more formal recognition of this judicial attitude; enabling provisions such as those involved in *Schnell* do not negate common law doctrines requiring fairness or the fulfillment of fiduciary obligations.⁴⁶

⁴¹ Note 15 and accompanying text *supra*.

⁴² Note 8 and accompanying text *supra*.

⁴³ See MBCA, *supra* note 1, at §§ 27, 4(1). See also *In re Auer v. Dressel*, 306 N.Y. 427, 118 N.E.2d 590 (1954).

⁴⁴ 285 A.2d 437 (Del. 1971).

⁴⁵ *Id.* at 439.

⁴⁶ In essence, enabling statutes should not be construed as regulatory statutes designed to nullify common law doctrines regarding the fairness of the use of such powers. Numerous enabling provisions in corporate statutes are also illustrative of the problem presented in *Schnell*. For example, section 59 of the Model Act, granting corporations the power to amend the articles of incorporation, should not preclude actions to challenge the fairness of such amendments. In *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945), the state statute permitted amendment of the articles without reference to permissible or impermissible amendments. However, the court negated the attempt of voting trust trustees to give themselves power through an amendment of the articles, holding such an amendment amounted to a breach of the trustees' fiduciary duties to the shareholders.

Similarly, section 6 of the Model Act, allowing the corporation to repurchase its own stock, does not sanctify all repurchases of stock. Such transactions are still open to attacks based on fairness or fiduciary obligations. See *Donahue v. Rodd Electrotpe Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975) (controlling shareholders must cause the corporation to offer

There are three justifications for state courts disregarding purportedly exclusive statutory standards: rules of statutory construction,⁴⁷ the institutional failure of the legislature in terms of corporation law,⁴⁸ and the state courts' concurrent responsibility with the legislature to define what is "property" under state law.⁴⁹

Various canons of statutory interpretation can be used to justify judicial disregard of enabling type provisions. In particular, state courts can rely on those rules which imply that enabling provisions should not be construed to nullify common law remedies.⁵⁰

However, justifications for disregarding provisions which specifically attempt to regulate the internal affairs of corporations through statutory standards cannot be based solely on rules of statutory construction. Such arguments must rest upon other grounds, primarily, the legislature's institutional weakness in corporation law and, moreover, the courts' responsibility in defining property.

II. DISREGARD OF STATUTORY NORMS: THE LACK OF LEGISLATIVE CHOICE.

The legislature's institutional weakness in the area of corporation law arises from the legislature's lack of a "true" choice⁵¹ in selecting the appropriate policies to apply to the corporation's internal affairs. This situation must be compared to other areas where the legislature makes law.⁵² The "internal affairs rule"⁵³ deprives the legislature of meaningful choices

each stockholder an equal opportunity to sell shares to the corporation at an identical price); *cf.* *Williams v. Nevelow*, 513 S.W.2d 535 (Tex. 1974) (stock repurchase valid as long as the corporation was solvent at the time of repurchase, there was no bad faith, the repurchase did not contribute to the corporation's bankruptcy or harm future creditors, and there was an excess of unrestricted surplus).

⁴⁷ See note 34 *supra*.

⁴⁸ See pp. 181-84.

⁴⁹ See pp. 184-90 & note 39 *supra*.

⁵⁰ See note 34 *supra*.

⁵¹ The legislative choice in the area of regulating the internal affairs of corporations may be described as a Hobson's choice—one without a real alternative. Or, as my colleague John Barkai once described it, such choices are reminiscent of "dorm food."

⁵² For example, a New Jersey corporation which did business in Hawaii and had employees in Hawaii would, as to those employees, be subject to Hawaii's employment discrimination laws. The Hawaii legislature could formulate its employment discrimination policy in a meaningful manner. A particularly stringent Hawaii statute could not be avoided by incorporating in a state with a lax policy. In almost every other area other than the internal affairs of corporations, state legislatures have a similar ability to exclude undesirable policies.

⁵³ The "internal affairs rule" mandates that the internal affairs of a corporation shall be determined by the laws of the state of incorporation. See *Rogers v. Guaranty Trust Co.*, 288 U.S. 123 (1933), where the Supreme Court held that it was proper for the district court to dismiss a suit to recover shares sold to directors, because the suit involved the internal affairs of a foreign corporation. Some inroads have been made on this rule, particularly

in corporation law. Since the legislature cannot fulfill its usual institutional role in this area, the courts must play the major role in setting state corporate policy. State courts should not always be required to defer to legislative norms in the area of corporation law.

Ultimately, however, no state can completely prevent application within its borders of another state's corporate laws.⁶⁴ In essence, it is not that the Model Act is coming to Hawaii; it has already arrived. True, the legislature has not yet implemented the Model Act, and there would be some real significance to this actual "implementation," but in an objective sense, the Model Act is already part of Hawaii's "law."

To illustrate this point, imagine a Martian sent to Earth to study Hawaii's law. His mission is to report to his superiors on the "law" that applies to various types of rights found in Hawaii—land, contractual interests, employment rights and, lastly, a shareholder's interest in a corporation.

Suppose that in studying the law affecting shareholder rights he encountered a corporation incorporated in a jurisdiction which has adopted the Model Act, let us say New Jersey. Assume further that this corporation had its principal place of business and its property in Hawaii and most of its shareholders were Hawaii residents. To our Martian, this is a "Hawaiian" corporation in the same sense that a parcel of land in Hawaii is "Hawaiian" property. Our Martian then observes several events in this corporation's life—dividend payments, the elimination of cumulative voting, a merger, an amendment of the articles, and so on.

When asked to report on the law governing real property in Hawaii, our Martian handed his superiors a book titled "Hawaii Revised Statutes—Property." When asked to report on an unemployed worker's rights to receive compensation, he gave his superiors "Hawaii Revised Statutes—Unemployment Compensation." When asked to describe the law governing a shareholder's property interest in this particular corporation, our Martian hands in a book entitled "New Jersey Corporation Law." Is he wrong? Is it improper to describe Hawaii corporation law by reference to New Jersey corporation law? His method of analysis has been consistent. In a sense, he is not wrong. New Jersey law "explains" the pertinent law the same way the Hawaii Revised Statutes describe the law of other interests.

where a foreign corporation does most of its business in the forum state, as opposed to the state of incorporation. Perhaps the strongest case following this view is *Western Airlines Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961), where a California court applied California law to a corporation incorporated in Delaware to prevent the corporation from eliminating the right of cumulative voting.

The Model Act seeks to foreclose the forum state's ability to apply its own laws. Section 106 states "and nothing in this Act contained shall be construed to authorize the State to regulate the organization of the internal affairs of such corporation." See *MBCA*, *supra* note 1, at § 106.

⁶⁴ See note 53 *supra*.

After examining other corporations located in Hawaii, our Martian would see that his description of Hawaii law as to corporations was underinclusive. He should subsequently hand in a book titled "Hawaii Revised Statutes—Corporations," another book titled "Delaware Corporation Law" and so forth. In fact, he would soon realize that to accurately describe the corporation "law" that applies in Hawaii, he needs a corporation code for every state and territory of the United States.

The purpose of this illustration is to show that the legislative choice regarding corporations is not the same choice that the legislature has in other areas. The legislative body's ability to select certain policies normally entails the equal ability to preclude the application of other policies within the state. This is not true in regulating the internal affairs of a corporation. The power to determine what law governs a corporation rests with those who control its ability to incorporate or reincorporate.⁵⁵ In regulating corporations, the legislature does not have the full range of policymaking choices. It cannot exclude undesirable policies from applying to corporations and shareholders in Hawaii. Thus, the judicial branch should be accorded a greater role in defining state corporation law, including the ability to disregard legislative standards.

One might argue that the "preemption" of Hawaii law by another jurisdiction's law does not justify the courts in usurping the legislature's policymaking functions. After all, federal law "preempts" state law in many areas, but such preemption does not justify depriving state legislatures of their traditional role in choosing the proper policy. The analogy to federal preemption, however, is inappropriate. In corporation law, one state, such as Delaware, has the power to reduce the standards of all states. Indeed, this has been the impact of Delaware law.⁵⁶ However, when the "preemp-

⁵⁵ Reincorporation, accomplished by amending the articles and filing in a new state, is often used to obtain the benefits of a less restrictive corporation code. See proxy statement of Trans-Texas Airways, Inc., cited in R. HAMILTON, *CORPORATIONS* 130-31 (1976):

The Board of Directors is of the opinion that reincorporation in Delaware, which is the domicile of many leading corporations, would achieve the flexibility desired. . . .

Under Texas law, an amendment to the articles of incorporation requires the approval of the holders of at least two-thirds of the stock of the corporation. Delaware law provides that amendments to the certificate of incorporation must be approved by the holders of a majority of the corporation's stock entitled to vote thereon,

Shareholders of a Delaware corporation have no appraisal rights in the event of a sale, lease or exchange of the assets of the corporation or in the event of a merger or consolidation of the corporation in which they receive solely stock of the surviving corporation [subject to several conditions authors note] Shareholders of Texas corporations have appraisal rights in the event of a sale of assets (other than in the ordinary course of business), merger or consolidation.

Former S.E.C. Chairman William Cary has proposed a Federal Corporate Uniformity Act to eliminate the incentives for incorporating in Delaware, see Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974).

⁵⁶ Amendments to the Model Business Corporation Act have undoubtedly been influenced by developments in Delaware as well as other states. Former S.E.C. Chairman, and

tion" is federal, the policies expressed by the federal law reflect a plurality or majority of the states in Congress. No one state dominates federal policy as does Delaware. Moreover, the clear tendency of federal law is to "upgrade" state standards.⁵⁷ At least, federal law never prevents the states from adopting more stringent standards.⁵⁸ In corporation law, however, the impact of "liberal" states, such as Delaware, is to "downgrade" state law.⁵⁹ Additionally, the effect of the "internal affairs rule" has been to make a state's attempt to maintain higher standards meaningless.⁶⁰

III. A SHAREHOLDER'S INTEREST AS STATE-CREATED PROPERTY: EXCLUSIVE REMEDIES AND PROCEDURAL DUE PROCESS.

The strongest and most controversial instance where judicial disregard of a statute can be predicated on the court's general responsibility to define state-created property rights is in regard to those statutes which make an appraisal remedy the shareholder's exclusive remedy in a fundamental corporate change.⁶¹ A shareholder's interest in a corporation can

Professor, William Cary has stated: "Over the years, . . . the Model Act has been watered down to compete with the Delaware statute on its own terms rather than offering alternative approaches." Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665 (1974). For example, section 5 of the Model Act, allowing greater permissiveness in the indemnification of directors, officers, and agents, was derived from California and Delaware. See note 6 *supra*. In 1969, the Model Act adopted the Delaware norm of requiring only a majority vote to approve a merger.

⁵⁷ Most federal remedial legislation provide minimum standards. They do not provide, as does Delaware corporation law, a rationale for lowering the standards of protection. Examples of the impact of federal law can be found, *inter alia*, in the areas of environmental protection, employment discrimination, federal securities regulation, OSHA, and in many other areas. See, e.g., *District of Columbia v. Train*, 521 F.2d 971 (D.C. Cir. 1975); *Environmental Defense Fund, Inc. v. Corps of Engineers*, 470 F.2d 289 (8th Cir. 1972), *cert. denied*, 412 U.S. 931 (1973); *Scherr v. Volpe*, 466 F.2d 1027 (7th Cir. 1972).

⁵⁸ The operation of the internal affairs rule in only one state, which attracts corporations by eliminating shareholder protections, prevents other states from adopting effective, more stringent standards. Most federal remedial legislation provide minimum standards, allowing the states to enact more stringent ones. For example, states may adopt environmental protection laws, safety laws, or consumer protection laws which have higher standards than their federal counterparts.

⁵⁹ See generally Cary, *supra* note 56.

⁶⁰ For an example of an attempt to "out-Delaware" Delaware, see Downs, *Michigan to Have a New Corporation Code?*, 18 WAYNE L. REV. 913, 913-14 (1972). For a clear admission of a state's inability to protect shareholders, see the Report of the Law Revision Commission of New Jersey in 1968, *cited in*, Cary, *supra* note 56, at 666:

"It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions."

⁶¹ Another instance where the courts should intercede to define and protect state-created property rights is where a shareholder's voting right is involved. Where one provision in the

be analogized to the universe of "new property"⁶²—benefits and economic interests created by the state.⁶³ This stems from the fact that a corporation is simply a creature of state law and, thus, a shareholder's interest in a corporation is similarly created by state statute. As such, the procedures by which a corporation terminates a shareholder's interest must be measured against procedures⁶⁴ which terminate other state-created property interests.⁶⁵ This analysis particularly applies to "exclusivity" provisions that assert a dissenting shareholder's sole remedy in a fundamental corporate change is the appraisal remedy.⁶⁶ A legislative attempt to deny a shareholder an equitable action in state court can be attacked along the same lines as a legislative attempt to bar a recipient of state welfare from

corporation statute gives shareholders the right to cumulate their votes, MBCA, *supra* note 1, at § 33, and another grants the shareholders the power to reduce the board size, MBCA, *supra* note 1, at § 36, or classify the board, MBCA, *supra* note 1, at § 37, the statute should not be read so as to imply that a reduction or classification solely to eliminate a minority shareholder's influence is beyond judicial review. See *Weinberg v. Dillingham Corp.*, Civ. No. 61290 (1st Cir. Ct. Hawaii, filed April 25, 1980). The same issue that exists as to exclusivity provisions applies here, namely, is an interest in the corporation taken subject to legislative restrictions? Under the view expressed in this article, the corporation's power to classify or reduce its board does not preclude a court from reviewing the fairness in using that power. The legislature is not the ultimate authority on shareholder's cumulative voting rights. Cf. *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977). The shareholder's right to vote his shares is a fundamental right of the shareholder. The legislature cannot, by merely allowing the reduction or classification, establish the extent of a shareholder's interest in the corporation. The court must supervise legislative determinations of a shareholder's interest in order to protect them from transactions that lack "fairness." See *Tevis v. Beigel*, 174 Cal. App. 2d 90, 344 P.2d 360 (1959).

⁶² The term "new property" was coined by Professor Reich, in Reich, *The New Property*, 73 YALE L.J. 733 (1964). "New property" includes state-created property interests such as welfare benefits to which a shareholder's interest in a corporation might be analogized.

The author recognizes that the "vested rights" characterization of the shareholder's interest in the corporation has been generally rejected. *Perl v. IU Int'l Corp.*, 61 Hawaii 622, 642 n.14, 607 P.2d 1036, 1047 n.14 (1980). However, the "new property" concept urged by this article is more narrowly restricted to rights created only by state statute, such as welfare benefits. It does not suggest a resurrection of broader, more traditional property concepts to describe the shareholder's interest. See, e.g., *Applestein v. United Board & Carton Corp.*, 60 N.J. Super. 333, 159 A.2d 146, *aff'd*, 33 N.J. 72, 161 A.2d 474 (1960). "The majority, no matter however overwhelming . . . , may not trample upon the property and appraisal rights of the minority shareholders . . . , no matter how few they may be in number." *Id.* at 352-53, 159 A.2d at 157.

⁶³ See note 39 *supra*.

⁶⁴ The fourteenth amendment prevents a state from depriving a person of property without due process of law. See *generally* *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104 (1978); *McCoy v. Union Elevated R.R.*, 247 U.S. 354 (1918); *Chicago, B. & Q. R.R. v. City of Chicago*, 166 U.S. 226, 241 (1897).

⁶⁵ See *Goldberg v. Kelley*, 397 U.S. 254 (1970). See also *Bell v. Burson*, 402 U.S. 535, 542 (1971): "[I]t is fundamental that except in emergency situations due process requires that when a State seeks to terminate [a protected] interest . . . , it must afford 'notice and opportunity for hearing appropriate to the nature of the case' before the termination becomes effective."

⁶⁶ See 2 MBCA ANN., *supra* note 27, at § 80(d).

challenging administrative actions in state court. If both interests are property under state law, then both trigger procedural due process rights under the fourteenth amendment.

The classic response to claims for constitutional protection of state-created property is that since the state created the property interest, the recipient takes it subject to the limitations placed by the state.⁸⁷ In other words, a shareholder has no constitutional claim against an exclusivity provision because he takes his interest in a corporation subject to such a provision. However, the weakness in this "take it as you find it" argument is similar to the weaknesses in the now defunct rights-privileges distinction in constitutional law.⁸⁸

Furthermore, since only "property" interests deserve constitutional protection, if the state, by statute, deems an interest not to be property, the state may argue that such interests do not trigger constitutional pro-

⁸⁷ See, e.g., *Wyman v. James*, 400 U.S. 309 (1971) where the Court held that a state did not violate the fourteenth amendment by conditioning welfare benefits on the recipient family's consent to "home visits" by a caseworker. Speaking for the majority, Justice Blackmun wrote: "[T]he visitation in itself is not forced or compelled, and . . . the beneficiary's denial of permission is not a criminal act. If consent to the visitation is withheld, no visitation takes place. The aid then never begins or merely ceases, as the case may be. There is no entry of the home and there is no search." *Id.* at 317-18. Compare Justice Sutherland's majority opinion in *Frost & Frost Trucking Co. v. Railroad Comm'n*, 271 U.S. 583 (1926):

It would be a palpable incongruity to strike down an act of state legislation which, by words of express divestment, seeks to strip the citizen of rights guaranteed by the federal Constitution, but to uphold an act by which the same result is accomplished under the guise of a surrender of a right in exchange for a valuable privilege which the state threatens otherwise to withhold. . . . If the state may compel the surrender of one constitutional right as a condition of its favor, it may, in like manner, compel a surrender of all. It is inconceivable that guarantees embedded in the Constitution of the United States may thus be manipulated out of existence.

Id. at 593-94.

⁸⁸ In *McAuliffe v. Mayor of New Bedford*, 155 Mass. 216, 29 N.E. 517 (1892), Justice Holmes argued that government employment was a privilege and, hence, not deserving of constitutional protection. Since such employment was a privilege, the government could attach conditions such as restrictions on political activity. The analysis was expanded to other constitutional rights in subsequent cases, see *Barsky v. Board of Regents*, 347 U.S. 442 (1954). The rights-privileges distinction, which would have excluded state-created property interests from procedural due process protection, has been largely abandoned. See, e.g., *Douglas v. California*, 372 U.S. 353 (1963); *Slochower v. Board of Higher Educ.*, 350 U.S. 551 (1956). See also Alstyne, *The Demise of the Right-Privilege Distinction in Constitutional Law*, 81 HARV. L. REV. 1439 (1968); Comment, *Another Look at Unconstitutional Conditions*, 117 U. PA. L. REV. 144 (1968). The state cannot now deny a shareholder an action in state court simply on the grounds that an interest in a corporation is merely a privilege, to which the state may attach conditions.

One may encounter the argument that because the termination of a shareholder's interest in a corporation is not "state action," the fourteenth amendment's procedural due process requirements do not apply. But clearly, a corporation's ability to terminate a shareholder's interest by liquidation, merger or sale of substantially all the assets is made possible solely by state statute.

tection.⁶⁹ Under this reasoning, an exclusivity section represents the state's determination that a shareholder's interest in a corporation is not property and thus does not require procedural due process protection. An exclusivity section implies that a shareholder's property right is simply a right to an economic return. As such, a shareholder does not have a right to hold up a merger, consolidation or other change of the corporate enterprise.⁷⁰

One might term this as the "Monte Carlo" view of a shareholder's interest in his corporation. A shareholder's interest is like a chip on a roulette table. It is fungible with other investments—mutual funds, savings accounts and pension interests.⁷¹ There are no real rights to control the

⁶⁹ Cf. *Homer v. Richmond*, 292 F.2d 719, 722 (D.C. Cir. 1961): "One may not have a constitutional right to go to Baghdad, but the Government may not prohibit one from going there unless by means consonant with [procedural] due process of law."

⁷⁰ The philosophical basis of limiting a shareholder to his appraisal remedy is based on a view that a shareholder has no real interest in the *form* of his or her investment. In explaining the old view that a shareholder has an interest in the nature of his investment, Professor, later Dean, Manning wrote:

[O]ne's history is part of his present. Monuments often outlive the philosophies they were built to glorify. The pyramids are one example. The appraisal statutes are another. To the nineteenth century mind contemplating such matters, a corporate merger was a major and significant event. In the first place it involved a species of corporate assassination. A "corporation" died. . . . The shareholders of corporation A somehow became shareholders of corporation B and no longer shareholders of corporation A. The mere statement of such a preposterous proposition did violence to fundamental principles. How could a man who owned a horse suddenly find that he owned a cow? Furthermore—or perhaps this is but another statement of the same point—even if this transmutation could somehow be brought off, surely it could not constitutionally be done without the owner's consent.

Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 246 (1962).

Some commentators have attacked the view that a shareholder has an interest in his investment's form.

One does not invest in a unique corporate entity or even a particular business operation, but rather in a continuous course of business which changes over a long period of time. . . .

It does seem, however, that an unrealistic importance has been attached to the investor's interest in changes in corporate form.

Folk, *supra*, note 26, at 1280-81 (footnote omitted). However, some courts have noted that shareholders may be realistically interested in elements other than an economic return on their investment.

"Money may well satisfy some or most minority shareholders, but others may have differing investment goals, tax problems, a belief in the ability of . . . management to make them rich, or even a sentimental attachment to the stock which leads them to have a different judgment as to the desirability of selling out."

Jutkowitz v. Bourns, Cal. Super. Ct. C.A. 000268 (Nov. 19, 1975), cited in *Singer v. Magnavox*, 380 A.2d 969, 977 n.8 (Del. 1977).

⁷¹ For arguments that market price reflects the value of the stock in terms of its rights and limitations, see Hyman, *Do Lenient State Incorporation Laws Injure Minority Shareholders*, in *THE ATTACK ON CORPORATE AMERICA* 166, 170 (M. Johnson ed. 1978).

The shareholder's interest in a "close" corporation is not, however, as fungible as an in-

form and nature of the investment. Thus, if the shareholder's interest is limited solely to an "economic return," then the appraisal remedy does not deprive the shareholder of any value.⁷²

The problem with this reasoning is that if the state legislature can unilaterally determine what constitutes "property" under the Constitution, then a danger exists that the state may define "property" so as to avoid constitutional obligations.

For example, while the Supreme Court has stated that a teacher's interest in tenure can be considered "property" for the purposes of proce-

vestment in a publicly-held corporation. This type of investment is *dependent* upon the identity of the investment relationship. Three elements determine not only the identity of that investment relationship but the value of it as well.

First, shares of the close corporation are held, usually, by a limited number of persons and are not, if at all, widely marketed or publicly traded. Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 406 N.E.2d 131 (1980). See, e.g., F. O'NEAL, CLOSE CORPORATIONS § 1.02 (2d ed. 1971); Covington, *The Tennessee Corporation Act and Close Corporations for Profit*, 43 TENN. L. REV. 183, 187 (1976); Kessler, *The New Jersey Business Corporation Act and the Close Corporation*, 23 RUTGERS L. REV. 632 (1969) [hereinafter cited as Kessler, RUTGERS]; O'Neal & Moeling, *Problems of Minority Shareholders in Michigan Close Corporations*, 14 WAYNE L. REV. 723 (1968). Secondly, few corporations have distinct spheres of management and ownership interests, as management is usually composed of investors. F. O'NEAL, *supra*, at § 5(c); Kessler, RUTGERS, *supra*, at 641-49. See generally O'Neal & Moeling, *supra*, at 723. But see Benitendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910) (voting agreements which grant a shareholder disproportionate voting power judicially invalidated). See note 82 *infra*, for a discussion of sections 34 and 35 of the MBCA which authorize, through the use of shareholder agreements and provisions in the by-laws, direct shareholder management. Kessler, *Hooray(?) for the Model Act—the 1969 Revision and the Close Corporation*, 38 FORDHAM L. REV. 743 (1970) [hereinafter cited as Kessler, FORDHAM]. Finally, shareholders in the close corporation usually exercise some control over the transferability of corporate shares through the use of share-transfer restrictions. See note 82 *infra*, for a discussion of section 54(h) of the Model Act which authorizes the use of share-transfer restrictions. L.L. Minor Co. v. Perkins, 246 Ga. 6, 268 S.E.2d 637 (1980). See generally Gregory, *Stock Transfer Restrictions in Close Corporations*, 1978 S. ILL. U.L.J. 477; O'Neal & Moeling, *supra*, at 725-31; Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HASTINGS L.J. 227, 234-40 (1961); Painter, *Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 VILL. L. REV. 48 (1960). There is a monetary necessity in maintaining the corporate identity by restricting entry into the corporation to those investors who can contribute to the business in a profitable manner. This is often referred to as *delectus personae*, or keeping the corporation closed. J. CRANE & A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIPS § 5(c) (1968) (the phrase literally means "choice of person"); Kessler, FORDHAM, *supra*, at 745 (control over the admission of new participants as a matter of self-survival).

Thus, the "fungibility" of the investment, and ultimately its value, is dependent upon the identity of the corporation and the degree of control which an investor has *vis-à-vis* other investors. Unlike the over-the-counter investment, the nature of the close corporation investment is best described as being a shared, dependent interest. See generally Hetherington, *Special Characteristics, Problems and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 20-23.

⁷² Since "cashing out" the shareholder by means of the appraisal remedy represents a fair valuation of his interest, under this theory the shareholder is entitled to no more.

dural due process, it concedes that the ultimate determination of whether it is property rests with state law.⁷⁵ Suppose a state legislature sought to punish a feisty state university by enacting a statute that declares that tenure is not "property."⁷⁶ Must the courts accept this characterization and refuse to require procedural due process in the tenure process? Suppose the legislature, to avoid the obligation to compensate, declared that easements in land, water rights, or even land was not "property" for the purposes of procedural or substantive due process.⁷⁸ The state should not be able to nullify the Constitution by evasive statutory definitions of property.

First, the sources that define "property" are not simply statutory. The Supreme Court has implied that all sources of state law must be considered: statutes, court decisions, traditions, and practice.⁷⁶ Second, since state courts ultimately determine what a statute means, they have an inherent "supervisory" role in determining what constitutes "property" under the Constitution. The definitive interpretation of a statute, such as one that declares tenure not to be "property" or that a shareholder's interest does not extend to the form of the investment, is that meaning given it by the state courts.⁷⁷

Third, statutory definitions run the danger of being self-serving. Legislative decisions, made in the political arena, involve compromises and trade-offs. In such a setting, the legislature might be tempted to define what state property is by the expediency of who deserves constitutional

⁷⁵ *Perry v. Sindermann*, 408 U.S. 593 (1972).

⁷⁶ For example, in *Perry*, the Court held that a non-tenured teacher aware of rules and understandings, officially promulgated and fostered, was entitled to rely on a belief that his interest in his employment was "property" and therefore protected by the procedural due process requirements of the fourteenth amendment. Suppose, however, the state legislature was to declare by statute that despite such rules and understandings, all non-tenured teachers did not have a "property" interest in their employment; would the courts have to accept such a state statutory characterization? The problem is that a state could avoid the application of the fourteenth amendment by declaring by statute that many interests were not property.

⁷⁸ See *Demorest v. City Bank Co.*, 321 U.S. 36 (1944) (state court reinterpretation of law); *Board River Power Co. v. South Carolina*, 281 U.S. 537 (1930); *Muhlker v. Harlem R.R.*, 197 U.S. 544 (1905) (new statute challenged as deprivation of due process). A similar question is raised in applying the contracts clause of the Constitution. The term "contract" is not defined in the Constitution. Suppose a state attempts to define by statute a former contractual right as no longer being a "contract" and thus, not protected under the Constitution? See *Indiana v. Brand*, 303 U.S. 95 (1938).

⁷⁶ See *Board of Regents v. Roth*, 408 U.S. 564 (1972): Property interests "stem from an independent source such as state law—rules or understandings that secure certain benefits and that support claims of entitlement to those benefits." *Id.* at 577. See also *Perry v. Sindermann*, 408 U.S. 593 (1972) (rights to retention by non-tenured faculty grounded in rules and understandings of university); *Goldberg v. Kelley*, 397 U.S. 254 (1970) (entitlement to welfare benefits grounded in statute).

⁷⁷ The courts have the "last word" in giving a definitive meaning to statutes. *Levy, supra* note 19, at 5.

protection.

On the other hand, under the traditional explanation of judicial behavior, courts must declare what is the true state of affairs.⁷⁸ Thus, in determining what constitutes "property" the court would look to the "real world."⁷⁹ Since courts must define what is property as opposed to what should be property,⁸⁰ there is wisdom in ultimately deferring to the courts' definition. Indeed, the judicial branch's responsibility to preserve the integrity of the Constitution requires scrutinizing the legislative definitions. Without such judicial review, access to constitutional protection can be manipulated by state legislatures.

Thus, it is the state courts which must ultimately judge the fairness of statutory definitions of property, such as those contained in exclusivity provisions.⁸¹ The essence of this question is whether it is objectively accurate to describe a shareholder's interest as simply the right to an economic return.⁸² Again, only the courts can properly decide this issue.

⁷⁸ *Id.* at 2.

⁷⁹ Some feel that, the same danger of employing self-serving property definitions exists with state courts. They too are often accused of defining state-created property in light of their determinations of what deserves due process protection. See *Hughes v. Washington*, 389 U.S. 290 (1967) (Stewart, J., concurring); *Robinson v. Ariyoshi*, 441 F. Supp. 559 (D. Hawaii 1977) (state supreme court determination that certain water rights no longer existed held to be a "taking").

Two constraints, however, bind judicial, and not legislative, definitions. First, the courts' normal institutional role is to determine "what is," not "what should be," as the legislatures must do. Therefore, courts do not normally see themselves as acting in a policymaking capacity and are not concerned with, for example, the wisdom of certain choices concurring the state fisc. Secondly, if a state court's intent is to define property to evade the constitution, under the "constitutional evasion" doctrine, the Supreme Court will reexamine, as a federal question, such characterization's legitimacy. See *Ward v. Love County*, 253 U.S. 17, 22 (1923); *Terre Haute & Indianapolis R.R. v. Indiana*, 194 U.S. 580 (1904).

⁸⁰ In other words, the courts may not say that certain interests are "property" simply because it is wise policy to consider them so. Rather, they must justify their holding on the grounds that it is "true" that such interests are property. See Levy, *supra* note 19, at 2: "In the traditional view appellate lawmaking is unthinkable: judges are not to 'pronounce a new law, but to maintain and expound the old one.' The judge merely *finds* the preexisting law; he then merely *declares* what he finds."

⁸¹ The Hawaii Supreme Court has already given its insights into this issue in *Perl v. IU Int'l Corp.*, 61 Hawaii 622, 607 P.2d 1036 (1980).

⁸² Clearly, in a close corporation, the shareholder's interest is much more than the mere expectation of an economic return. *In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954); *Gearing v. Kelley*, 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962). For example, where the statute requires a two-thirds vote to amend the articles, a shareholder who accumulates more than one-third of the stock has acquired the ability to veto certain corporate transactions and participate in the management of the corporation.

It is conceded that at the other end of the spectrum, a shareholder's interests and expectations in a large, publicly held corporation do more closely resemble the right to an economic return. Manning, *supra* note 70. However, this contrast only brings out one more weakness in the Model Act. See generally O'Neal, *Close Corporation Legislation: A Survey and an Evaluation*, 1972 DUKE L.J. 867 (1972). The Model Act attempts to bring within its standards both publicly held corporations and closely held corporations. Yet, the nature of a

CONCLUSION

If one agrees with the assertion that corporation codes do not appropri-

shareholder's interest in these two types is clearly different. See note 71 *supra*.

Given this inclusive nature, it is important that the judiciary take an interventionist stance and develop appropriate standards for the exercise of corporate power within the context of the close corporation. The differences between the close and public corporation indicate a need to address different interests. For example, the shareholder's investment in a close corporation is a shared one, and derives much of its value to the shareholder from the investor's ability to exercise control over the corporation in a manner different from that exercised within the context of a public corporation. See generally Hetherington, *supra* note 71, at 20-25; Andre, *Louisiana Close Corporations: Problems of Control Under the Louisiana Business Corporation Law*, 45 TUL. L. REV. 259, 260-62 (1971).

Because the reality of a shareholder's interest in a closely held corporation is fundamentally different from that of a publicly held corporation, the judicial attitude in each situation should be different.

There are four sections of the Model Act which deserve special attention from the judiciary when applied to the close corporation. For example, sections 35 and 34, in conjunction, permit the incorporators to substitute direct shareholder management for the traditional board of directors through the use of shareholder agreements. Section 34 does not, however, provide any standard by which courts can determine the validity of the agreements. This raises the question of how far the judiciary should go in protecting, if at all, minority interests in the close corporation. See generally Hetherington, *supra* note 71, at 20-25.

Section 54(h) poses similar problems. Although the Model Act authorizes the imposition of restrictions upon the sales or transfers of corporate stock, it does not define valid restrictions. The only requirement is that the restriction must not be inconsistent with law. MBCA, *supra* note 1, at § 54(h). The Model Act does not elaborate further, in that section nor in any other section, on the extent or nature of permissible restrictions. By failing to qualify the provision with appropriate language or by example, as other states have done, e.g., N.J. STAT. ANN. § 14A:7-12(3) (West 1969); DEL. CODE ANN. tit. 8, § 202 (1975), the drafters have shifted the burden of developing these proper standards to the state courts.

Generally, the common law standard has been "whether the restraint is sufficiently needed by the particular enterprise to justify overriding the general policy against restraints on alienation." 12 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 5461.3 (rev. perm. ed. 1971). Although sufficiently broad to cover every possible situation the common law standard does not illuminate the necessary considerations. When the validity of these restrictions is at issue, the state courts should develop the standard in light of three major considerations: (1) the nature of the close corporation in terms of the principle of *delectus personae*; (2) the position of the minority shareholder and potential overreaching by fellow investors, Elson, *Shareholders' Agreements, A Shield for Minority Shareholders of Close Corporations*, 22 BUS. LAW. 449, 451 (1967); and (3) whether the state has any special interests to protect. *Groves v. Prickett*, 420 F.2d 1119 (9th Cir. 1970) (restrictions on alienation of shares must not unreasonably deprive a shareholder of substantial rights); *Treadway Cos. v. Care Corp.*, 490 F. Supp. 668 (S.D.N.Y. 1980) (court imposed duty on controlling shareholder to protect minority shareholder's interests); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577, 585 (1964).

Another section of the Model Act which is open to abuse in the close corporation context is section 78, which gives the board of directors the power to mortgage or pledge all the corporate assets even though the transaction is not in the usual and ordinary course of business. The board of directors is statutorily permitted to exercise this power without shareholder consent; and barring shareholder agreements providing otherwise, see note 71 *supra*, standards may be developed which are distinct from those of a public corporation. Fales, *Judicial Attitudes Towards the Rights of Minority Stockholders*, 22 BUS. LAW. 459 (1967);

ately balance shareholder protections and management powers, then the primary blame must rest with the state legislature's inability to meaningfully choose desirable policies. One proposal designed to ameliorate this state impotence is federal chartering of multistate corporations.⁸³ Such proposals, however, have not received widespread support. In the alternative, this article suggests that state courts assume primary responsibility for ensuring fairness in corporate transactions by applying common law doctrines and standards.

The proposed adoption of the Model Act in Hawaii presents two obstacles to judicial usurpation of the legislative function in corporation law. First, should the common law doctrines not explicitly retained in the Model Act be viewed as surviving its enactment, that is, *expressio unius est exclusio alterius*?⁸⁴ For example, since the Model Act does not deal with a majority shareholder's fiduciary duty to minority shareholders, does enactment of the Model Act indicate that the legislature intended to nullify this common law concept? In the cases of all corporation codes, including the Model Act, the answer should be no. The Model Act, unlike, for example, the proposed Federal Securities Codes, does not purport to be a "code" in the sense that it completely replaces the common law. The Model Act was not intended to be so comprehensive. Moreover, its purpose, as the primary purpose of all state corporation codes, is to define the corporation's powers. Its enabling provisions should not be construed as nullifying common law doctrines regarding the fairness of the use of such powers.

The second issue, whether the courts should abide by legislative attempts to explicitly abrogate common law doctrines, is more troublesome. Ordinarily, the courts should abide by the legislature's intent in construing statutes. Thus, if the legislature intends to replace a common law standard with a new statutory one, the courts should usually honor this intent. However, in applying fiduciary standards of reviewing corporate transactions for fairness, courts may ignore such attempts to nullify their equitable powers. First, the states have a residual power to "do equity" when a case is properly presented. Second, since state legislatures cannot meaningfully formulate policies in the corporate area, the ultimate responsibility to ensure fairness falls on state courts. Third, state courts have the final responsibility for defining the nature and extent of state-created property interests, including the shareholder's interest in the

see also O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978) [hereinafter cited as O'Neal, BUS. LAW.]; 33 N.Y.U.L. REV. 700 (1958). There may be instances, for example, when close corporations may have need for different standards of conduct as to what constitutes oppressive acts, misapplication or waste of corporate assets. See O'Neal, BUS. LAW., *supra*, at 884; Fales, *supra*, at 459; O'Neal & Moeling, *supra* note 71, at 732-33; Hetherington, *supra* note 71, at 1.

⁸³ See R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 15-17 (1976).

⁸⁴ See 2 J. SUTHERLAND, *STATUTORY CONSTRUCTION* 123 (4th ed. 1973).

corporation.

The Model Act has two objectives: to define corporate powers and to set forth the conditions or standards under which those powers may be fairly exercised. The first objective should be the only purpose of state corporation codes. The second objective is more ideally left to the state courts. A legislature cannot adequately anticipate all of the possible schemes and combinations that may amount to unfairness. The determination of fairness is better left to the courts, which can decide each case on its own facts. Moreover, if state corporation codes can preclude judicial scrutiny for fairness, a single state could effectively eliminate any concept of fiduciary duties. The only adequate response to such a trend would be an understanding by all state courts that the primary responsibility for enforcing fairness, state statutes notwithstanding, lies with them.

Thus, state legislatures may appropriately claim the right and responsibility of setting forth, by statute, corporate powers. Indeed, since corporations and their concomitant powers exist only by the force of state statute, it is only the legislature which can create corporate powers. But, the formulation of standards by which to judge the proper use of those powers should be left to the state courts. Since the legislature cannot prevent the courts from adopting such an attitude, the courts must simply realize that in this area there are adequate justifications for an interventionist, as opposed to a deferential posture. Indeed, absent a federal act setting fiduciary standards, a recognition of judicial responsibility in supervising corporate transactions is the only means of restoring some balance between shareholder protections and management powers.