UNEQUAL TREATMENT AND SHAREHOLDERS' WELFARE GROWTH: "FAIRNESS" V. "PRECISE EQUALITY"

BY NICOLA DE LUCA*

ABSTRACT

This article argues that a strong or rather mechanical equal treatment rule in share repurchases, distributions in kind, or capital reductions is not efficient. An economic analysis of the law shows that disparate treatment of shareholders may increase shareholders' overall welfare. Disparate treatment, however, should not result in the oppression of minorities. Rather, oppression of minorities should be prevented with the fairness standard. Fairness requires one to consider the interests of others, but not to pursue others' interests to the detriment of one's own. Unfairness is a disregard for the interests of the minorities which could be taken into consideration at no cost.

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*Assistant Professor of Business Law, Second University of Naples, Law School, and Visiting Research Scholar 2008, Yale Law School. J.D. 1997, Luiss University (Rome); J.S.D. 2003, Catania University. I would like to express my deepest gratitude to Professors Guido Calabresi, Jonathan Macey, Roberta Romano, and especially to Henry Hansmann, not only for valuable comments on earlier drafts, but above all for their kind and warm hospitality during the fall semester 2008 at Yale Law School. I am also truly grateful to Girolamo Tessuto, Associate Professor of English, Legal English and Translation, Second University of Naples, Law School, and to Ashleigh Ormsby and all editors of Volume 35 of The Delaware Journal of Corporate Law for contributing to the linguistic revision of this article. Of course, I am the only person responsible for all errors or omissions in this article. Under consent of the Journal, this article is also published in 54 Rivista delle Società 629-98 (2009).
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I. INTRODUCTION

Solvent corporations have two means of making distributions to shareholders: dividends and share repurchases. Corporations may also reduce their stated capital and reimburse to the shareholders part of their contribution of assets to the firm.1 European law does not permit "spill-outs" of assets, such as distributions of dividends or share repurchases, unless they are made out of a surplus or upon a capital reduction. American corporate law, however, generally does permit such a "spill-out" of assets.2 Both approaches have advantages and correspond to the social and economic background to which they refer.3

Still, both European and American law face a common problem related to the distribution of corporate assets that comparative legal researchers do not frequently address.4 Generally, the right to receive dividends is proportional to the amount of capital contributed to the firm. Dividends are paid upon a pro rata basis for two main reasons. First, this technique stimulates agents to perform better in the interest of their principals.5 Second, it is

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1The shareholders cannot "withdraw their share of firm assets at will, thus forcing partial or complete liquidation of the firm." Henry Hansmann & Reinier Kraakman, What is Corporate Law?: in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 7 (2004); see also John Armour et al., What is Corporate Law?, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (forthcoming 2d ed. 2009) (developing the arguments for their proposal).

2United States legislatures that have adopted the Model Business Corporation Act permit distributions out of capital (the aggregate value of the consideration paid by shareholders); EU rules, New York rules, and, to some extent, Delaware rules permit distributions only out of a surplus (equity exceeding capital value). If dividends can be paid only out of surplus, and surplus is insufficient or unavailable due to losses, a capital reduction becomes necessary. Surely, no distribution can be made if, as a result, the corporation would become insolvent, either in an equity a balance sheet sense. MODEL BUS. CORP. ACT § 6.40(c) (2008); Second Council Directive 77/91/EEC, art. 15, 1976 O.J. (L 26) 1 (EC) [hereinafter Second Directive], amended by Council Directive 2006/68/EC, 2006 O.J. (L 264) (EU); see, e.g., Edward Rock et al., Significant Corporate Actions, in THE ANATOMY OF CORPORATE LAW, supra note 1, at 149-53 (2004).

3See Luca Enriques & Jonathan R. Macey, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, 86 CORNELL L. REV. 1165 (2001) (discussing the effects of the European rules on capital formation and maintenance and proposing to replace them with the American rules); see also Nicola de Luca, Purgazione del bilancio dalle perdite e informazione preassembleare. Spunti per una riflessione intorno agli interessi protetti nelle riduzioni di capitale [Losses Write-off and Disclosure. The Case for a Review of the Interests Involved in a Capital Reduction], 35 GIURISPRUDENZA COMMERCIALE II 974 (2008) (Italy) (opposing the argument against the rule "recapitalize or liquidate" and explaining the reasons for the European rules).

4But see Luca Enriques et al., The Basic Governance Structure: Minority Shareholders and Non-Shareholders Constituencies, in THE ANATOMY OF CORPORATE LAW, supra note 1 (forthcoming 2d ed. 2009).

5See Henry Hansmann & Reinier Kraakman, Agency Problems and Legal Strategies, in
easier to raise money from the public when investors are given standardized goods that can be traded in a secondary market at a certain price. Shares granting equal dividend and voting rights (one-share, one-vote) are goods suitable for being traded in secondary markets, such as stock exchanges, at a certain price per unit. The more reliable the expectations are for pro rata distributions, the more likely the corporation will be able to issue shares and raise capital.6

Although share repurchases might be considered a kind of distribution, they make more sense upon a non pro rata basis. The same may be true for capital reductions as well. Suppose one shareholder needs cash or wishes to withdraw from a corporation. In this instance it is provable that not all shareholders would want to simultaneously sell their shares. Also, the corporation may not have enough cash to buy all of those shares at the same time and run the risk that its assets would become insufficient to run the firm. Similarly, suppose one shareholder wants to manage one of the plants of the firm and offers to purchase the plant upon the surrender of her shares (a selective reduction of the stated capital would be equivalent). Or the plant could be distributed in kind to the same shareholder, while the others would get cash pro rata. These types of transactions would be considered differently under EU and U.S. laws. As a review of case law will show, the very same issue could be resolved differently by an English or German court; a Massachusetts or Delaware court can also resolve issues differently. Indeed, when all shareholders are not treated precisely the same, some courts would question whether these transactions are permissible. But some courts would allow such transactions if they are fair. The reason for this trade-off is the uncertain necessity to comply with the principle of equal treatment of shareholders.

Articles 19 and 42 of the EU Second Directive provide the rule of equal treatment for shareholders who are in the same position.7 This rule is applicable both in the case of repurchasing the company's own shares and in capital reductions. Some U.S. courts and legal scholars also require that share repurchases follow an equal treatment rule (capital reduction has little importance in the United States). Other courts and scholars argue that corporations may treat shareholders unequally, as long as the disparate

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7See Second Directive, supra note 2, arts. 19, 42.
treatment is at least *fair*. This school of thought convincingly argues that fairness does not require precise equality.\(^8\)

This article’s main concern is to deal with these issues. Directors and—often in Europe—majorities make business decisions, and some of those decisions imply disparate treatments: for example, buying out shares from a retiring shareholder or selling a plant to one shareholder upon surrender of her shares to the corporation. In some cases, directors or majorities take personal advantage of their decisions. Perhaps a strong equal treatment rule avoids oppression of the minorities, while restricting the boards and majorities’ room to maneuver in situations where no oppression occurs. If the goal of an equal treatment rule is to avoid oppression of minorities, it should intervene only when disparate treatment is unfair. As an intermediate solution, the EU rule requires equal treatment of shareholders who are in the same position. This rule, however, is unclear and vague. Not surprisingly, the implementation of the equal treatment norm among the various European member states is highly heterogeneous, and ultimately shows a lack of confidence in its efficacy. European courts often rely on a fairness standard rather than on the equal treatment norm. American courts, such as Delaware’s, require directors and majorities to pass an entire fairness test when unequal treatment of shareholders occurs. The disparate treatment, however, is not per se unfair.

This article claims that inequalities should be permitted as long as they achieve economic results in terms of growth in shareholders’ welfare. The majority or directors make the decisions, but those decisions must meet the fairness requirement. What *fair* means and who should prove fair or unfair conduct, however, is a major issue. First of all, one must consider the fact that a repurchase of shares from some, but not all shareholders, may be fair to both those who do and do not sell their shares if the price at which the shares are purchased is fair. The price would be fair if it accurately reflects the present discounted value of all expected future distributions by the firm. How to estimate the fair value of the shares, however, is not discussed here. Rather, my concern is whether buying shares from some shareholders at a fair price may still be considered unfair because it strikes against an equal treatment rule. Therefore, fair price will always be presumed. Given this assumption, the duty of fairness does not require the best effort to satisfy the interests of minorities.

\(^8\)See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 110 (1991); *infra* Parts III.C., V.C., V.D.
As European scholars suggest, fairness requires one to consider others' interest, but not to pursue others' interest to the detriment of one's own. An oppression of the minority occurs when the directors or the majority act in bad faith or disregard the interests of minorities that could be taken into consideration at no cost. Consistent with this approach, the directors or majorities should not have the burden to prove the validity, legitimacy, or properness of the business purpose on which they rely. Nor may the courts question these issues. But, directors and majorities must disclose the purpose upon which they make their decisions, and the decisions must be reasonable.

Minorities may challenge an action, or in some cases inaction, as unreasonable. Minorities can challenge the alleged reasoning behind the directors' or majorities' actions as untrue or inconsistent with the disproportionate results achieved. Since the minority shareholder bears the burden of proof, it is not inappropriate to facilitate that duty. EU law very often requires a shareholders' meeting filter to undertake some business decisions, such as capital reductions and share repurchases, which can only be enacted upon a general meeting resolution. This requirement implies a decision-making process that helps minorities bear the burden of proof. Directors must submit a motivated proposal to the shareholder; then the shareholders must meet, discuss the proposal, and vote. The decision taken may be challenged by dissenting shareholders, and if they prove that the alleged reason is inconsistent or untrue, the court may hold the decision void or order monetary compensation.

This solution can also be substantially implemented in American case law. When courts require directors to pass an entire fairness test, directors must show a reasonable purpose for their action. I do not think that passing an entire fairness test means shifting the burden to the directors to prove the validity, legitimacy, or properness of the business purpose. Rather, as some recent cases dealing with the squeeze-out of minorities show, the disclosure of an action's purpose helps the minority to challenge its reasonableness: i.e., when the alleged reason is untrue or is inconsistent with the proposed results.

Ultimately, this article contributes to a significantly new approach in comparative law, aiming "to focus on similarities," rather than "emphasize differences." This approach may "illuminate[ ] an underlying commonality of structure that transcends national boundaries." The article is organized

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9Hansmann & Kraakman, supra note 1, at 3-4.
10Id.; see Armour et al., supra note 1.
as follows: Parts II and III provide information on common law systems (the United Kingdom, United States, and Australia) and report the most significant case law on the topic; Part IV draws a general overview of the equal treatment norm provided under the EU directives and the implementation laws of the member states; Part V considers the economic foundation of an equal treatment norm; Part VI challenges its findings and suggests a different pattern of inquiry; Part VII develops the economic arguments by providing that the fairness standard prevents oppression of minorities; and Part VIII states the conclusion.

II. CAPITAL REDUCTION AND SELECTIVE PURCHASE OF SHARES UNDER (ANCIENT) ENGLISH CASE LAW: "EQUALITY V. FAIRNESS"

The first case in which the issue of equal treatment of shareholders in corporate distributions was brought before a court demonstrates the notion that, while equal treatment and fairness are bound concepts, they are not necessarily synonymous. Since the late nineteenth century, English case law has clearly recognized that a capital reduction should treat all shareholders fairly and equitably, especially if different classes of shares are involved.11 The courts do not allow themselves, however, to consider the reason for, or extent of, a capital reduction12 or how the reimbursement should be

11Three leading cases: Trevor v. Whitworth, (1887) 12 App. Cas. 409, 415 (H.L.); In re Denver Hotel Co., [1893] Ch. 495, 500; British & Am. Tr. & Fin. Corp. v. Couper, [1894] A.C. 399 (H.L.). On disparate treatment of different classes of shares, see Poole v. Nat'l Bank of China Ltd., (1907) 23 T.L.R. 567 (H.L.); In re Floating Dock Co. of St. Thomas, [1895] Ch. 691, 692 (discussing the allocation of losses in the presence of preferred shares). In Poole, a British bank having capital expressed in British pounds operated in Hong Kong in U.S. dollars; the Bank suffered losses due to devaluation and decided to recover the losses by extinguishing all founders' shares and part of the ordinary shares. 23 T.L.R. at 567. Two minority shareholders of founders' class claimed that: (1) the reduction had not been confirmed by a founders' special resolution and (2) that the reduction would be unfair and unequal for the different classes of shares. The court dismissed the opposition by rejecting that the reduction could be considered unfair. Id. In Prudential Assurance Co. v. Chatterley-Whitfield Collieries Co., [1949] 1 All E.R. 1094, a company, due to the nationalization of the coal industries, passed a resolution for reduction of capital in excess of the wants of the company, to reimburse only holders of preferred shares. Id. Indeed, the holders of ordinary shares would undertake more risky activities in which they would not involve holders of preferred stock. Id. The House of Lords, nevertheless, upheld the capital reduction. Id; see also In re N. Eng'g Indus., Plc., (1994) 2 B.C.L.C. 618, 625 (stating that all classes of shares were to vote separately in a reduction to zero).

12For example, a reduction aiming to avoid nationalization or minimize the taxation has been considered legitimate. See Ex parte Westburn Sugar Refineries, Ltd., [1951] All E.R. 881, 884 (H.L.); David Bell Ltd., [1954] S.C. 33. In Caldwell & Co. v. Caldwell, [1916] S.C. 120, 124 (H.L.), it was said that the courts have the power to check if the losses are effective, as this would interfere with the right of creditors to make an opposition. Recently, in In re Hunting Plc. [2004] EWHC 2591 (Ch.), it was also made clear that it is not necessary to show that the capital is in excess
implemented. In British & American Trustee & Finance Corp. v. Couper (BA Trustee), a company incorporated under English law operated in Britain and the United States. The shares were divided between two groups of shareholders, as was the board; the majority was British, and the minority was American. Because of the U.S. part of the business, the company faced a deadlock and the shareholders agreed to a substantial split or spin-off. Since no such reorganization was provided for under English law, they agreed to reduce the legal capital to the extent that it was "in excess of the wants of the company." The company implemented the reduction by allocating the U.S. assets to the American shareholders. Both the general meeting and the special-class meetings (ordinary's and founders') approved the proposal. As English law still requires, the proposal was subsequently subjected to the court's approval. One shareholder appealed, claiming that a capital reduction cannot affect only part of the shares of a single class. He argued that it was forbidden to allot parts of the company's assets to some shareholders; the reimbursement should be the same for all. The House of Lords did not follow this view and confirmed the reduction plan. In doing so, the House of Lords faced the ambiguous and contradictory solutions offered by two earlier cases on share repurchases—Trevor v. Whitworth.
and *In re Denver Hotel Co.* It recognized the legitimacy of a reduction or a selective purchase of the company’s own shares affecting all shareholders unequally. The court will uphold such a resolution not only when all shareholders agree, but also if a majority passes a resolution authorizing a selective reduction or purchase of the company’s own shares. The court may confirm it, believing that the minority shareholders are treated fairly even if they are not necessarily treated equally.

The trend beginning in early English case law was further articulated by U.S. courts stating that equality and fairness are not synonymous. In other words, a corporation may treat shareholders differently to the extent that the treatment meets the requirement of fairness. Eventually, English statutory law strengthened minorities’ protection in selective buybacks, by prohibiting the shareholder whose shares will be purchased from voting.  

(by questioning whether a company can buy her own shares and, in the affirmative case, whether she can do it only from a single shareholder. *Id.* The court, after lengthy arguments, concluded that the purchase of the company’s own shares is to be considered ultra vires; in any case, it may be limited to some shareholders. *Id.* at 436 (per Lord Macnaghten).

*23*[1893] Ch. 495. In *In re Denver Hotel Co.*, the House of Lords distinguished *Trevor*, by affirming that a company has power to reduce its capital and to accept surrenders of its shares that are fully paid up, but is forbidden to purchase its own shares. *Id.* The company passed a special resolution that the nominal capital of the company should be reduced by paying off the capital represented by the shares of shareholders willing to run one of the two hotels managed by the company and by extinguishing the liability thereon. *Id.* at 495-96. The resolution was not confirmed at first instance, on the grounds that although no opposition of the creditors or of shareholders was made, the agreement still was not unanimous, since almost one-seventh of the whole number of shareholders—not an insignificant minority—did not give their consent. *Id.* at 501-03 (per Judge North). *But see In re Quebrada Ry., Land & Copper Co.*, (1889) 40 Ch.D. 363, 366 (stating that it is irrelevant that an insignificant minority does not give explicit consent). Reversing Judge North’s decision, in *In re Denver Hotel*, the House of Lords expressed itself somewhat ambiguously, considering that a sale of assets is a normal transaction and does not require the approval of the court. *In re Denver Hotel*, [1893] Ch. at 505. Moreover, the surrender of shares, although linked to such a transaction, is not a purchase of shares. "The surrender of them is pure gain to the company." *Id.*

*24*See Companies Act, 2006, c. 46, § 695(3) (Eng.). The general rules on purchases of a company’s own shares are provided by under sections 658-676 of the Companies Act. *See id.* §§ 658-76. A limited company "may only purchase its own shares (a) by an off-market purchase, in pursuance of a contract approved in advance in accordance with section 694; (b) by a market purchase, authorised in accordance with section 701." *Id.* § 693. A purchase is "off-market" if the shares either (a) are purchased otherwise than on a recognised investment exchange, or (b) are purchased on a recognised investment exchange" under part 18 of the Financial Services and Markets Act 2000 "but are not subject to a marketing arrangement on the exchange." *Id.; see Financial Services and Markets Act, 2000, c. 8, §§ 285-312 (Eng.). All listed companies are subject to a marketing arrangement under Part 6 of the Financial Services and Markets Act 2000. *See Financial Services and Markets Act, 2000, c. 8, §§ 72-103. An off-market purchase needs an authorization from the general meeting (and for PLCs must be implemented within eighteen months). As pointed out in the text, pursuant to section 695(3) of the Companies Act:

Where the resolution is proposed at a meeting of the company, it is not effective if—(a) any member of the company holding shares to which the resolution relates
And since 1968 The City Code on Takeovers and Mergers has provided a General Principle under which all shareholders of the same class must be treated similarly by an offeror, including the issuer. This rule has been of great importance to the evolution of British capitalism towards capital market efficiency and fragmented ownership.

III. THE EQUAL OPPORTUNITY RULE UNDER AMERICAN CASE LAW: "MANAGEMENT-FRIENDLY APPROACH V. MINORITY-FRIENDLY APPROACH"

American case law also faces the problem of equal treatment of shareholders, especially with respect to purchases of a company’s own shares. The problem of equal treatment is exacerbated by the fact that directors of American corporations are entrusted with all distribution exercises the voting rights carried by any of those shares in voting on the resolution, and (b) the resolution would not have been passed if he had not done so.

Companies Act, 2006, c. 46, § 695(3). For private companies, see id. § 717.


26 See Julian Franks et al., Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 581, 585 (Randall K. Morck ed., 2007) (“The Takeover Panel was established in 1968. Its first rules included mandatory bid and equal price requirements ensuring that offers would be made at the same price to all shareholders once 30 percent of a target had been purchased.”).

27 As will be better explained further on, equal treatment of shareholders and equality among shares are not synonymous concepts. States’ statutes do not provide the shareholders with an explicit right to equal treatment. Compare 805 ILL. COMP. STAT. ANN. 5/7.35 (2004) (granting that the general meeting’s chairman will act with impartiality and fairness to all the shareholders through appointed inspectors), with MODEL BUS. CORP. ACT § 7.08(c) (2008) (imposing only a duty of fairness). See also 805 ILL. COMP. STAT. ANN. 5/7.75 (providing each shareholder with the right to examine the corporation’s books). Equality among shares consists generally of equality of voting powers, pro rata dividends, and preemptive rights: it is unclear whether the principle of equality among shares is a default rule. Not all statutes provide a one-share, one-vote default rule. But see, e.g., 805 ILL. COMP. STAT. ANN. 5/7.40. But, pro rata dividends are generally the default rule. See, e.g., MODEL BUS. CORP. ACT § 12.01(4) (permitting pro rata distributions of assets to the holders of one or more classes or series of the corporation’s shares). Share dividends may be distributed, however, to only some classes. See id. § 6.23(a). On the contrary, no preemptive rights are granted by statutes unless the articles so provide. See, e.g., id. § 6.30; DEL. CODE ANN. tit. 8, § 157 (2001). Another general default rule is that "all shares of a class or series must have terms, including preferences, rights, and limitations, that are identical with those of other shares of the same class or series." MODEL BUS. CORP. ACT § 6.01(a); see also 805 ILL. COMP. STAT. ANN. 5/6.10. One relevant exception is provided for under the Delaware Corporate Code. See DEL. CODE ANN. tit. 8, § 151(b) (2001) being allowed to redeem single shares of a same class). Although some statutes grant equality among shares, the courts are still the ones to decide whether such a principle should be enforced. See, e.g., Grover v. Simmons (In re Sealand Corp. S’holders Litig.), 642 A.2d 792, 799 (Del. Ch. 1993); Bank of N.Y. Co. v. Irving Bank Corp., 536 N.Y.S.2d 923 (Sup. Ct. 1988).
policies, whereas EU directives require member states to provide a shareholders' meeting filter in their statutes.28

A. Buyback and All Holders Rule

The buyback of shares under U.S. law is widely discussed. It raises a problem of equal treatment, or equal opportunity, especially when (1) the corporation aims to freeze out or squeeze out a minority shareholder (or carry out a going-private transaction), or (2) when, failing a market for shares, a buyout is the only tool that allows minorities to be cashed-out.29

Following the famous Delaware case—Unocal Corp. v. Mesa Petroleum Co.,30—the SEC passed the so-called all holders rule which requires all publicly held corporations, as well as bidders, to make an offer to all shareholders and to pay the same price for their shares.31 This rule, which is

28See James D. Cox, Equal Treatment for Shareholders: An Essay, 19 CARDOZO L. REV. 615, 633 (1997) (arguing that if similar operations "were effected through an amendment of the articles of incorporation, the adversely affected stockholders would have received a class vote and, in many states, dissenters would be accorded an appraisal remedy").

29Various techniques achieve minority squeeze-outs or freeze-outs under U.S. law. See generally James D. Cox & Thomas Lee Hazen, Cox & Hazen ON CORPORATIONS § 23.03, at 1404 (2d ed. 2003); 1 ROBERT B. THOMPSON, O'NEIL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 3:1, at 3-2 (Supp. 2008); Victor Brudney & Marvin A. Chirelstein, A Restatement of Corporate Freezouts, 87 YALE L.J. 1354, 1356 (1978) [hereinafter Brudney & Chirelstein, Corporate Freezeouts]; Victor Brudney & Marvin A. Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 324 n.56 (1974) [hereinafter Brudney & Chirelstein, Fair Shares]; Edward F. Greene, Corporate Freeze-Out Mergers: A Proposed Analysis, 28 STAN. L. REV. 487 (1976) (discussing three different types of mergers which freeze out the minority stockholders of the acquired corporation). European law is generally more protective. In fact, shareholders cannot be cashed-out through reverse stock splits or mergers, particularly because of Article 3(a) of the Third European Directive. See Council Directive 78/855/EEC, art. 3, 1978 O.J. (L295) 36, 37 (EC) (permitting "a cash payment, if any, not exceeding 10% of the nominal value of the shares so issued or, where they have no nominal value, of their accounting par value"). The right to squeeze out is granted by Article 15 of the Thirteenth Directive. Pursuant to Article 15:

Member states shall ensure that an offeror is able to require all the holders of the remaining securities to sell him/her those securities at a fair price. Member states shall introduce that right in one of the following situations: (a) where the offeror holds securities representing not less than 90% of the capital carrying voting rights in the offeree company, or (b) where, following acceptance of the bid, he/she has acquired or has firmly contracted to acquire securities representing not less than 90% of the offeree company's capital carrying voting rights and 90% of the voting rights comprised in the bid. In the case referred to in (a), member states may set a higher threshold that may not, however, be higher than 95% of the capital carrying voting rights and 95% of the voting rights.

Thirteenth Directive, supra note 25, art. 15.

30493 A.2d 946 (Del. 1985).

similar to that in the United Kingdom and all other EU member states, aims to protect the market and all investors. It does not, however, affect closely held corporations and sales of control blocks. When those are involved, equal treatment of shareholders becomes a significant issue.

B. The Donahue Doctrine

In *Donahue v. Rodd Electrotype*, a minority shareholder, Donahue, sued the directors for breach of fiduciary duties for having purchased the company's own shares from only one of the existing shareholders, Rodd.32 This Supreme Judicial Court of Massachusetts decision is followed by some state courts, but not by Delaware. In this case, a parent company offered to its employees, Rodd and Donahue, an opportunity to purchase its subsidiary's shares (both employees took advantage of the opportunity and of the 1,000 outstanding shares, Rodd acquired 200 shares and Donahue acquired 50 shares).33 Later, Rodd and Donahue achieved independence from the parent company by buying all of the remaining shares on behalf of the subsidiary, now Rodd Electrotype.34 Rodd donated most of his shares to his three children, who became directors.35 At the time of Rodd's retirement due to his poor health, the company repurchased the remaining block of Rodd's stock at a fair price.36 The company refused, however, to repurchase any shares from Donahue's widow at that price, suggesting instead a threat to freeze out the widow in an effort to induce her to sell her shares to the company at a lower price.37

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33 *Donahue* distinguishes *Spiegel v. Beacon Participations, Inc.*, 8 N.E.2d 895 (Mass. 1937). In *Spiegel*, the Supreme Judicial Court of Massachusetts stated that a buyout of shares is not ultra vires, and it is not oppression of the minority, as long as the shares are purchased out of surplus. 8 N.E.2d at 913. The remaining shareholders, in fact, increase their participation and will benefit from a greater liquidation. *Id.* at 914; *see also* *Comolli v. Comolli*, 246 S.E.2d 278, 281 (Ga. 1978) ("The minority stockholder has an interest in the liquidity of the corporation. He looks to the earned surplus for payment of dividends.").
34 *Donahue*, 328 N.E.2d at 509.
35 *Id.*
36 *Id.* at 510.
37 *Donahue*, 328 N.E.2d at 511.
The Supreme Judicial Court of Massachusetts held that Rodd's children breached their fiduciary duties as directors. The court held that if there is no market for the shares of closely held corporations, then the corporation should be considered a partnership. In a partnership, "a partner who feels abused by his fellow partners may cause dissolution by his express will . . . at any time." The court announced, in effect, a formal equal treatment rule in share repurchases for closely held corporations. This goes far beyond partnership law, which has no such formal rule but simply imposes a strict standard of conduct for fiduciaries. The court based its decision on the idea that the majority shareholder cannot use his or her power to obtain disproportionate benefits. Therefore, the oppressed minority is entitled to compensation or to claim the invalidity of the shares' repurchase. Consequently, either Rodd Electrotype had to equally buy shares from Donahue's widow or Rodd had to pay back what he had received for the purchase of his shares.

C. The Nixon Doctrine

While some courts follow the Donahue doctrine, even for corporate control transactions, Delaware took a very different approach in Nixon v.

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38 Id. at 520.
39 Id. at 514-15.
40 Id. at 514 (internal quotations omitted).
41 See Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928).
43 Donahue, 328 N.E.2d at 518.
44 Id. at 520-21.
45 See Comolli v. Comolli, 246 S.E.2d 278, 281 (Ga. 1978). Three brothers (Felix, Louis, and Mario) held substantially equal shares of a family corporation. Id. at 279. Louis and Mario froze-out Felix, see Comolli v. Comolli Granite Co., 211 S.E.2d 750 (Ga. 1975), but Mario died prematurely. Comolli, 246 S.E.2d at 279. Felix offered his brother's widow to buy her shares at fair price, but she refused. Id. Louis, not having enough cash to buy himself all his brother's widow's shares, agreed with her to buy only ten shares, at the same price Felix had offered. Id. The remaining 240 shares were bought back by the corporation. Id. The Georgia Supreme Court held Louis liable for breach of fiduciary duties towards Felix. Id. at 280-81. Citing Donahue, the purchase of the shares was considered void. Id. at 281; see also United Parts v. Tillis, 432 So. 2d 674, 674-75 (Fla. Dist. Ct. App. 1983) (holding that minority shareholders were also entitled to interests; minority shareholders brought a successful action to compel board of directors to purchase a proportionate number of their shares as were purchased from majority shareholders).
46 See Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir. 1955). Perlman was strongly criticized in Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 716-18 (1982). The facts of Perlman are, however, very relevant, since the buyer of the shares was not only planning to take over control, but also to act in self interest and to the detriment of the corporation and the minority shareholders. Compare id. (Easterbrook & Fischel's analysis), with Robert. W. Hamilton, Private Sale of Control Transaction: Where We Stand Today, 36 Case
Blackwell, as did Massachusetts just one year after Donahue in Wilkes v. Springside Nursing Home, Inc. In Nixon, minority shareholders alleged that the directors breached their fiduciary duty by enacting a share repurchase plan and a life insurance program that only applied to employee-shareholders. The plaintiff, Blackwell, complained that the plan for stock options provided only employee-shareholders with the right to receive dividend shares and the option at retirement to sell their shares back to the company. Blackwell was not an employee and was not otherwise protected by the articles, bylaws, or stockholder agreements. Blackwell claimed that the corporation owed a duty to make an equal offer to all shareholders under the same terms and conditions. The Delaware Supreme Court, relying on different legal scholars and reasoning than the

W. RES. L. REV. 248, 256-59 (1985). See also Calvert v. Capital Sw. Corp., 441 S.W.2d 247, 257 (Tex. Civ. App. 1969) (stating that a shareholder dissenting from certain corporate actions may demand payment for fair value of his shares). For the opposite approach, see, for example, Clagett v. Hutchinson, 583 F.2d 1259, 1264 (4th Cir. 1978), a Maryland-law case stating that an equal opportunity rule, if applied, would result in the stifling of many financial transactions due either to a purchaser's inability to purchase the additional shares, or from a lack of inclination to purchase those shares. If not applying Donahue in a control block sale, see Kennedy v. Titcomb, 553 A.2d 1322, 1323-24 (N.H. 1989). See also Haberman v. Murchinson, 468 F.2d 1305, 1312-13 (2d Cir. 1972) (agreeing with Christophides v. Porco); Christophides v. Porco, 289 F. Supp. 403, 404-05 (S.D.N.Y. 1968) ("A majority or controlling stockholder is under no duty to other stockholders to refrain from receiving a premium upon the sale of his stock which reflects mere the control potential of that stock."); Ferraioli v. Cantor, 285 F. Supp. 354, 356 (S.D.N.Y. 1967); Ritchie v. McGrath, 571 P.2d 17 (Kan. Ct. App. 1977) (holding that directors do not breach fiduciary duties "by inviting some but not all of the minority shareholders to join with them in a sale at a premium price").

48626 A.2d 1366, 1376-78 (Del. 1993); see also Toner v. Balt. Envelope Co., 498 A.2d 642 (Md. 1985) (stating that a refusal of equal opportunity is not a per se breach of fiduciary duty); Delahoussaye v. Newhard, 785 S.W.2d 609, 609-14 (Mo. Ct. App. 1990) (affirming the legitimacy of buying shares from challenging shareholders in order to reduce dissent).

49353 N.E.2d 657 (Mass. 1976). The summary before the case in the North Eastern Reporter Second Series describes the action as, "Minority shareholder in close corporation brought action for declaratory judgment against majority shareholders for breach of incorporation agreement and breach of fiduciary duty." Id. at 657. For over fifteen years, the corporation never paid dividends but rather provided return to its shareholders in the form of salary. Id. at 659-61. The Supreme Judicial Court of Massachusetts held that in a close corporation, majority shareholders owe a duty of utmost good faith and loyalty in their dealings with a minority shareholder. Id. at 661. The court also found that the majority shareholders did not show a legitimate business purpose for removing the minority shareholder from payroll or for refusing to reelect him as a salaried officer and director. Id. at 663-64. "[B]y terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment." Id. at 662-63. The court did not, however, apply an equal treatment rule and remanded the case to the trial court for a determination of damages. Id. at 663-65.

50Id. at 1369-71.

51Id. at 1373.

52Id. at 1377.
Massachusetts Supreme Judicial Court in *Donahue*,\(^{53}\) dismissed the claim by affirming that "stockholders need not always be treated equally for all purposes."\(^{54}\) The court affirmed that fairness does not necessarily require precise equality and held that the selective purchase of shares on the basis of a stock option plan fulfills the board's duty under an entire fairness test.\(^{55}\) Generally, a legitimate business purpose, such as a stock option plan for employees, meets the fairness requirement and will pass the entire fairness test.\(^{56}\)

D. *Developments of Nixon and the Reverse Stock Splits Cases*

Modern American courts must decide whether to follow a management-friendly approach, as Delaware does, or a minority-friendly approach, as Massachusetts does.\(^{57}\) New York courts have found a compromise and follow an intermediate approach.\(^{58}\) Many cases are relevant. In *Hollis v. Hill*,\(^{59}\) a case similar to *Donahue*, the Fifth Circuit,

\(^{53}\)Nixon, 626 A.2d at 1377 (citing Easterbrook & Fischel, *supra* note 46, and holding that the stock option plan was not unfair). *Compare id.*, with *Donahue v. Rodd Electrotype Co. of New Eng., Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) (citing different scholars, namely Brudney & Chirelstein, *supra* note 29, at 515 n.19).

\(^{54}\)Nixon, 626 A.2d at 1377.

\(^{55}\)Id.

\(^{56}\)Delaware courts, allowing boards to show that their behavior is in good faith, do not strictly require the demonstration of a legitimate business purpose in minority freeze-outs. *See*, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *see also* Lerner v. Lerner Corp., 750 A.2d 709, 721-23 (Md. Ct. Spec. App. 2000) (discussing at length the rationale behind whether a court should look for a legitimate business purpose in the context of a minority freeze-out); *infra* note 71 and accompanying text. *But see Tooley v. AXA Fin., Inc.*, No. 18414, 2005 WL 1252378, at *5 (Del. Ch. May 13, 2005) (holding that a delay in the decision to accept a tender offer by the majority shareholders at the expense of the minority shareholders was (barely) sufficient proof to rebut the business judgment rule in overcoming a Rule 12(b)(6) motion to dismiss).


\(^{58}\)New York courts use a standard that considers the reasonable expectations of the shareholder in determining the oppressive conduct. *See*, e.g., *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1137, 1177-80 (N.Y. 1984) (explaining New York law); *see also* Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695-96 (Sup. Ct. 1947) (explaining that New York courts will examine whether the majority position's action was in good faith to determine breach of fiduciary duty to minority stockholders); *infra* note 159 and accompanying text.

\(^{59}\)232 F.3d 460, 471 (5th Cir. 2000).
applying Nevada law, decided over dissent that the corporation, not the majority, should purchase all the shares of an oppressed minority. 60 In Frank v. LoVetere, 61 however, the District Court for the District of Connecticut, influenced by Nixon’s rationale, did not recognize a legitimate business purpose, and instead found that the plaintiff had "stated a valid claim for unequal treatment based on the malice or ill will of the [directors]." 62

The Nixon/Donahue doctrines have surfaced in many significant cases involving reverse stock splits that have resulted in substantial squeeze-outs of minority stockholders. In Applebaum v. Avaya, Inc., a company listed on the New York Stock Exchange passed a resolution to effectuate a stock split immediately followed by a reverse stock split. 63 The purpose of this double transaction was to reduce the number of shareholders in order to relieve the corporation of several million dollars in administrative costs. 64 Shareholders with any number of shares below the exchange ratio would be bought out for cash. 65 Shareholders managing to retain at least one whole share of stock would also maintain any fractional shares. Fractional shares, however, would disappear when the forward stock split was enacted. 66 This disparate treatment was challenged by one shareholder who possessed twenty-seven

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60Id.
62Id. at 340; see also Crosby v. Beam, 548 N.E.2d 217, 220-21 (Ohio 1989) (using the Donahue standard to find a right of action for minority shareholders alleging a breach of fiduciary duty against the majority shareholders).
64Applebaum, 812 A.2d at 883.
65Id. at 883-84.
66Id. at 884.
shares. The Delaware Supreme Court dismissed the claim, and in doing so, carved out a fundamental principle. Disparate treatment is not prohibited by law, and although the principles of equity allow courts to intervene when technical compliance with a statute produces an unfair result, "equity and equality are not synonymous concepts." Furthermore, under Delaware law, courts cannot create a safeguard against shareholder inequality that does not exist in a statute. In this instance an equitable remedy was not necessary because the proposed transaction was designed in good faith to accomplish a rational business purpose—saving the corporation transaction costs.

In *Lerner v. Lerner Corp.*, the court discussed whether a proper business purpose was required to allow a reverse stock split. In *Lerner*, two brothers agreed that the majority shareholder brother would run the company and the other would receive dividends each year. The company ran smoothly for many years until the majority shareholder decided to effectuate a reverse stock split. This act would reduce his brother's holdings to a fraction of one share and would be cashed out at fair value. The plaintiff argued that there was no valid business purpose for the reverse stock split. The corporation argued that a valid business purpose did exist because dividends had to be paid to the stockholders each year, which limited the ability of the corporation to retain profits for working capital. The court concluded that a reverse stock split aimed towards freezing out a minority shareholder was not per se unfair and did not require the existence of a proper business purpose. Although using a different burden of proof, a well-known Australian case adopted a similar solution in discussing the legitimacy of a call-clause used to squeeze out minority shareholder, which was adopted by resolution at a company's general meeting.

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67 Id. at 885.
68 Applebaum, 812 A.2d at 886-87.
69 Id.
70 Id.
71 Id.
73 Id. at 711.
74 Id.
75 Id. at 712.
76 Lerner, 750 A.2d at 712.
77 Id. at 722-23.
78 Gambotto v. WCP Ltd. (1995) 182 C.L.R. 432, 444-48 (Austl.). In Gambotto, the majority shareholder, holding 99.7% of the shares of WCP Ltd. passed a call-clause providing shareholders holding more than 90% of the shares in the company the power to buy out all the remaining outstanding shares. Id. at 437. After a very troubled path through the courts of first instance (the court of appeals reversed the district court's decision), the High Court of Australia reversed the court of appeals' decision and stated that "an alteration of articles of association so as
E. Summary

English common law quickly overcame the value of formal equality, entrusting the principle of fairness with the role of providing a benchmark for unequal treatment.\(^7\) Common law courts have found that unequal treatment of minority shareholders is permissible, not only under the consent of the minority, but also if the majority's consent is denied without an adequate reason.\(^8\) An English common law court's approval of this type of transaction depends on whether the unequal treatment meets the requirement of fairness.\(^9\) Either the majority must show that the unequal treatment is fair, or the minority must show it did not consent because the proposed action is unlawful or may harm the minority without reason.\(^10\) BA Trustee found both these tests valid without explaining which of the two is of greater importance.\(^11\)

The two opposing schools of thought followed by American courts make the American solution unclear. In both Donahue and Nixon the facts allow for a similar solution without requiring the courts to affirm or reject a general principle of equal treatment. Applying either standard to these seminal cases, the Rodd children were reasonably unfair to Donahue's widow,\(^12\) and the Blackwell brothers were in a different position with respect to the retiring employees.\(^13\) In both cases, however, the courts seized the opportunity to declare their doctrinal, and perhaps political, orientation as to confer upon the majority power to expropriate the shares of a minority may be exercised lawfully only if (a) it is exercisable for a proper purpose and (b) its exercise will not operate oppressively in relation to minority shareholders." \(^{14}\) Id. at 432. The burden of proof for both conditions lies with the majority. \(^{15}\) Id. at 447. Since the majority did not present sufficient evidence to prove that the company derived any particular advantage by freezing out the minority, the court in Gambotto decided in favor of the minority and voided the amendment to the articles of association passed by the majority. \(^{16}\) Id. at 448.

\(^7\) See supra note 11 and accompanying text.
\(^8\) See supra note 23 and accompanying text.
\(^9\) See supra note 23 and accompanying text.
\(^10\) See supra notes 11-23 and accompanying text.
\(^11\) See supra notes 14-23 and accompanying text.
\(^12\) See Donahue v. Rodd Electrotype Co. of New Eng., Inc., 328 N.E.2d 505, 510-11 (Mass. 1975); EASTERBROOK & FISCHEL, supra note 8, at 247 (criticizing the Donahue holding and suggesting that the court's holding in Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976) provided a more well reasoned approach to this issue); see also STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 816-21 (2002) (comparing and broadly criticizing the Massachusetts "(in)famous line of cases").
\(^13\) See Nixon v. Blackwell, 626 A.2d 1366, 1377 (Del. 1993); Robert A. Ragazzo, Toward a Delaware Common Law of Closed Corporations, 77 WASH. U. L.Q. 1099, 1128-30 (1999) (criticizing the Nixon holding). For a strong criticism of Nixon, see Cox, supra note 28, at 616, which argues that "[o]ne can easily get lost in a vast semantical battle under Nixon's approach to fairness, where qualities unrelated to the share terms are considered in evaluating how value is to be distributed among the owners."
permitted in common law systems. These political bills are relevant in the market among states for a corporate charter. This adds to the widespread belief that the prevalence of Delaware in corporate law is not due to the letter of the statute, but to other factors, including the liberal attitude of the courts, which follow a laissez-faire policy that refuses mandatory solutions not arising from the contractual equilibrium among equal parties. 86 The rationale of Nixon, and its developments in Applebaum and Lerner, is certainly emblematic of this attitude. It is still unclear whether the business purpose is relevant,87 what exactly the rule of fairness requires, and which party should prove fair or unfair behavior.

IV. THE PRINCIPLE OF EQUAL TREATMENT OF SHAREHOLDERS IN EUROPE

Unlike U.S. courts and older United Kingdom cases, EU member states' legislators and courts must follow an equal treatment rule with respect to share repurchases and capital reductions. Article 42 of the Second Directive, concerning reductions and increases of capital in particular, states that "the laws of the member states shall ensure equal treatment to all shareholders who are in the same position." 88 Amended in 2006, Article 19 of the Second Directive also provides that share repurchases shall be enacted "without prejudice to the principle of equal treatment of all shareholders who are in the same position." 89 Article 15 of the Second Directive concerns dividends and does not refer to either the equal treatment rule or the pro rata


88Second Directive, supra note 2, art. 42. Article 42's language is surprisingly broader than expressed in the Preamble, which appears to be concerned with an increase or reduction of capital: Whereas it is necessary, having regard to the objectives of Article 54(3)(g), that the Member States' laws relating to the increase or reduction of capital ensure that the principles of equal treatment of shareholders in the same position and of protection of creditors whose claims exist prior to the decision on reduction are observed and harmonized.

Id.

89Id. art. 19.
distribution rule. The pro rata distribution rule does, however, exist under all EU member states' laws (with exceptions set forth under section 60 AktG). The European equal treatment rule is weaker, and somewhat more ambiguous, than the one fashioned by the Supreme Judicial Court of Massachusetts. Its enforcement actually requires one to specify the meanings of equal treatment and same position.

The EU member states that have implemented the European equal treatment rule apply it in three different ways. Those member states that have not implemented the rule permit courts to decide upon general principles. First, in Germany, as well as in Holland and Austria, the European rule was incorporated into the Stock Corporation Act (Aktiengesetz) as a general clause. This clause adopted the exact language of Article 42 Second Directive. Spain followed suit in 2009. Case law, however, is very limited and where inequities occur the principle of equal treatment is very rarely addressed. Commentators and courts generally refer to the general principle of fairness, of which the equal treatment rule is considered an expression. Second, France and Belgium, with very different approaches, arrive at similar results. In this group, the equal treatment rule is not a general principle. It only applies to capital reductions, "capital redemption," and share repurchases, if the shares must be cancelled. The rule is expressed in the negative, prohibiting unequal treatment of shareholders, rather than ensuring equal treatment. This rule also has a strong deterrent effect because it provides criminal liability for a breach thereof. But because this application allows limited room for interpretation, no case law arises. French commentators, however, criticize this choice. Third, in Spain and Portugal, unequal treatment of shareholders in share repurchases or capital reductions is permitted. The law, however, requires that when

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90See id. art. 15.
91The German law allows non-equal distribution of dividends under certain circumstances. First of all, section 60(2) of the German Stock Corporation Act permits dividends to be paid on non pro rata basis if not all shareholders have fully paid-up their subscribed shares. Aktiengesetz [German Stock Corporation Act] [AktG], Sept. 6, 1965, BGBl. I, § 60(2), translated at http://www.doingbusiness.org/documents/lawlibrary/Germany-stock-corporation-law/. Second, section 60(3) AktG also allows non pro rata distributions upon a majority shareholders' meeting's resolution, if the charter provides accordingly. Id. § 60(3). This rule encourages incumbent shareholders to subscribe an increase of capital necessary to provide fresh financial support to a new venture. Actually, the company may grant to the new issued shares a greater dividend, notwithstanding the new issue does not create a new class of shares. See generally Götz Hueck, Der Grundsatz der gleichmäßigen Behandlung im Privatrecht [The Principle of Equal Treatment in Private Law] 48 (1958); Uwe Höffner, § 53a, Aktiengesetz [Stock Corporation Act] 288 (8th ed. 2008) (citing other references therein).
92See infra Part IV.C.
disparate treatment occurs, the shareholders (or classes of shares) who are affected differently must confirm the general meeting's resolution by majority vote. Interesting case law shows the weaknesses and virtues of this solution. Also, the new rule of equal treatment of shareholders introduced in 2009 will certainly interfere with future case law. Finally, Italy and the United Kingdom did not implement the rule of equal treatment of shareholders in the Civil Code or the Companies Act. These two countries permit courts to decide upon general principles. Italian and English courts, however, decide similar cases in a very different way.

A. The EU Second Directive and the Principle of Equal Treatment of Shareholders

EU corporate law requires a much higher level of involvement from shareholders at the general meeting than American corporate law. In European corporate law, reduction of capital, share repurchases, and dividend distributions are decided by the general meeting (insisted by a proposal from the board of directors). For several reasons, the repurchase of shares that are not cancelled may not be considered a distribution. Additionally, some rules affecting the decision-making process increase the level of protection of minority shareholders. Thus, the EU rules substantially avoid the ex post intervention of an equal treatment rule.

One may not fully understand the importance of the EU equal treatment rule without knowing which rules are relevant to share repurchases and capital reductions; these rules differ significantly from the U.S. rules. First, "where there are several classes of shares the decision by the general meeting . . . shall be subject to a separate vote, at least for each class of shareholders whose rights are affected by the transaction." This rule is applicable both to capital reductions and share repurchases (if the shares must be cancelled), but it is implemented differently by member states. Suppose that a company wants to repurchase and cancel a certain number of shares and there are two classes outstanding: class A, common stock; class B, preferred stock. Under German and French law, after the general meeting has passed the resolution, two special meetings (the common stockholders' and the preferred stockholders') must always be called. Both must confirm the general meeting's resolution, otherwise it is ineffective. Under English, Italian, or Spanish law, separate meetings take place only when classes' rights are "affected" or "prejudiced"—for example, only if common stock

93Second Directive, supra note 2, art. 31.
class A or preferred stock class B is to be repurchased. This rule requiring a
double majority vote allows disparate treatment among different classes of
shares, but avoids inequities. The double majority rule, however, does not
cover disparate treatment among shareholders of the same class (except in
Spain and Italy, as will be shown). Also, it does not cover substantial (but
non-formal) disparate treatment. Application of the equal treatment rule
has been limited to these cases (cases have arisen in Germany and the issue
has been discussed by French commentators).

Second, under the EU Second Directive, repurchases of shares which are not to be cancelled must not mandatorily follow the double majority
rule, unless the member states’ legislation so provides. These types of
transactions are controlled by additional rules governing share repurchases.
Under EU law, only a limited number of fully paid-up shares (generally 10%
altogether) may be repurchased and maintained in the corporate treasury;
these shares can be purchased only out of surplus. The surplus paid shall
be included among the liabilities in a reserve unavailable for distribution.
Treasury shares do not become authorized shares and must be accounted for
on the balance sheet as an asset. Treasury shares increase the pro rata
dividend of the outstanding shares. In terms of voting, treasury share voting
rights are frozen and the majority cannot take advantage of the situation
because quorums include the treasury shares. Furthermore, unlike in the
United States, the directors have little room to maneuver in share
repurchases. Not only it is not within a director's or the directors' power to
purchase the company's own shares at will, but also a general meeting must
authorize the duration of the authorization and the minimum and maximum
price of the repurchase. Shareholders may challenge the general meeting's
resolution by claiming that the price range is too wide or the decision-
making process is unlawful. Unless the member states’ legislation permits
the general meeting to specify which shareholders may sell back their shares,
such as in Spain and Portugal, it is very unlikely that shareholders can bring
cases before European courts. Also, legislation or market authorities often
specifically define equal treatment or same condition, and usually

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94An example of such treatment would be when the company, following a reduction of
capital, enacts a reverse stock split whose exchange ratio produces fractional shares, and not all the
incumbent shareholders may maintain the same number of whole shares (granting full voting rights)
that they had before the capital reduction.

95Second Directive, supra note 2, art. 20(2).

96Id. art. 22(1)(b). A different rule, however, is provided for all EU listed corporations as
EC, 2002 O.J. (L 243) 1.
repurchases effectuated in a stock exchange market are per se respectful of an equal treatment norm.

Third, the Second Directive allows companies (if permitted by the member states) to make a compulsory withdrawal of shares: redemption of shares which constitutes reduction of capital or redemption of capital, which does not constitute a reduction of capital. "Compulsory withdrawal must be prescribed or authorized by the statutes or instrument of incorporation before subscription of the shares which are to be withdrawn are subscribed for."97 Since this information is given before subscription, a compulsory withdrawal violates the equal treatment rule, unless specifically allowed by the member state, as in France.

This brief overview of the EU Second Directive rules has shown the following key points: (1) the European principle of equal treatment of shareholders plays a small role, because EU member states must follow rules granting participation of minorities in the decision-making process, and minorities have substantial protection devices against majorities' or directors' abuses; and (2) EU member states' implementation of the equal treatment rule is not homogeneous. Thus, the advantages of a mandatory, but vague, equal treatment norm are not clear.

B. Germany, Austria, and Holland's Implementation

Germany's law follows the EU Directive very closely. In fact, Germany has copied and pasted Article 42 Second Directive into a new section 53a of the Stock Corporation Act (AktG).98 In addition, section 71(1)(8) AktG expressly specifies that a purchase of a company's own shares may not prejudice the equal treatment principle for shareholders who are in the same position.99

German legal scholars consider the equal treatment rule to be an explanation of the general duty to behave fairly (expressed by section 242 of the German Civil Code [hereinafter BGB]).100 Equal treatment prohibits

97Second Directive, supra note 2, art. 36(1)(a).
98AktG § 53(a). Section 47a of the Austrian Companies Act (öAktG) and articles 92(2) and 99 of the Dutch Civil Code [Burgerlijk Wetboek, Boek 2] provide similarly. A similar rule is also provided by under the Swiss Code of Obligations, article 706(2)(3) and section 176 of the Bosnian Business Organizations Code.
99AktG § 71(1)(8).
100See generally BARBARA GRUNEWALD, GESELLSCHAFTSRECHT [CORPORATE LAW] (6th ed. 2005); HUECK, supra note 91; HÜFFER, § 53a, supra note 91, at 239; THOMAS RAISER, RECHT DER KAPITALGESSELLSCHAFTEN [LAW OF CORPORATIONS] 116 (3d ed. 2001); KARSTEN SCHMIDT, GESELLSCHAFTSRECHT [CORPORATE LAW] 462 (4th ed. 2002); DIRK VERSE, DER GLEICHBEHANDLUNGSGRUNDSATZ IM RECHT DER KAPITALGESSELLSCHAFTEN [THE PRINCIPLE OF EQUAL
discrimination without objective reason.101 Thus, according to German law, directors authorized by shareholders either to purchase or to resell the corporation's own shares must treat all shareholders equally. This rule, however, has important exceptions. First, a buy-back or resale of shares on a regulated stock exchange is considered per se equal treatment.102 Second, shareholders have a preemptive right to new share issuances and resale of shares held in the treasury of the company.103 Because these preemptive rights can be withdrawn by the company,104 both a selective sale and repurchase of the companies' own shares are plausible, if the interest of the company as a whole requires it.105 Although a high majority is necessary,
minorities may challenge the shareholders’ meeting’s resolution by alleging that it fulfills a selfish interest of the majorities. In these cases, courts have not found a violation of the equal treatment rule, but instead considered whether the behavior of the majority meets the fairness requirement. Indeed, German commentators agree that section 53a AktG specifically addresses corporate bodies, such as the board of directors, the supervisory board, and the general meeting; it does not extend to shareholders.

If occurring circumstances are set forth in the charter or bylaws peremptorily, the redemption of shares may be compulsory for either the corporation or the shareholders. Such circumstances might include withdrawal at the will of the shareholder or the company, or a refusal of a granting after a share transfer. Many commentators believe that such clauses are valid and do not interfere with the principle of equal treatment. Two explanations are offered to ex-plaintiffs. The first reasons that since the original charter provides for these clauses, all shareholders have presumptively agreed to them. The second explanation argues that since the circumstances under which a call-clause will be enforced may apply to all shareholders, a problem of equal treatment cannot arise.


See HÜFFER, supra note 91, at 96; Raiser, *Gleichheitsgrundsatz, supra note 100, at 92; Raiser, Rezension, supra note 100, at 421; see also GRUNEWALD, supra note 100, 16-18; RAISER, supra note 100, at 116; SCHMIDT, supra note 100, at 462-63; WIEDEMANN, supra note 100, at 258; WIESNER, supra note 100, at 103; Lutter & Zöllner, supra note 100, at 576-77.


HÜFFER, supra note 91, at 1170.

Unless the charter authorizes a share redemption for cancellation, capital reductions must follow the same pro rata rule as in liquidation. German legal scholars claim that this rule refers to the principle of equality among shares set forth in section 11 AktG—"all shares must grant equal rights"—not the principle of equal treatment of shareholders set forth in the new section 53a AktG. As in the Applebaum and Lerner cases, however, substantial discriminations may still occur. In two recent landmark cases on reverse stock splits, Sachsenmilch and Hilgers, the German Supreme Court held that formal equality may not be challenged under section 53a AktG unless the behavior of the majority shareholder is unfair under section 242 BGB.

111 See Bundesgerichtshof [BGH] [Federal Court of Justice] Feb. 9, 1998, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 692 (1998) (F.R.G); 138 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 71 (Sachsenmilch) (F.R.G.). In this case, capital reduction was followed by a reverse stock split with a 750 to 1 ratio. Indeed, section 222 AktG permits reverse stock splits after a capital reduction, only to the extent that, by correspondingly reducing the par value of the shares, the par value would become less than an entire monetary unit or its multiples (now, 1 euro; at the time of this case 50 DM). The minority shareholders claimed that the choice of a 750:1 ratio would be unjustly detrimental since other ratios, such as 10:4, would have consistently reduced the amount of fractional shares. Also, the minority complained of being frozen-out in order to allot future preemptive rights to a lender, which was desiring to become majority shareholder. The German Supreme Court dismissed the claim affirming that a reduction of capital does not require any other reasoning, but to follow the procedural rules implied by the law.


112 Bundesgerichtshof [BGH] [Federal Court of Justice] July 5, 1999, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1444 (1999) (F.R.G.); NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 3197 (1999) (F.R.G.); 142 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 167 (Hilgers) (F.R.G.). Here, the general meeting passed a resolution of reduction to zero, followed immediately by an increase of capital to an amount barely above the minimum prescribed by the law. Notwithstanding that the new capital was substantially trivial, the par value of the shares was maintained very high (50 DM each, at a time when the minimum was 5 DM). The minority shareholders claimed that if the majority had chosen a lower par, the minority would have exercised its preemptive rights, being able to subscribe new whole shares and not only fractional shares. The German Supreme Court accepted the claim, stating that the majority owes a duty of fairness towards the minority to determine the par value which allows the highest possible number of whole shares. The court, however, referred to section 242 BGB, considering section 53a AktG inappropriate.

113 Compare Krieger, supra note 111, at 890, and Marcus Lutter, § 222, in 5/1 KÖLNER KOMMENTAR ZUM AKTIENGESETZ [COLOGNE COMMENTARIES ON STOCK CORPORATION ACT] 659 (Zöllner, ed. 1995), with VERSE, supra note 100, at 240, 253, 308. The former argue that a rule of equal treatment would not be relevant since the court has no power to interfere with the decision to reduce the capital, how much part should be reduced, or what change ratio should be chosen: as seen in the Hilgers case, such a problem may not be solved with the equal treatment norm, but by imposing fair conduct on the majority towards minorities. The latter argues that the existence of section 53a AktG permits the court to decide whether the majority has taken into consideration only its own interest and utility, or the interest and utility of the company as a whole. Following this second approach, a reduction has to be implemented in the way that achieves the
In sum, in a case like Donahue, the minority shareholder is entitled to challenge a resolution from the general meeting because the majority shareholder cannot show an interest of the company as a whole that would justify buying shares only from herself. But a German court would require the minority shareholders to show a violation of the fairness standard, and not simply a disparate treatment. In a case like Nixon, a German court may have come to the same conclusion as the Delaware Supreme Court. If redemption is only authorized in the charter, then the directors can show that it is in the interest of the company to repurchase shares only from retiring employees, or at least show that the employees are in a different position than the other non-employee shareholders. Cases like Applebaum or Lerner could not arise under German law and, in any case, would be solved differently.

C. France and Belgium's Implementation

The German AktG applies equality as a general principle for capital reductions, but the French and Belgian implementation of Article 42 Second Directive affects only capital reductions and an operation called "capital redemption" [amortissement du capital], which consists of redeeming the subscribed capital without reduction of the latter.114 Both the French Commercial Code and Belgian Companies Code prohibit capital reductions from compromising equality among the shareholders.115 The Belgian Code...
specifies, however, that a properly motivated general meeting resolution may allow for disparate treatment of different classes of shares. 116 A similar solution is favored by French commentators. 117 An equal treatment rule is also applicable to a capital reduction implemented by the redemption and cancellation of shares. 118 To comply with the equal treatment norm in this case, it is sufficient that a company make an offer to all shareholders of all classes. 119 Given this equal purchase offer, each interested shareholder has a right to sell an amount of shares equal to the proportion between her shares and the shares of all the other expressly interested shareholders.

Because of the criminal responsibility for a breach thereof, and because the courts have general power to give protection against unfair conduct following the abus de majorité [abuse of the majority] doctrine, 120 the equality rule in capital reduction may not be enforced elsewhere. 121 Moreover, thoughtful commentators claim that if an equal treatment norm in capital reduction was not foreseen, the unaddressed problems would be better resolved by the principles of fairness. 122 Because of this limitation, the equal treatment norm does little more than prohibit the implementation of unfair resolutions. Therefore, a strict equal treatment norm has very little meaning and may be considered in disharmony with the French legal system.

Returning to the Donahue and Nixon cases, under French law, both Mrs. Donahue and the Blackwell brothers would have the same right as Rodd or the employees to sell their shares, unless they possessed shares of
different classes. In the BA Trustee case, French courts would impose dissolution of the company or a proportional split. Cases such as Applebaum, Lerner, Sachsenmilch, or Hilgers would not be related to the equal treatment of shareholders, since French commentators think reverse stock splits should be scrutinized under the abus de majorité doctrine.

D. Spain and Portugal's Implementation

Similar to the German section 53a AktG and Article 42 Second Directive, the Spanish Companies Act, art. 50-bis now provides a general principle of equal treatment of all shareholders in a same position.123 Unlike French law, Spanish law permits a waiver of the equal treatment rule in both capital reductions and share repurchases for cancellation.124 All shareholders, regardless whether affected by a disparate capital reduction or repurchase of shares,125 must separately confirm the resolution by a majority
vote. Put differently, if a capital reduction or withdrawal of shares affects shareholders differently, the general meeting’s resolution must be confirmed by a special resolution and majority vote from the ad hoc community of shareholders receiving a disparate treatment. Article 164.3 LSA plainly applies in cases where a particular class of shares is cancelled; it is also considered a general principle to solve all the cases in which the implementation of a general meeting’s decision would result in disparate treatment of some shareholders. 126 Recent inquiries referred to Article 164.3 LSA in order to solve problems such as squeeze-outs of minorities 127 or selective redemptions of shares. 128

In contrast to the German and French examples, relevant cases have come before the Spanish courts. In all cases, the special meetings' resolution failed. In a case similar to Lerner, a corporation named Sociedad Anonima
Hotelera Internacional y Turistica, SA (Sihoturs)\textsuperscript{129} was facing a bitter internal conflict among shareholders. To solve the problem, the majority shareholder passed a capital reduction to compel withdrawal of the dissenting minority’s shares. The disclosed purpose for the capital reduction was the real one: i.e., that the presence of this shareholder would compromise the normal course of business. The Dirección General de Registro y Notariado [the Spanish General Direction of Registrar] (DGRN) awkwardly held that the resolution would require confirmation of the obstructionistic, squeezed-out shareholder, under Article 164.3 LSA.\textsuperscript{130}

In Novoprint,\textsuperscript{131} a case similar to BA Trustee, 99.85% of the shareholders attended the general meeting and unanimously adopted a resolution to reduce the share capital in order to repay in full all the shares held by three shareholders (holding around 40% of the shares). The shares would be reimbursed in kind, through the award of a building. Since the reduction would affect the shareholders differently, a separate vote from special meetings (both the special meeting of all shareholders whose shares were canceled and refunded, and the special meeting of all the remaining shareholders) would be necessary. However, DGRN considered that the transaction was fair, no one objected, and even if 0.15% had voted against the resolution, their vote would not have been equivalent to a right to veto.\textsuperscript{132}

Finally, in Rural Informática,\textsuperscript{133} a company in a bad economic state repurchased the shares of one minority shareholder, without calling any special meetings. The Spanish Supreme Court held that the capital reduction was void, but did not base its decision on the grounds that no special meetings were called or that the price paid was grossly disproportionate.\textsuperscript{134}


\textsuperscript{130}See also RDGRN, Jan. 9, 1998 (R.J., No. 270) (LA LEY 2161/1998) (Geltra case) (discussing whether a company may selectively cancel the shares held in the company’s treasury). For criticism, see DEL POZO, supra note 124, at 69-70; del Pozo, supra note 124, at 62-63; María de la Sierra Flores, “Acciones propias-reducción de capital” y el principio de paridad de trato de los accionistas [Capital Reduction- Repurchase of shares: The Principle of Equal Treatment of Shareholders], 14 REVISTA DE DERECHO DE SOCIEDADES [RdS], 459, 472-73 (2000-1); see also ORTUÑO BAEZA, supra note 124, at 354-60.

\textsuperscript{131}RDGRN, Mar. 1, 1999 (R.J., No. 1372) (LA LEY 6697/1999).

\textsuperscript{132}See del Pozo, supra note 124, at 68. Art. 164.3 LSA not only gives minorities the right to vote against the general meeting’s resolution, but it also forces the board of directors to disclose the purpose of the disparate treatment. If the information given to the general or the special meeting is untrue or incomplete, the resolution is void. Furthermore, a resolution which does not give any information is void. See also ORTUÑO BAEZA, supra note 124, at 277-78; Paz-Ares, supra note 124, at 58-59.


\textsuperscript{134}In the zone of insolvency, the reimbursement of shareholders is also a concern of
Rather, the Court claimed that the decision violated the principle of equal treatment specified under Article 42 Second Directive. The decision will gain importance because of the new equal treatment rule set forth in the Spanish Company Law, art. 50-bis, introduced in 2009.

Under Spanish law, both the Donahue and the Nixon cases would have been decided in favor of the plaintiffs, unless they consented to the disparate treatment. Relying on Novoprint's reasoning, the BA Trustee case would have been solved as the House of Lords did. On the contrary, the Lerner case would be reversed, as the Sihoturs case shows.

E. Italy and the United Kingdom's Choice Not to Implement

Two major European member states, the United Kingdom and Italy, have chosen not to implement Article 42 Second Directive. The United Kingdom's choice is based on its common law tradition examined earlier. A very different situation faced Italy's legislative process. A specially designated legislative commission was appointed in 1986 with the task of reforming the Italian Civil Code in accordance with the Second Directive's principles. After a long debate, the reform commission declared that it was desirable not to implement Article 42 Second Directive for two main reasons: (1) a principle of equal treatment of shareholders is implicit, and (2) explicating the norm would be dangerous since it could be misinterpreted and difficult to apply to all real situations. By implementing the 2006 amendments of the Second Directive, including an explicit reference to the principle of equal treatment for purchases of the companies' own shares, the Italian Government maintained the choice expressed by the reform commission in 1986.

creditors, who may claim for directors' liability.

See del Pozo, supra note 124, at 65-66. The criticism insists that either this interpretation prospectively considers also Article 163.4 LSA in contrast with Article 42 Second Directive, or it does not make sense to consider against Article 42 Second Directive a capital reduction to be effected through selective redemption and cancellation of shares while the same effect can be pursued through a capital reduction under Article 164.3 LSA.

See supra Part II.

The reform commission's rationale, by chairman Professor Floriano d'Alessandro, is reported by a privileged source. See Floriano d'Alessandro, La seconda direttiva e la parità di trattamento tra soci [The Second EU Directive and the Principle of Equal Treatment], 32 RIVISTA DELLE SOCIETÀ 1 (1987) (who personally disagreed with this choice); see also Carlo Angelici, Parità di trattamento degli azionisti [Equal Treatment of Shareholders], 85 RIVISTA DEL DIRITTO COMMERCIALE 11 (1987) (who supported the choice).

In 1998, special reference to the principle of equal treatment was expressed in Article 132 Legislative Decree, Feb. 24, 1998, n.58, "Testo unico delle disposizioni in materia di intermediazione finanziaria, ai sensi degli artt. 8 e 21 della l. 6 febbraio, 1996 n. 52" [Securities act,
Very few Italian cases, most dealing with distributions in kind, address the principle of equal treatment. 140 The solution that Italian courts fashion is unclear. Some courts consider a distribution in kind void because it cannot accomplish the principle of equal treatment.141 Others argue that it is legitimate as long as the same goods can be distributed pro rata to all shareholders. 142 Still others rely on the possibility of ensuring that all shareholders receive the pro rata equivalent in cash. 143 Legal commentators are generally in favor of a very strong equal treatment rule. 144 It is not clear, however, what interests this rule protects or what its advantages are. 145

Notwithstanding the general belief that Italian law is substantially or functionally "bad law," 146 the law itself grants equality to shares of the same


146 See Corte app., Genova, July 5, 1986, 15 GIURISPRUDENZA COMMERCIALE II 1988, 730 (affirming the viability of a distribution in kind to the extent that the equal treatment rule can be accomplished by assigning pro rata the same goods — such as shares in the company's portfolio—to all shareholders). For criticism, see Marco Cassottana, Atti di disposizione patrimoniale contrari all'interesse sociale e sindacato dell'autorità giudiziaria [Assets Distribution Against the Interest of the Company as a Whole and Judicial Review], 15 GIURISPRUDENZA COMMERCIALE II 731 (1988).

146 See Trib. Vicenza, Mar. 23, 1999, DIRITTO FALLIMENTARE E DELLE SOCIETÀ COMMERCIALI 1999, II, 566 (affirming that the equal treatment rule is accomplished when the distribution in kind may assure each shareholder the monetary equivalent of a distribution in cash, hence it not being necessary to distribute goods of the same kind); see also Cass., Mar. 23, 2004, n.5724, LE SOCIETÀ 2004, 1241 (confirming the viability of a bylaw clause granting a building cooperative the right to distribute buildings to its cooperators at the termination of their relationship).

146 See, e.g., Raffaele Nobili & Marco Saverio Spolidoro, La riduzione di capitale [Capital Reduction], in VI.1 TRATTATO DELLE SOCIETÀ PER AZIONI [TREATIES ON THE CORPORATION] 236-40, 258-59 (Giovanni E. Colombo & Giuseppe B. Portale eds., 1993).

146 Although allowing the possible waiver of a strict equality rule when a valid business purpose so suggests, a recent book confirms this general belief. See GIACOMO D'ATTORRE, IL PRINCIPIO DI EGUAGLIANZA TRA SOCI NELLE SOCIETÀ PER AZIONI [THE PRINCIPLE OF EQUAL TREATMENT IN THE JOINT STOCK COMPANY] (2007).

146 See Ronald J. Gibson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 HARV. L. REV. 1642, 1655 (2006); Rafael La Porta et al.,
class and very strongly protects minorities. This protection is displayed by the following: (1) mandatory pro rata allotment of dividends and share dividends;\textsuperscript{147} (2) voting rights bound to a very strict one-share, one-vote principle;\textsuperscript{148} (3) waiver of preemptive rights only by a majority vote and in the interest of the company as a whole;\textsuperscript{149} and (4) shareholders cannot be cashed-out, either by capital reductions (reverse stock splits) or by mergers.\textsuperscript{150} Also, listed corporations must grant equal treatment to all investors, including shareholders.\textsuperscript{151}

Furthermore, non-listed corporations have an important choice to make. These corporations either set up a termination date or are perpetual. If they are perpetual, all shareholders may withdraw at will.\textsuperscript{152} If they have a termination date, all shareholders may withdraw after the expiration date, notwithstanding whether the meeting decides to set another termination date.\textsuperscript{153} Additionally, courts hold that a termination date set for longer than the average human life span is fictitious and shareholders may withdraw at will.\textsuperscript{154} As a result, there is, or should be, very little room for a principle of equal treatment in share repurchases and capital reductions. Analyzing the Donahue and Nixon cases under this rubric would result in a decision in the plaintiff's favor. In neither case would equal treatment be relevant—minority shareholders could still withdraw at will. The Italian application would not yield a definitive answer in BA Trustee or Novoprint because Italian courts still doubt whether it is necessary to grant precise equality in distributions in kind. Finally, Lerner, Sihoturs, and Rural Informática would not be decided in favor of the majority shareholder, unless a redemption clause in case of deadlock is stated in the charter.

F. A Final Overview

The comparative overview clearly shows a great deal of confusion surrounding the issue of equal treatment of shareholders. Not only do American courts follow two opposing approaches, but European legislatures and courts similarly follow different approaches despite a general principle expressed by Articles 19 and 42 Second Directive. A contradiction arises

\textsuperscript{147}Arts. 2350, 2433, 2442 C.C.
\textsuperscript{148}Id. art. 2351.
\textsuperscript{149}Id. art. 2441.
\textsuperscript{150}Id. art. 2501-ter, n.2; 2506-bis, n.1.
\textsuperscript{151}FINANCIAL CODE, Arts. 92, 132.
\textsuperscript{152}Art. 2437(3) C.C.
\textsuperscript{153}Id. art. 2437(2).
when developing a theory based on the principle of equal treatment: we observe that similar problems are treated differently, and different situations are treated similarly.

As the legal scholar who served as chairman of the 1986 Italian reform commission has pointed out, the principle of equal treatment is so evanescent and ambiguous that its application should be restricted to cases where there is a clear oppression of the minority. This argument foreshadows a point developed later in this article: that a rule of equal treatment of shareholders does not make sense if its goal is nothing more than to compel directors and majorities to behave fairly.

V. THE LAW AND ECONOMICS OF EQUAL TREATMENT IN CORPORATE DISTRIBUTIONS

Having reviewed both the American and European regimes, we will now turn to the doctrinal background that is the nexus for these broadly opposing approaches. This divergence is especially present in American case law.

The existence of an equal opportunity rule for all shareholders is highly controversial among legal scholars. Generally, those who support an equal opportunity rule claim that it is applicable to sales of control blocks. Yet Berle and Means argued that control is itself a corporate asset. According to them, if a premium should go anywhere, it "must go into the corporate treasury," and indirectly benefit all shareholders. A similar conclusion is reached by those who affirm the right to equal opportunity. Therefore, these scholars counsel that in the sale of control blocks, the premium should be proportionally shared directly among all shareholders.

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155 See d’Alessandro, supra note 138, at 3 (focusing on the poor awareness among commentators of the real significance of the equal treatment norm); Angelici, supra note 138, at 12-15 (referring to German legal scholars, the author is of the opinion that the principles of fairness cover all the issues which a rule of equal treatment should address).


Over time the equal opportunity approach has been suggested in relation to several operations that normally precede or follow the acquisition or consolidation of corporate control (especially freeze-outs, squeeze-outs, going-private transactions, and leveraged and management buyouts). These operations all involve fiduciary duties of directors or shareholders. It is the debate relating to these further problems that gave rise to the arguments that led to the Donahue and Nixon decisions. These arguments were proposed by scholars based at Harvard and Chicago (hereinafter the Harvard School or the Chicago School Approach).  

A. Equal Opportunities in Sales of Control Blocks

The problem of equal opportunity in the sale of control blocks must be distinguished from the problems discussed in this article. The equal-sharing Harvard School approach argues that, in the case of selling control blocks, all shareholders have an equal opportunity to sell the same portion as the controlling shareholder (proportional to the total amount offered). This approach relates to the principle that all shares (of the same class) are to be treated equally because this is fair. Arguments for and against this approach have been made, and ultimately, economic analyses have shown that both the equal treatment rule and the market rule may be efficient. In particular, the equal treatment rule stops some efficient transactions, but also...

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159 See, e.g., Bebchuk, supra note 158, at 1706-08 (highlighting the equal treatment of shareholders by comparing tender offers to mergers). Professor Bebchuk, however, clearly overlaps equal treatment and fairness, as he declares that equal treatment is desirable, however, not only for its instrumental value but also as an independent objective, an end in itself. This independent value of equal treatment is based on what I view as widely held notions of fairness. These notions of fairness suggest some presumption in favor of pro rata division. Id. at 1707. But see Easterbrook & Fischel, supra note 46, at 703 (correctly objecting to the syllogism that "fiduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment").

160 See generally Cox & Hazen, supra note 29, § 12.01, at 620-23. For complete references, see supra note 2.
halts some inefficient transactions. In fact, while American case law follows the market rule, Article 5 Thirteenth Directive relating to takeover bids adopts a general equal opportunity rule where the target is a listed company.

In my opinion, closely held corporations should be left to the market rule. Drag-along or other similar clauses may grant minorities the right to share in the premium or take over the company. Also, such clauses are effective devices for majorities to squeeze out minorities through white knights at a fair price.

As the comparative overview has clearly shown, however, an equal opportunity rule should be relevant to driving the conduct of corporate bodies, such as the board of directors and the shareholders' meeting, when managing the corporation and its assets, but does not seem relevant to the disposal of shareholders' personal rights, such as the ultimate sale of shares.

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161 See Lucian Arye Bebchuk, 
Efficient and Inefficient Sales of Corporate Control, 109 Q.J. ECON. 957 (1994); Marcel Kahan, 
Sales of Corporate Control, 9 J.L. ECON. & ORG. 368 (1993). Both analyzed transactions that transfer a company's controlling block from an existing controller to a new controller. Kahan and Bebchuk compare the market rule, which is followed in the United States, with the equal opportunity rule, which prevails in other countries. Their conclusion is that the market rule is superior to the equal opportunity rule in facilitating efficient transfers of control but inferior to it in discouraging inefficient transfers. In an overall perspective, they hold that the market rule is superior if existing and new controllers draw their characteristics from the same distributions. See Bebchuk, supra; Kahan, supra; see also Lucian Arye Bebchuk & Marcel Kahan, 

162 See Abraham v. Emerson Radio Corp., 901 A.2d 751, 757-62 (Del. Ch. 2006). In Abraham, a minority stockholders' complaint failed to state a claim that the controlling stockholder improperly sold a controlling block of shares a in sporting goods company to a strategic buyer in the same market that sought to usurp company's assets for the buyer's benefit and to the stockholders unfair detriment; the complaint failed to plead circumstances that controlling stockholder knew, suspected, or should have suspected that buyer was either a looter or was dishonest and had improper plans for company, and failed to identify exactly what buyer had done with company's assets that was improper. Id. at 759, 762; see also Doleman v. Meiji Mut. Life Ins. Co., 727 F.2d 1480, 1482-84 (9th Cir. 1984) (summarizing the opposing scholarships); DeBaun v. First W. Bank & Trust Co., 120 Cal. Rptr. 354, 360-61 (Cal. Dist. Ct. App. 1975) (stating that appellant bank became aware of facts that would have alerted a prudent person that looting would take place and thus owed a duty to the corporation and minority shareholders); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985) (specifying that "a director has no duty to disclose his stock dealings to the corporation, nor does he have a duty to offer his shares to the corporation before selling them to another"); Martin v. Marlin, 529 So. 2d 1174, 1179 (Fl. Dist. Ct. App. 1988) (stating that "[i]f there is no duty to share one's own profit, there is no duty to share one's friends' profits").

163 A drag along clause in a shareholders' agreement enables specified shareholders or a specified majority of shareholders to require all shareholders to participate in a sale of all the shares to a third party buyer. The minority shareholders will not be permitted to frustrate or exploit a sale of the whole company provided that all shareholders are selling or being required to sell on the same terms.
or control blocks. This is the deciding argument that counsels against overlapping the principles of shareholders’ equal treatment with premium-shopping opportunities among all shareholders in the sales of control blocks. For the latter, indeed, European scholars focus on market egalitarianism, rather than on a principle of equal treatment of shareholders.

B. The Harvard School Approach

The Harvard School Approach implies that the board of directors (or the majority) follow an equal opportunity rule in the case of purchasing a corporation’s own shares, distributions in kind, cash-out mergers, or forward and reverse stock splits. The Harvard School notes that most corporate laws, including those in the United States, provide for shareholders’ pro rata equality in dividend distributions. Under the Harvard School framework, dividends must be shared among shareholders on a pro rata basis because this strengthens the expectations of minority shareholders. If directors or majorities could allocate dividends upon a non pro rata basis, the cost of raising capital among investors who would then bear the risk of receiving profits disproportionate to their investment would increase considerably. This would significantly restrict the total offer. Issuers would rely more consistently, if not exclusively, on their own equity, resulting in an inefficient allocation of resources—something a system of free collective bargaining would surely avoid. Accordingly, corporation law and fiduciary principle[s] provide a standardized contract which removes the element of

164 The reason for Article 5 of the Thirteenth Directive is not that all shares of the same class are to be treated equally, but that market egalitarianism is necessary to build efficient markets. See generally Massimo Montanari, Il principio di parità di trattamento fra disciplina del mercato mobiliare e diritto delle società [The Principle of Equal Treatment between Stock Market Regulation and Corporate Law], GIURISPRUDENZA COMMERCIALE 1899, 900-02 (1996) (referring to the ideas developed by Louis Loss, The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States, 33 MOD. L. REV. 34 (1970)).


166 See generally Brudney & Clark, supra note 158; Brudney & Chirelstein, Corporate Freezeouts, supra note 29; Brudney, Equal Treatment, supra note 158, at 1077, 1081, 1087-89; Brudney & Chirelstein, Fair Shares, supra note 29.
uncertainty by presuming homogenized treatment of investors of the same class in distributions of dividends and on liquidation.\textsuperscript{167}

There are several corollaries to this approach. Unequal treatment can be justified only if agreed to in the charter and not if it is within the majority or directors' discretion.\textsuperscript{168} A distribution in kind is not permissible unless the same asset can be distributed to all shareholders, or all the shareholders consent to a distribution partly in kind and partly in cash.\textsuperscript{169} Minority freeze-outs should be forbidden.\textsuperscript{170} The purchase of a company's own shares should not be permitted, except for buybacks of fractional shares and for closely held corporations without an available share market.\textsuperscript{171} Taking the corporation private should be allowed under an equal treatment rule, after the effectiveness has been analyzed by a judicial or administrative appointment of negotiators acting for the minority. This transaction could also be approved by requiring prior approval of the transaction by an administrative agency or the courts.\textsuperscript{172}

\textbf{C. The Chicago School Approach}

Some scholars have attempted to mitigate the severe consequences of the Harvard School's proposal.\textsuperscript{173} Relying on shareholders' welfare growth, groups such as the Chicago School have strongly criticized this approach. As Easterbrook and Fischel state:

\textit{[M]any scholars, though few courts, conclude that one aspect of fiduciary duty is the equal treatment of investors. Their argument takes the following form: fiduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment. The conclusion does not follow. The argument depends on an equivalence between equal and fair treatment. To say that fiduciary principles require equal}

\textsuperscript{167}Brudney, \textit{Equal Treatment}, supra note 158, at 1089.
\textsuperscript{168}Id.
\textsuperscript{169}Id. at 1078-80.
\textsuperscript{170}Id. at 1092.
\textsuperscript{171}Brudney, \textit{Equal Treatment}, supra note 158, at 1092.
\textsuperscript{172}Id. at 1113.
\textsuperscript{173}See, e.g., Booth, \textit{supra} note 87, at 873-80. Professor Booth develops the idea that the equal treatment norm ensures liquidity in markets, but suggests that a strict enforcement of the rule should give way to a valid business purpose. A valid business purpose should be measured as an expected increase of the return on investments' rate. Notwithstanding a valid business purpose, a majority could not enact unequal treatments of shareholders if it would prejudice the minority. \textit{Id.} at 874-75.
treatment is to beg the question whether investors would contract for equal or even equal treatment.\textsuperscript{174}

Easterbrook and Fischel go on to argue that

if the terms under which the directors obtain control of the firm call for them to maximize the wealth of the investors, they select the highest-paying venture and abide by the rules of distribution. If unequal distribution is necessary to make the stakes higher, then duty requires inequality . . . . The \textit{ex post} inequality . . . is no more "unfair" than the \textit{ex post} inequality of a lottery, in which all players invest a certain amount but only a few collect. The equal treatment of the investors . . . and the gains they receive from taking chances, make the \textit{ex post} inequality both fair and desirable.\textsuperscript{175}

The ultimate conclusion of the Chicago School Approach is that whoever produces a gain should be allowed to keep it "subject to the constraint that other parties to the transaction be at least as well off as before the transaction. Any attempt to require sharing simply reduces the likelihood that there will be gains to share."\textsuperscript{176}

Although mainly referring to corporate control transactions, the Chicago School Approach is useful for solving the issues acknowledged in this paper. It emphasizes that directors do not breach their fiduciary duties toward all shareholders by performing unequal treatments that benefit some but do not prejudice others. Unequal treatment can be a device to increase shareholders' welfare, and if shareholders' welfare increases the added value may be shared unequally. This approach, however, needs further development.

D. Towards an Improvement of the Chicago School Approach

The Chicago School argues that dividends must be shared on a pro rata basis because dividend policy transfers welfare and does not increase

\begin{footnotesize}
\begin{enumerate}
\item EASTERBROOK & FISCHEL, \textit{supra} note 8, at 110; see Easterbrook & Fischel, \textit{supra} note 46, at 703.\textsuperscript{174}
\item EASTERBROOK & FISCHEL, \textit{supra} note 8, at 111; see Easterbrook & Fischel, \textit{supra} note 46, at 704.\textsuperscript{175}
\item Easterbrook & Fischel, \textit{supra} note 46, at 698.\textsuperscript{176}
\end{enumerate}
\end{footnotesize}
Indeed, a rule allowing non pro rata distributions of dividends would not increase the value of the company, but rather impose a cost on shareholders by forcing them to monitor the outflow of capital from the company. This effect would ultimately reduce the aggregate welfare. But the commentators that articulate this principle—the majority of American legal scholars—fail to differentiate among the various techniques that achieve a distribution for shareholders. In particular, they do not adequately consider the effects that follow distributions in kind and repurchases of shares. Not surprisingly, they strongly criticize the Donahue doctrine by emphasizing the severe consequences of a strict equal opportunity rule upon the contractual equilibrium of closely held corporations.

The Chicago School Approach needs, therefore, some improvement. These improvements include acknowledging that: (1) equal treatment of shareholders can be implemented if it results in a growth in a shareholders' welfare; (2) distributions may increase shareholders' welfare by creating additional value and not simply transferring wealth; (3) where additional welfare derives from a disparate treatment of shareholders, such treatment is to be allowed as long as no specific shareholder has either been compensated or can claim damage; (4) unequal treatment of shareholders may not be allowed if it does not meet the requirement of fairness; and (5) in determining fairness, others' interests must be considered in good faith, but need not to be pursued to one's self-detriment.

VI. UNEQUAL TREATMENT AND SHAREHOLDERS' WELFARE GROWTH

Neither equal treatment of shareholders in different positions nor equal treatment of shareholders in the same position is necessarily efficient from an economic point of view. Equal, but not "precisely" equal, treatment in corporate distributions may increase shareholders' welfare, without prejudicing anyone.

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177EASTERBROOK & FISCHEL, supra note 8, at 143.
178Id. at 245-48. Indeed, if the parties were called to negotiate a rule of equal treatment, it is unlikely they would select a rule requiring an equal opportunity for all and, especially, for all at once. The parties would not agree on a rule of equal opportunity to assure all members the right to receive salary increases (or at least the right to a salary), regardless of their conduct. Similarly, they would not agree that the company purchase shares pro rata from all shareholders at once, but that it buy out all the shares from all shareholders wishing to withdraw at the time of retirement. As a result, a mandatory equal opportunity rule would not be what the parties would have agreed to had they had the chance to bargain ex ante on these issues. See Cox, supra note 28, at 630-32.
A. Equality of Shareholders v. Equality of Shares

Unlike European legislators and scholars, both the Harvard and Chicago School Approaches overlap "equal treatment of shareholders" and "equality among shares." This leads to some misinterpretation. The rule of sharing dividends pro rata, or the "one-share, one-vote" rule, relates to the idea of equality among shares, which is a fundamental device for building secondary markets, and which has nothing to do with "justice" or "fairness." Secondary markets may only work if standardized and fungible goods may be traded.179

Standardization, however, does not necessarily mean uniformity. All capital markets acknowledge classes of shares characterized by preferential dividend rights or differentiated voting rights. The privileges that characterize these classes are set up in advance in the corporate charter because the investors rely on these characteristics when they consent to contribute capital. Most jurisdictions, however, allow these characteristics to subsequently be altered, subject to strict procedures that ensure the involvement of the stakeholders.

The common rule for such alterations is the double majority system provided for under the European Directives; the general meeting passes an amendment to the charter by majority vote, then special class meetings give their consent to these amendments.180 Purchasers of already-issued shares always know what kind of investment they are about to make. Although the characteristics of a certain class of shares may change over time, a procedural framework is established to ensure that the alterations are not up to the majority's or directors' discretion. These rules granting equality among shares prevent the pernicious effects that the Harvard School predicts would result from not following the rule of shareholders' equal treatment.

A very different concern is the principle of equal treatment of shareholders. From an economic perspective of the corporate phenomenon, absolute shareholder equality would require one to consider all shareholders equal, notwithstanding the different quality and quantity of shares each

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179 For more details and for wide comparative references, see de Luca, supra note 6, at 867.
180 For evidence of the lack of such a rule in the American system, see Williams v. Geier, 671 A.2d 1368 (Del. 1996). The justices were satisfied that an amendment to the corporation's articles—establishing a tenure voting arrangement that the minority unsuccessfully argued disproportionately advantaged the majority—had followed approval by majority vote, and the majority did not believe the amendment's disproportionate effects required a minority shareholders plebiscite. Id. at 1380-82. For criticism, see Cox, supra note 28, at 619-20, 633, who argues that if the amendments were effected through a shareholders' meeting, the minority would be entitled to a class vote and, in some states, to an appraisal remedy.
This approach would unavoidably strike against one of the fundamental principles of the western economy, employing corporations as the dominant entrepreneurial framework. Corporations are not only governed by a majority principle, but they are also governed by a majoritarian principle related to shares of interest. Indeed, the necessity to put all members of a community on the same playing field belongs to a very different economic and social model. This model is typically seen in mutual companies or by some non-profit organizations, where the majority principle is related to people and not to shares of interests, and votes are counted on a per capita basis. The majority principle related to shares of interest, however, is in itself an expression of inequality, because shareholders that are outside the majority group do not run the business either directly, or indirectly, through the appointment of directors. So they count less. This may lead some to question the justification for the shares of interests' majority principle or the morality of capitalism in general, that may invoke (or misinterpret) the Aristotelian concept of distributive justice. But this seems to be a sterile and fundamentally wrong debate. The majority rule is a fundamental device to solve the deadlock which absolutely equal parties would unavoidably face.

Given that the law cannot provide an equal treatment of shareholders principle ignoring the number of shares shareholders own, it could be significant (especially from an economic point of view) to question whether a rule that requires equal treatment for those who are in a same position would make sense. It is not by chance that the EU Second Directive uses this language in Articles 19 and 42. *Same position and equal treatment* are both vague concepts. Economic analysis shows, however, that shareholders in the same position need not always to be treated equally, and that shareholders in different positions should in some cases be treated similarly. But economic analysis does not suggest that equal treatment means identical treatment. Ultimately, an equal treatment rule that is aimed at preventing oppression of minority shareholders is not economically efficient.

181 Explanation of a misleading approach is provided in Booth, supra note 87, at 873. Booth argues that "equality of treatment among shareholders" is a "moral value," which corresponds to the principle of equality before the law, the foundation of any political system. The zenith of confusion is reached by alleging that "[t]he principle is so simple that it seems intuitive that it must apply to corporations, at least in the absence of a better one." *Id.*

182 See generally ARISTOTLE, NICHOMACHEN ETHICS, at V, 1131a, 20.
B. New Wealth, Same Position, and Unequal Treatment

First, assume that a company, Alpha, manages a building and needs to buy a copy machine. Titius owns 60% of Alpha's stock and serves as the sole director. Caius owns 30%, and Sempronius 10%. Both the minority shareholders, Caius and Sempronius, professionally sell copy machines of different brands. Assume that the two brands' copy machines are similar in quality and price. If an equal treatment rule applies, the director must buy two copy machines, two halves, or nothing. All these solutions would be inefficient for the company.

A lottery solution (which is efficient for the company) would also have problems. On the one hand, the lottery would grant equal treatment \textit{ex ante}—probably, the pro rata rule would require shareholders to be given the chance to sell their copy machines in equal proportion to their shares of interest in the company—but not \textit{ex post}—equal chance is not strictly the same as equal treatment. On the other hand, the lottery must be specifically agreed upon, because it is not the default rule in the case of deadlock (the default rule is dissolution).

To comply entirely with the equal treatment rule, the only plausible solution is to buy the copy machine from a different seller. This seems, however, to be an awkward result that forces the company into buying a copy machine from any seller except the shareholders. Even if either shareholder offered to sell below market price, the director would not be able to choose between Caius and Sempronius. Why would an equal treatment rule be efficient in this case? If the director is independent, he could toss a coin and avoid the problem. If he is not independent (suppose Caius is his brother), his choice might raise a problem of fairness with Sempronius, but this circumstance does not raise problems of equality. This example substantially covers all the situations in which a corporation may need to enter into business relation with one of its shareholders: similar cases may arise from selling a building in the possession of a shareholder to the corporation or from supplying any kind services to the corporation (accounting, book keeping, cleaning services, paper supply and so on). Also, replacing the copy machine with the company's own shares would repeat the same problem, immediately drawing attention to the main issue discussed in this article.

Second, suppose that the company is permitted to repurchase shares and both minority shareholders need cash for personal use. The company has issued ten shares altogether. Titius has six, Caius three, and Sempronius
one. Assume that the company has surplus available to buy one single share at book value, so that the example would satisfy the pertinent legal requirements, such as EU legislation. Assume also that the company is indifferent regarding the repurchase (the marginal utility of a unit of liquidity and that of an additional share are the same). Both Caius and Sempronius prefer one unit of cash for one share. Thus, the aggregate welfare increases if the company buys shares from one of the shareholders (the company is indifferent, one minority shareholder is better off, and the other is not worse off). The only issue is from whom to buy? If an equal treatment rule applies, the company could not buy any shares because it cannot buy half of a share from each and its limited surplus prevents it from buying two full shares.

If from a financial point of view repurchases of shares and dividends are equivalent, an adequate solution would be to distribute dividends pro rata. The distribution of dividends, however, involves a permanent reduction of corporate assets. In contrast, the repurchase of shares does not reduce the assets’ value on the balance sheet since the treasury shares can be resold. Although this point is completely clear to European commentators, it may be difficult for Americans.

183 European legislation requires that repurchases are effectuated only out of the surplus and within a certain percentage, usually 10%, of the stated capital. See Second Directive, supra note 2, art. 20(2).

184 One may question why not lower the price at which the share will be purchased so that the share is repurchased from the shareholder having the greatest need of cash at the lowest price. The company will be better off and the other shareholder would not be willing to sell. This hypothesis, however, would raise a question of fairness, since the company (and the majority shareholder) would clearly be accused of oppressing the minority shareholder. As stated in the Introduction, this article always assumes fair price, and the concern at issue is whether unequal treatment may be unfair notwithstanding that the price is fair.

185 European law pays much more attention to this point than the American Model Business Corporation Act (MBCA) does by requiring that the acquired shares are included among the assets shown on the balance sheet and a reserve in the same amount, unavailable for distribution, is included among the liabilities: this means that the surplus that the company uses for the buy-back is not “distributed” to the shareholders whose shares are bought, but may be further distributed (pro rata) when the company resells the treasury shares. See supra note 178 and accompanying text. This argument, however, makes sense also under the American perspective. Pursuant to section 6.31 of the MBCA, the treasury shares degrade from outstanding to authorized shares; in other words, although they disappear from the balance sheet, they still can be resold at directors’ will. See MODEL BUS. CORP. ACT § 6.31 (2008). The favor that some commentators showed when the MBCA adopted this rule is exaggerated. See BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 190 (3d ed. 1990) (questioning whether new scholars could consider the “dimwitted if not downright cretinous” idea to include the treasury shares in the balance sheet). In my opinion, this rule causes serious misunderstanding, as far as it suggests in a certain way that dividends and repurchases are alternative devices for the same kind of distribution. They are actually not. Fundamentally, a capital reduction or a repurchase of shares (which are to be cancelled) terminate
To avoid doubts, suppose the company has established a put option on the repurchased share, to be exercised in one year. In this example, the share repurchase is essentially a one-year loan by the corporation. The corporation has strong protection because it may sell the share to a third party if the debtor is unable to repay the debt. Under these circumstances, the company cannot be indifferent as to whether it distributes cash or repurchases shares. A dividend distribution would involve Titius, the majority shareholder, who does not need cash. And, the treasury shares acquired by the company increase the expectations of the remaining shareholders in future dividend distributions. These expectations, however, would increase nonproportionally. If Caius’ share is repurchased, Titius and Sempronius gain 6.66% and 1.11%, respectively, over Caius’ next year’s distribution. But if Sempronius’ share is repurchased, Titius and Caius would gain 6.66% and 3.33%, respectively, over Sempronius’ distribution. Therefore, from an economic point of view, the company should purchase the share from any of the shareholders. By preventing the company from choosing one (either by lottery, or by a decision from the directors or majority shareholders), the equal treatment rule is inefficient.186

Both examples illustrate how disparate treatment that increases the aggregate welfare of the shareholders is logical from an economic point of view. If the company is indifferent, an efficient solution requires one of the shareholders to have the opportunity. But under these circumstances, application of the equal treatment rule achieves an inefficient solution.

By permitting shareholders that are not in the same position to be treated differently, the EU equal treatment rule may solve this inefficiency. Assuming that shareholders who do not possess the same number of shares are not in the same position, it follows that the director, or the general meeting, should be able to choose one shareholder. Nevertheless, it would hardly be plausible that the reason why the disparate treatment is appropriate the stakes, unlike a dividend distribution which does not affect the relationship between the company and the shareholders. Therefore, we face completely different situations, which cannot be overlapped as Americans commentators often do, focusing on misleading clues that arise from the MBCA. If a company declares a dividend payable only in favor of certain shareholders (or some shareholders of a same class), the others stockholders suffer prejudice (unless they are specifically compensated). But if a company reduces the stated capital and reimburses only some shares (or buys some shares back for cancellation), the other shareholders do not suffer any prejudice, provided that the price is correct. In fact, unless the company is insolvent, the remaining shareholders maintain their right to receive liquidation and in addition they increase their share of interest for all further dividend distributions. If this was not correct, it should also be forbidden to allow bylaw clauses permitting the redemption of shares or the withdrawal of shareholders since such redemptions or withdrawals would unavoidably result in prejudice of the remaining shareholders. This would be, however, clearly incorrect.

186In addition, self-dealing should not be prohibited as long as the price is fair and the transaction is not detrimental to the corporation.
depends on the number of shares possessed by the shareholders; i.e., in the first example, Caius' copier (suppose, Canon instead of Xerox) should not be chosen because he possesses more shares than Sempronius. Therefore, it is not always true that the disparate treatment of shareholders who are in different positions is per se reasonable. Rather, as evidenced in the following examples, disparate treatment may make sense if two or more shareholders have an identical number of shares. The following examples will show that: (1) being in the same position is not relevant to the equal treatment analysis, and (2) disparate treatment of shareholders who are in a different position may still be unfair.

Third, suppose the same three shareholders are holding shares: Titius owns six shares, and Caius and Sempronius have two shares each. Titius does not need any cash, but the two minority shareholders do. The company can buy one share from either Caius or Sempronius. Titius, being a majority shareholder, decides that Caius' share should be repurchased because they are brothers. This example is very close to Donahue.187 Sempronius would allege violation of the equal treatment rule. Based on the facts, however, the aggregate welfare would increase by favoring either Caius or Sempronius, even though both need to liquidate. While it is impossible to please all, it is reasonable to satisfy at least one.188

Under a strict equal treatment rule, the only plausible solution is not to buy any shares. This is shown in the Massachusetts solution. And because there is no objective reason for favoring Caius (unless the relationship with the majority shareholder is relevant to the company), this buyback would be inconsistent with Nixon. Moreover, if we apply the EU equal treatment rule, liquidating Caius over Sempronius would not be reasonable because both possess two shares and the siblings' relationship cannot be a factor that puts

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188Such cases in which the company must choose one (or only some) among several shareholders who are in exactly the same position may seem artificial. Also, as argued supra note 184, such cases can be solved just by lowering the price at which the shares are repurchased. On the one hand, being in the same position is not at all artificial in publicly traded corporations, where most of the shareholders have a trivial stake. Repurchasing from one shareholder in particular may be perfectly fair although it does not strictly accomplish the equal treatment rule. In effect, both Italian and German law (which provide an equal treatment rule for shareholders—of listed corporations—under the same position) make it clear that repurchasing shares in the stock exchange is per se respectful of the equal treatment rule. Hence, the purchase effectuated in the stock market creates a presumption of impartiality, and so of fairness; still, the equal treatment rule is not exactly accomplished. On the other hand, I do not consider the possibility of lowering or raising the price, since it may help and not prevent oppression of minorities; in Donahue, the price at which Rodd's shares were repurchased was exactly the book value. Still, oppression occurred. See Donahue, 328 N.E.2d at 510.
Caius in a different position. Still, although Titius has an interest in the deal, his choice does not seem unfair and is not detrimental to the company, unless he does not give his consent. Distributing cash would be worse, since all three shareholders, including Titius, would receive a pro rata distribution.

Fourth, to complicate the previous example, we will assume that the company does not have scarce resources; it may buy two shares instead of one. Also, suppose that the director and majority shareholder, Titius, is indifferent and truly independent, because he is a brother to both Caius and Sempronius and loves them equally. Should the company buy one share from Caius and one share from Sempronius, or in the alternative, buy two shares from Caius and none from Sempronius, or vice versa? Because in theory the marginal utility of money is diminishing, the solution granting an optimum allocation of resources is the one in which the company buys one share from each.

Now assume that Caius has an interest in the liquidation of all his shares because that would allow him to buy a piece of property. If he cannot liquidate, the deal fails. Caius is older and in poor health, similar to Rodd in the Donahue case. On the other hand, Sempronius has an interest to sell all his shares because he has a mortgage loan. If he can exchange his shares for cash, he can repay a part of the loan and pay lower interest rates for the future. If the company buys a share each, then Sempronius will proportionally repay the loan, but Caius will not be able to buy the piece of property. If the company buys two shares from Sempronius, he could redeem a greater part of his loan, but not be able to liquidate it, while Caius' deal would still fail. If the company buys two shares from Caius, then he will be able to pursue his venture, but Sempronius would continue to pay the same loan rates as he paid before.

It is clear that the aggregate welfare will increase if the company, instead of buying one share from each, buys two shares from either of them. If the company followed the equal treatment rule it would forego any attempt to make a repurchase. If Caius and Sempronius were in the same position (personal conditions and personal ventures are irrelevant), the EU equal treatment rule would require the company to choose an inefficient solution—buying one share from each. Not being governed by the equal treatment rule, Titius, an affectionate brother and majority shareholder, would probably choose to benefit the shareholder who is in greater need, the shareholder who gains the greater marginal utility of an additional unit of currency, Caius. If I am not grossly mistaken, no one would consider this unreasonable, or unfair. But still, it would not be equal.
C. Transfer of Existing Wealth, Same Position, and Unequal Treatment

Both the Harvard School and the Chicago School maintain that dividend distributions are not likely to increase welfare because they are simply transfers of existing wealth from the company to its shareholders. Disparate treatment should be allowed only if it produces a welfare increase and does not damage any shareholder. As a result, dividend distributions must follow the equal treatment rule. But when considering that the equal treatment of shareholders is not the same as equality among shares, the consequences do not follow the premises. As will be shown, qualitative unequal treatment is also reasonable in distributions and capital reductions.

Notwithstanding Modigliani and Miller's distribution policy theory,\textsuperscript{189} the economic assumption on which a decision to distribute part of the social assets to shareholders still depends on a comparison between the marginal utility rate of money by the company and by the shareholders. If the shareholders' marginal utility rate of money is greater than the rate for the company, then a strong case can be made for a distribution. If the directors' —or, in Europe, the general meeting's—choice is rational,\textsuperscript{190} the dividends to be declared and paid are optimized when the outflow of money ensures that the utility of an additional unit of money by the company equals that of the shareholders.\textsuperscript{191}

\textsuperscript{189}See Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 AM. ECON. REV. 650, 650 (1984) (arguing that dividends are "irrelevant because investors could home brew their own dividends by selling from or borrowing against their portfolios"); Merton H. Miller & Franco Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. BUS. 411, 428, 430 (1961); Franco Modigliani, Debt, Dividend Policy, Taxes, Inflation and Market Valuation, 37 J. FIN. 255 (1982). As Easterbrook observes, notwithstanding the authority of Modigliani and Miller's theory, "Businesses find dividends obvious. Boards declare them regularly and raise them from time to time or face disquiet from investors, or so they think. Many managers are sure that higher dividends mean higher prices for their shares." Easterbrook, supra. Compare Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261 (1958), with ALEXANDER BARGES, THE EFFECT OF CAPITAL STRUCTURE ON THE COST OF CAPITAL (1963).


\textsuperscript{191}These choices are influenced by conflicts of interests and agency costs. In addition, on this issue the approaches of the Harvard School and the Chicago School oppose each other. Compare Victor Brudney, Dividends, Discretion, and Disclosure, 66 VA. L. REV. 85, 85-86 (1980) (arguing that dividend policy affects share prices independently of earnings projections and existing conflicts of interests lead directors to an inefficient dividend policy; thus, he argues for mandatory disclosure of the reasons for the dividend policy), with Daniel R. Fischel, The Law and Economics of Dividend Policy, 67 VA. L. REV. 669, 700 (1981) (debating Brudney's conclusions as failing to consider relevant empirical evidence, market forces, and the cost of disclosure). See also Easterbrook, supra note 189, at 653-55 (arguing for keeping the existing American rules and entrusting directors with all dividend policy powers, as these rules maximize shareholders' welfare);
Once the amount of dividends to be declared (or the amount of the appropriate capital reduction) is determined, we face the distributive problem. As mentioned, the pro rata distribution rule responds to the standardization of shares necessary to build a secondary market. Since equality among shares does not relate to the equal treatment of the shareholders, it would be misleading to analyze whether it would be appropriate to distribute dividends in proportion to how much individual shareholder utility would increase, given that the personal utility function of the money may differ among various shareholders. It is not a goal of corporations or corporate law to allocate more dividends to the poorest shareholders.

Given the assumption that the total amount of monetary distribution is not a variable, it is, however, questionable whether it may be economically reasonable to differentiate a distribution based on the quality. This could be done by distributing cash to some shareholders and not to others, or by distributing different goods.

Fifth, suppose for example that Alpha intends to distribute a building or a plant in its possession because it is unnecessary or costly for the business to retain (that is, more or less, the situation faced in Novoprint and BA Trustee, respectively). Suppose Caius, holding 20\% of the company's stock, has an interest in acquiring the building to make it his home. Assume that the building has a reliable market value. To award the building to Caius, the company may in theory selectively reduce capital (under European law), repurchase part of his shares (under American law), or declare dividends in kind.

In the case of a capital reduction, Caius would surrender shares equal to the value of the building and the remaining shareholders, Titius and Sempronius, proportionally increase their shares of interest in the corporation. Unless the reimbursement is in kind, this solution (favored by the Novoprint and BA Trustee cases) substantially corresponds to the one examined under examples three or four.192

The second solution, a dividend distribution in kind, differs in that it does not alter the shareholders' interests. Hence, it must comply with a pro rata distribution rule; i.e., every shareholder must receive some dividends. If this solution must also comply with the equal treatment rule, we have several alternatives: (a) the equal treatment rule allows distributions in kind only if the same goods can be distributed pro rata (this is the solution favored by the Harvard School and some Italian courts); because there are not similar goods to be distributed, the building cannot be awarded to Caius; (b) equal

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Daniel J. Morrissey, Another Look at the Law of Dividends, 54 U. KAN. L. REV. 449, 451 (2006) (arguing that a "firm's internal investment opportunities are best left to its executives").

192See supra pp. 899-900.
treatment in corporate distributions may not be waived, but assets can be purchased from shareholders or be sold to them as long as the price is fair and the deal is not detrimental to the corporation—and the cash the company receives in exchange is distributed to all shareholders pro rata; (c) equal treatment does not mean precisely identical, but equivalent treatment—in this case the company may directly assign the building to Caius and distribute cash proportionally to Titius and Sempronius (such solution was substantially favored in BA Trustee, and is consistent with both the EU rule and the Nixon decision).

Now let us analyze these outcomes. Solution (a) is wrong because it relies on the false assumption that the equal treatment rule favors the majority and directors may not deny to minorities the right to receive their pro rata share of dividends. It is also inefficient because if the building is sold, and only cash dividends are paid, no shareholder is better off. Solution (b) is inefficient because it reaches the result indirectly when it could be achieved directly. Solution (c) is insufficient because, while it allows disparate treatment (which is not unequal), it does not facilitate the decision of which shareholder should receive disparate treatment.

Suppose further that Sempronius, holding 20% of the shares, likes the building, or even better, dislikes the possibility of Caius using that piece of property as his home (exactly as the minority shareholders claimed in BA Trustee). He alleges that the distribution violates of the equal treatment rule, which would require either precisely identical treatment, or that he also receive a piece of property. Both arguments would lead to deadlock.

Not by chance, in BA Trustee the House of Lords held that the minority claim was unreasonable and that the decision of the majority was fair and equitable. This confirms the conclusion that reasonableness and fairness are not guaranteed by an equal treatment rule. Of course this outcome must allow for the fact that the rule may be interpreted to allow disparate treatments that are not unequal.

The appropriate economic analysis, in my opinion, should be as follows. Titius and Sempronius should either receive an equivalent monetary distribution or increase proportionally their shares of interest. Caius, however, would also fulfill a personal interest (he may use the piece of property as his house) unable to be satisfied but by one of the shareholders. The fact that a distribution in kind may fulfill a personal interest that money cannot accomplish also shows that distributions may increase the aggregate shareholder welfare more than a uniform cash distribution could achieve.

If Sempronius demands that the building be sold to a third party and provides all shareholders with cash from the sale, he would not achieve anything more than what he would if the building was given to Caius. But Caius would receive a cash distribution that he personally would value less
than the building itself. Such a solution would be nonsense. If no equal treatment rule is followed, the majority shareholder, Titius, may award the building to Caius and grant Sempronius its equivalent in cash. That would comply with the pro rata distribution rule. The problem that Titius' choice to award the building to Caius may be unfair and oppressive to Sempronius is independent of the equal treatment of shareholders.

An analogous situation to the fourth example arises if the company distributes identical or divisible goods, such as shares held in the company's portfolio. Here, it is possible to show that applying the equal treatment rule would not be efficient or useful. By gradually changing all the assumptions into independent variables, the examples may be made even closer to reality. For the purpose of showing the ineffectiveness of an equal treatment rule, however, it is not necessary to write out all the possible examples.

**D. Substantial Unequal Treatment, Welfare Growth, and Loss of Shareholders' Value**

All the previous examples considered application of an equal treatment rule where the majority shareholder was not involved in self-dealing. In these cases, the equal treatment rule is clearly inefficient. Also, the equal treatment rule should not be considered a good device for preventing the oppression of minorities by a majority shareholder. Self-dealing is not necessarily inefficient from an economic point of view; rather,  

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193The rule can be represented with this formula. Given that \( u_\alpha, u_c, \) and \( u_s \) are the utility functions of Alpha, Caius, and Sempronius measuring the relative satisfaction from or desirability of the building (B) and of the money (M). Given that \( u_c(1B, 0M) > u_c(0B, 1M) \), and similarly \( u_\alpha(1B, 0M) > u_\alpha(0B, 1M) \). We define \( Z_0, Z_1, Z_2, Z_3 \) the alternative situations: \( Z_0 = \) no distribution; \( Z_1 = \) Alpha distributes B to Caius and M to Sempronius; \( Z_2 = \) Alpha distributes B to Sempronius and M to Caius; \( Z_3 = \) Alpha distributes M to both Caius and Sempronius, selling the property. Alpha is indifferent to the four solutions. Since \( u_\alpha(Z_1) > [u_\alpha(Z_0) - u_\alpha(Z_3)] > u_\alpha(Z_2) \), while \( u_\alpha(Z_3) > u_\alpha(Z_0) \), it follows that \( \sum_{s, c} u_s(Z_3) > \sum_{s, c} u_s(Z_1) \). Suppose Titius chooses \( Z_i \). This choice does not prejudice Sempronius, even if Sempronius' utility is greater in case of a cash distribution: \( u_s(Z_3) > u_s(Z_1) \). Caius' preferences are determined by an assessment of moral utility—that may be expressed as follows: \( w_s(Z_1) > w_s(Z_3) \)—which does not matter for Titius, as Sempronius receives exactly the same amount of money both in \( Z_3 \) and in \( Z_1 \) and, therefore, should be indifferent.

194Solutions to potential unfairness can be easily suggested. Since unfairness here could mainly arise only if the building is overvalued, an effective solution that ensures fair price would require holding an auction, so that third parties could bid. If these bids will be greater than the estimated value, Caius should have an option to pay the difference (or a reasonable compensation) in cash to Titius and Sempronius and keep the building. The same result could be achieved by requiring an independent expertise in advance, or granting Sempronius an appraisal remedy.

195See supra p. 900.
it constitutes an important legal issue involving fairness, disclosure, and burden of proof.196

Consider another example where a majority shareholder is self-dealing. In this instance the majority shareholder action is not beneficial to the company, and there is substantial unequal treatment of the minority. Notwithstanding these effects, the proposed action may be economically efficient and fair. What I ultimately would like to demonstrate is that an equal treatment rule that is designed to prevent such transactions is in reality inappropriate.

As a sixth example, assume that a company, Alpha, has no reason for making a distribution or a capital reduction, since its monetary resources are all necessary to run the firm. In this case, the company is not indifferent to a distribution or capital reduction since it would decrease the company's personal utility. Suppose, however, Alpha's director makes a distribution that prevents the company from meeting growth expectations in the coming years. Suppose further that the company, given a certain budget, has a five-year business plan which has been duly fulfilled for the first three years. The example is deliberately similar to the famous Sinclair case.197 The distribution is useful to Titius, the sole director and majority shareholder, because he plans to re-invest the money in a new venture (Beta), which has a return on investment rate (ROI) higher than that of Alpha. Caius receives the distribution but does not participate in the Beta venture. Notwithstanding the fact that both the Alpha company and Caius are indirectly worse off, Titius' decision is not unreasonable.

Generally speaking, the rationale on which a distribution decision should rely is that the marginal utility of the money for the company is less than it is for its shareholders; the same is also true for the ROI rate. In fact, Titius expects from the Beta venture to have a higher ROI rate than Alpha has in its own business; but the same is not true for Caius. From an economic point of view, Titius' decision is rational if he estimates that the shareholders' value loss in Alpha is less than the utility increase he derives from the investment in Beta. Caius receives equal dividends, but suffers prejudice on the shareholder's value in his sole Alpha venture. The shareholder's value in Alpha (unlike what Modigliani and Miller hold) is depreciated as a result of the distribution, as long as the company has no sufficient means to fulfill the business plan.

196See infra Part IV (discussing the problems under the entire fairness standard).
197See Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (holding that "Sinclair's decision, absent fraud or gross overreaching, to achieve expansion through the medium of its subsidiaries, other than Sinven, must be upheld").
Since dividends benefit all shareholders pro rata, the Delaware Supreme Court in *Sinclair* affirmed the distribution, reasoning that the directors, appointed by the majority shareholders, did not self-deal. But, under an equal treatment rule, which prevents not only formal but also substantial unequal treatment (as some commentators, especially in Germany, suggest), this distribution would probably not be allowed. While it achieves the pro rata distribution, it also yields a "corporate opportunity"\(^{198}\) for the majority shareholder that is detrimental to both the company and the minority shareholder. In this case an equal treatment rule would also be economically inefficient. If the equal treatment rule prevents Titius from declaring dividends, Titius loses the opportunity to invest the money in the Beta venture. Applying the Kaldor-Hicks efficiency criterion will illustrate this point.\(^{199}\)

Assume \(u_\alpha, u_t, \) and \(u_c\), are the utility functions of Alpha, Titius, and Caius measuring the utility derived from money (M) by Alpha (\(M_\alpha\)), the shareholders (\(M_{t,c}\)), or Beta (\(M_\beta\)). \(Z_0\) is defined as the time preceding the distribution, \(Z_1\) represents the time following the distribution, and \(Z_2\) represents the time following the investment in Beta. A variation in the utility is indicated by \(\Delta\). The individual choices are expressed by the following comparisons of utility: \(u_\alpha (Z_1) < u_\alpha (Z_0); u_c (Z_1) < u_c (Z_0); u_t (Z_1) < u_t (Z_0)\). The reason behind Titius' choice can be expressed as: \(u_t (Z_0) < u_t (Z_2)\). Considering the variations in personal utility, \(\Delta u_t (Z_0, Z_1) = u_t (M_1) < u_t (M_0)\); \(\Delta u_t (Z_1, Z_2) = u_t (M_1) < u_t (M_0)\), it follows that \(\Delta u_t (Z_0, Z_1) < \Delta u_t (Z_1, Z_2)\). In Caius' view, the increase in units of money is less than the depreciation of Alpha's shareholders' value: \(\Delta u_c (Z_0, Z_1) = u_c (M_c) < u_c (M_\alpha)\), thus \(\Delta u_c (Z_0, Z_1) < 0\). Assigning a number to these variations—\(\Delta u_t (Z_1, Z_2) = 2; \Delta u_{t,c} (Z_0, Z_1) = -1\)—and considering that Titius owns seven Alpha shares and Caius owns three, it follows that \(\Delta u_t (Z_0, Z_2) = 1.3\), while \(\Delta u_t (Z_0, Z_1) = -0.3\). Applying the Kaldor-Hicks criterion, Caius is indifferent to whether Titius declares dividends or not, as long as Titius directly compensates

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\(^{198}\)See *id.* In *Sinclair*, as in the above example, no real "corporate opportunity" problem arises, since the Beta venture is completely different from Alpha; Alpha's losses, as Sinven's, are not due to Beta's gains. *See id.* They are simply due to the necessity of additional assets, which the majority shareholder has withdrawn for the benefit of Beta.

\(^{199}\)See J.R. Hicks, The Foundations of Welfare Economics, 49 ECON. J. 696 (1939); Nicholas Kaldor, Welfare Propositions of Economics and Interpersonal Comparisons of Utility, 49 ECON. J. 549 (1939). The Kaldor-Hicks efficiency criterion is a measure of economic efficiency that solves some of Pareto efficiency weaknesses. Under Kaldor-Hicks efficiency, an outcome is considered more efficient if a Pareto optimal outcome can be reached by arranging some compensation from those that are made better off to those that are made worse off.
Caius' loss by means of 0.3 in cash (equal to the loss on shareholders' value which Caius suffers). Still, Titius gains something from the Beta venture. This example shows that an equal treatment rule, or any other rule that prevents such distribution, would be inefficient. Also, following Easterbrook and Fischel's view that suggests whoever produces a gain should be entitled to retain it, Titius will not share his gain in Beta with Caius. Still, the gross gain must be discounted by means of the damage to the shareholders' value that Caius suffers. In sum, from an economic point of view, Titius should not be prevented from pursuing his selfish interest, but the law should compel him to compensate the minority shareholders for the damage he causes them. Avoiding extra costs of litigation, ex ante compensation would be advantageous for all parties.

Not surprisingly, both German and Italian laws provide for this rule where the majority shareholder is a parent company and the minority shareholder does not take advantage of the gains of the group as a whole, but only of the subsidiary.

E. Results

It is appropriate to summarize the results emerging from the application of economic analysis. The examples consider cases in which disparate treatment does not result in the oppression of minorities. In most of the examples, the director and majority shareholder act as an independent referee and solve the deadlock that a mechanical equal treatment rule would produce. Also, more flexible equal treatment rules, such as the EU rule, would not be completely satisfactory. Most of the examples illustrate that the resolved deadlock increases aggregate welfare, either by fulfilling an interest of the company itself or by achieving a personal interest of one particular shareholder, at no expense to shareholders. The various examples show that corporate distributions may also increase welfare where the application of a pro rata rule is undisputed; capital reductions and share repurchases, however, must not follow a pro rata rule. The last, strong example shows that an interested distribution, producing direct prejudice to the company and to the shareholders' value may be reasonable from an economic perspective and should not be prevented by a substantially equal treatment rule. In this instance, compensation for the damage is appropriate. The final conclusion is that an equal treatment rule is completely undesirable.

Still, repealing or not implementing an equal treatment rule does not solve the problems the equal treatment rule was designed to address. In any of the given examples, oppression of the minorities could still occur. The remainder of the article will address this problem and suggest solutions with
the established reasoning of the Chicago School and Delaware Courts. In
developing this framework it is not precise equality but fairness that is
relevant. Nevertheless, if an equal treatment rule is too broad, a fairness
standard may be too vague and undermine certainty of the law. My purpose
here is to draw clear guidelines that will reduce the risk of uncertainty which
could come from principles that are too general.

VII. FAIRNESS V. PRECISE EQUALITY

As the Chicago School and the Delaware courts already have
meritoriously recognized, an equal treatment rule must surrender in the face
of cases in which its application would result in a reduction of the aggregate
welfare and waiver of its application does not prejudice anyone. Moreover,
the rule of fairness should replace the function that its supporters assign to
the rule of equality. Indeed, the relationships between majorities and minori-
ties, or between directors and shareholders, are very often characterized by
mutual interests or utilities rather than by contractual rights (and conversely
by duties rather than by contractual obligations). As civil law scholars
plainly recognize, the rule of fairness is certainly appropriate to ensure equi-
librium among the parties of a relationship when their interests, not recog-
nized by the law or contracted as a right, are involved.200

There is no reason to disregard interests that are not protected by the
law or contracted as rights if this might achieve substantial justice. Interests,
however, must be just interests. The principle of fairness should only serve
as a safeguard against injustice, not as an interpretational device able to alter
the contractual equilibrium on which parties have freely bargained. A mis-
leading interpretation would eventually empower courts to enforce obliga-
tions that parties could have explicitly negotiated *ex ante*, but for some
reason have not agreed.

A. Fairness, Diligence in Performance, Good Faith, and Best Effort

Civil law scholars, especially those referring to the German BGB or
the Italian Civil Code, point out that "fair behavior" and "diligence in per-
formance" are not synonymous concepts. Similarly, American courts also
distinguish "good faith" (an objective standard) and "best effort."201 The

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201 Good faith is a standard that has honesty and fairness at its core and that is imposed on
European idea is that the duty to diligently perform contractual obligations is the behavioral rule parties owe each other as a matter of parties' rights. Performance is due regardless of the cost to the agent, and the obligor who does not exactly render due performance is liable for damages regardless of whether she acted in good faith, unless she proves that the non-performance was caused by impossibility of performance not imputable to the obligor.202 Fairness, conversely, is a behavioral duty to fulfill (or at least to consider) other parties' utilities or interests that arise from a contractual relationship.

Civil law scholars refer to the duty to take into consideration other parties' interests as the duty of protection [in German, Schutzpflicht] or duty to safeguard [in Italian, obbligo di salvaguardia]. The first concept focuses on the duty to protect others' rights, property, and interests from the risk of damage that may result from the performance of the contractual relationship.203 The second concept focuses on the duty to fulfill or at least consider others' interests when such fulfillment does not result in an appreciable economic or personal sacrifice for the agent.204 Since both the duty of protection and the duty to safeguard are within the sphere of fairness, accomplishing these duties does not require diligence in performance. Put more simply, the protection or safeguard of others' interests may not be compelled regardless of the costs they may have for the agent.

Similarly, American courts argue that "[a] duty of good faith does not mean that a party vested with a clear right is obligated to exercise that right to its own detriment for the purpose of benefiting another party to the contract."205 As such, the duty of protection or to safeguard, or the American good faith standard often consists of the duty not to harm (a negative

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203 Cf. Hans Stoll, Abschied von der Lehre der positiven Vertragsverletzung [Farewell from the Doctrine of the Effective Damage] 136 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS 257, 285 (1932). In 2002, the German legislature passed an amendment to the BGB, including the duty of protection (Schutzpflichten) in section 241(2) BGB ("das Schuldverhältnis kann nach seinem Inhalt jedem Teil zum Rücksicht auf die Rechte, Rechtsgüter und Interessen des anderen Teils verpflichten" ["The obligation of every party of the contract should be performed considering others' rights, property, and interests."]). BGB, § 241(2) (F.R.G.).
204 See Bianca, supra note 200, at 209-10.
behavior) an interest that the agent has no reason to sacrifice. Fairness, therefore, is a generally suitable benchmark to assess whether particular conduct of the majority, or the directors, was achieved by ignoring an interest they should have considered.

These theoretical frameworks can contribute significantly to our analysis. Fairness requires majorities and directors to consider minorities' interests or utilities, at least when such a consideration does not impose a cost on the majorities and directors. Fairness, however, should not require a sacrifice of personal interests in order to fulfill others’ or to share gains. The courts' function is not to choose solutions between shareholders or directors, but to prevent oppression of minorities. In other words, this means preventing operations in which directors or majorities act in bad faith, and are motivated only by hatred, wickedness, or cynical disregard of others' interests. This translates into a willful lack of care and attention. Also, if majorities or directors produce a gain from an operation and take it for themselves, unfairness occurs only if the gain is harmful for minorities and the minorities are not compensated. Under these circumstances, courts shall intervene. Nevertheless, since judges are not required to be experts in business, they would not be empowered to evaluate whether the business purpose for the activity is valid, legitimate, or proper.

B. Business Purpose, Entire or Intrinsic Fairness, and the Burden of Proof

First of all, it must be determined which party bears the burden to prove that an operation achieving formal or substantially unequal effects is fair or unfair. This problem has been clearly addressed in both English and American case law, as well as in the Australian Gambotto case. English case law is somewhat ambiguous, stating that unequal treatment is permissible if it serves a worthy purpose, or if the minority is unable to prove that the conduct of the majority is unfair. This dual position, however, seems awkward. In fact, either the burden of proof lies with the majority to prove that the action has a purpose worthy of protection (and for lack of such proof a disparate treatment shall not be permitted, as the Gambotto case substantially stated), or the disparate treatment is per se legitimate unless it is proven that it unfairly undermines the minority, as the Lerner case substantially stated.

When disparate treatment occurs, the courts need to understand the economic reasons for such treatment. Requiring the directors or the majority
to prove the business purpose for its action can be both insufficient and excessive. The American debate on the business purpose doctrine\textsuperscript{206} has clearly acknowledged that it is not difficult to allege any business purpose in support of an action. It is very difficult to prove, however, if it is a valid, proper, or legitimate business purpose.

Moreover, courts have no power to interfere with business matters, and in most of the cases courts are asked to evaluate an action \textit{ex post}. Everyone agrees that a court cannot evaluate the validity of a business action by its results, but it can challenge the complete lack of reasonableness of an action,\textsuperscript{207} given evidence that the action could have never achieved the proposed result.\textsuperscript{208} This assessment has little to do with the validity, legitimacy, or properness of the business purpose and much to do with the fairness of the behavior.

When unequal treatment or self-dealing occurs, Delaware courts (recently superseding the business purpose doctrine) require the majority or the directors to pass the so-called entire fairness or intrinsic fairness test. This test implies a high degree of fairness and shifts the burden of proof. As a result, the majority or the directors may not invoke the presumption of the business judgment rule. In \textit{Weinberger} and \textit{Cinerama}, entire fairness means "the transaction must be the product of both fair dealing and fair price."\textsuperscript{209} In \textit{Sinclair}\textsuperscript{210} and its antecedent \textit{Guth},\textsuperscript{211} intrinsic fairness means
that the defendant must prove, subject to careful judicial scrutiny, that the transaction is "objectively fair."

Entire or intrinsic fairness, however, is quite an ambiguous concept, since it is not clear what the adjectives entire or intrinsic add to the concept of fairness. How much fairness is required to confirm that a share repurchase from one shareholder is entirely fair, or that a share repurchase from the majority shareholder (self-dealing) is intrinsically fair? Are entire fairness (fair dealing and fair price) and intrinsic fairness (objective fairness) different concepts? In cases where entire fairness or intrinsic fairness was required, the courts, de facto, were satisfied if the directors could show a plausible reason for their action. In Nixon and Applebaum in particular, a plausible business purpose (implementing an ESOP or reducing costs) sufficiently accomplished the requirement of entire fairness. So, at least one point is clear: the entire or intrinsic fairness test does not shift the burden of proof to the directors to show that their action is the result of their best effort to fulfill the interests of the challenging minority, but it is their burden to prove that their action is plausible or reasonable.

It must be considered, however, that even if the action is per se plausible or reasonable, it could still be substantially unfair. Referring back to Nixon will show this point. An ESOP is clearly a reasonable ground for repurchasing shares from retiring employees; still, a corporation may have enough financial resources to also permit buyouts of non-employees shareholders. If the directors do not buy out shares from a non-employee because they hate the guy, unequal treatment may be reasonable (objectively fair), but substantially unfair (action is in bad faith). Thus, should entire fairness also require that the directors prove that their action is in good faith or not in bad faith? I think not, for the following reasons.

First of all, it is much more difficult to show that conduct is correct and that agents acted in good faith, than to provide evidence to the

UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (affirming that the "fair price" aspect of an entire fairness analysis requires the board of directors to demonstrate "that the price offered was the highest value reasonably available under the circumstances"). In Weinberger, the court stated:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

457 A.2d at 711.

210Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

211Guth v. LoFt, Inc., 5 A.2d 503 (Del. 1939); see also Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952) (discussing the intrinsic fairness test).

212See GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC
contrary and show that the action was motivated by prejudice. Also, by allocating the burden of proof in this way, the minority may substantially claim a right to equal treatment whenever the directors or the majority are simply unable to prove that their action was objectively and substantially correct, or that they behaved in good faith. This could happen regardless of whether there is a good reason for the unequal treatment. This outcome seems inconsistent with the results of economic analysis. It is also contrary to the idea that fairness (meaning in this context a duty of protection or to safeguard) does not imply a requirement to undertake every possible effort to fulfill the interests of the minority (diligence in performance), but rather, only requires the majority or directors to consider the minority's interests in good faith.

For these reasons, I believe that the minority bears the burden of proving the directors' or majority shareholder's bad faith or cynical disregard of its interests. It may be difficult for the minority to prove the fraudulent intent of others. I acknowledge, therefore, the need of a legal mechanism that helps recognize its responsibilities. I suggest an intermediate solution that facilitates the test, but still keeps the burden of proof with the minority.

The most equitable solution emerges in several EU laws, including those of Italy. The idea is to make sure that the majority or the directors disclose *ex ante* the purpose of their action. This information enables the minority to show that the alleged reason is fictitious, or that the extent of the action is disproportionate to the goals it is supposed to achieve. In all European systems, this feedback is easily attainable because decisions concerning distributions, purchases of the companies' own shares, capital reductions (or increases), and forward or reverse stock splits, are all to be made upon resolution of a general meeting with a motivated proposal by the directors. Once the purposes are *officially* disclosed, it is much easier for the complaining minority to provide evidence that the unequal treatment is still unfair.

The minority's burden of proof can be substantially satisfied in two ways. First, the minority can prove that the official purpose of the action is fictitious and that the real purpose is to harm or freeze-out the minority. Second, the minority can show that, although the motivation may be truthful, the proposed action unfairly ignores or disregards detrimental effects that could have been avoided with a different solution at no cost. German scholars call this *necessity of action*, which was shown in particular in the *Sachsenmilch* case.
A similar outcome may be achieved, *ex post*, under the American entire fairness test. As pointed out earlier, passing an entire fairness test is not necessarily equivalent to requiring the majority or the directors to provide evidence that their action is carried out in good faith. As *Nixon, Applebaum, Lerner,* and *Weinberger* show, courts require an explanation that the action is not plainly unreasonable. Once the reasonable purpose of the action is disclosed, the minority must show that the effects are disproportionate or the action is still brought in bad faith.213

Referring to the examples made in Part VI, let us solve them with the proposed fairness standard. In the first example, the majority shareholder and sole director Titius chooses to buy the copy machine from the shareholder who is a reseller for Canon (Caius), instead of from the one who is a reseller for Xerox (Sempronius). Sempronius sues. Titius must show that it is not plainly implausible that the company could buy a copy machine, and that the price is fair (market price). Titius is not required to show how the business would improve by buying a copy machine, nor why he prefers Canon over Xerox. If Titius' choice is in bad faith, it is Sempronius' burden to prove that.

The same is also true for examples two and three, where Titius buys one share from his brother. Titius must prove that buying only one share is reasonable and that the price is not disproportionate. He need not prove that choosing his brother is objectively preferable. It is Sempronius' duty to show that choosing the brother is substantially unfair or in bad faith. For instance, he could show that Caius does not need any money. Or he could show that Titius repurchased Caius' share only to freeze the available surplus, so that Sempronius' share could not be purchased and dividends would not be distributed. Caius could also show that both Titius and Sempronius wanted to sell the share at a trivial price, which would be oppression. But if Titius and Sempronius need cash, it is plausible and not unfair that Titius prefers to benefit his brother or himself. That sort of self-dealing or dealing with interested parties requires disclosure and fairness. Fairness, however, cannot be understood as a constraint to fulfill other's interests instead of one's own.

If these arguments are applied to the decisions in *Donahue* and the *Nixon*, the predictable outcome would have been the following. In

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213This is substantially the outcome in *Wilkes*. See *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657, 663 (Mass. 1976) (stating that the controlling group must first demonstrate some legitimate business purpose for its action; if such a showing is made, the burden then shifts to the minority shareholder to show that the legitimate purpose should have been achieved through an alternative less harmful to the minority's interest); see also *Bainbridge*, supra note 84, at 819-23 (noting that while Massachusetts and Delaware doctrines differ, the results may not).
Donahue, Rodd's children would be asked why they bought out only shares from Rodd. Assuming it was not done in bad faith, they would have answered that the company had enough cash to buy only Rodd's shares. Although they knew that Mrs. Donahue would like to sell her shares, they chose to buy out their father so he could retire for health reasons. That would be reasonable. Now Mrs. Donahue would have the burden to show that the choice not to buy her shares was motivated by the Rodd children's intention to freeze her out. She would also need to show that the company could have also bought her shares at a fair price and would still be able to carry on the business. If this could be proved, Rodd's children's action would be considered unfair. Applying this argument to Nixon, if Nixon could allege a plausible reason why only the employee shares were bought, then the Blackwell brothers could try to prove that the company did not buy their shares under the same conditions as the employees because the directors only wanted them to sell at an unfair price. In both cases, the use of the fairness standard would fit the circumstances of the case much more closely than an equal treatment rule would.

C. Unequal Treatment Caused by Inaction and Burden of Proof

The discussion in the preceding section, however, needs to be analyzed in more depth and in other situations. The equal treatment rule has not been restricted to cases like Donahue or Nixon—situations in which the corporation selectively repurchases shares. Substantial unequal treatment may also occur when the corporation has not paid any dividends for an extended period of time because the directors or majority shareholders do not need them; for example, they reap benefits from the company through a salary or bonds providing a high return. In such cases, given that there is no market for the corporation's stock, minority shareholders have claimed that they are entitled to receive dividends, have their shares repurchased, or draw salary. Although some courts welcome these claims, the majority of commentators and courts reject such interference with the business activity. Also, opposite circumstances, such as those in the Sinclair case, may create substantial inequities. How would a fairness standard apply in these situations?

In Dodge v. Ford Motor Co., following Hunter v. Roberts, Throp & Co., the Supreme Court of Michigan decided that

\(^{214}\) 170 N.W. 668 (Mich. 1919).

\(^{215}\) 131 N.W. 131 (Mich. 1890).

Courts of equity will not interfere in the management of the directors unless it is
a refusal to declare and pay [appropriate] dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done. [Consequently] the directors must justify their action, or failure or refusal to act.216

The court found their justification inadequate217 and ordered the corporation to pay additional dividends.218

Whether or not one agrees with the outcome of the Dodge case, all should disagree with the court's reasoning. Although corporations are organized to distribute dividends, the decision to pay dividends is one of business judgment. From a Coasian perspective,219 the default rule (at least for American corporations) is that the minority does not have a right to receive regular dividends or to withdraw at will. Shareholders, however, may negotiate ex ante in order to allocate the results of an activity; similarly, nothing

19 dodge, 170 n.w. at 683.
20Id. at 684-86. The case is bizarre. Called to testify as chairman and majority shareholder of Ford Motor Co., Henry Ford provided a detailed justification of the industrial necessity or opportunity for keeping the profit as investment for the future growth of the corporation. This would achieve the ultimate interest of the shareholders, as he said. Id. at 683. Perhaps, Ford also understood that the Dodge brothers were up to organizing another automobile company and did not want to support them financially. Anyway, as a notorious philanthropist, Ford had the audacity to declare his very famous quote:

"My ambition," said Mr. Ford, "is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back into the business."


stands in the way of agreements that grant the distribution of regular dividends. \(^{220}\) Hence, the transaction costs for such arrangements lie with the minority, and courts should not restate the starting positions. Courts may interfere with the business activity, but only if it is proven that the directors' action or inaction is plainly unreasonable or in bad faith. As previously discussed, directors may only be required to explain the reasons for their action or inaction. The fairness standard requires the minority to prove unreasonableness or bad faith.

_Gottfried v. Gottfried_ demonstrates that while there may be evidence of "bitter animosity" among shareholders, courts should not order the business to declare dividends unless it is proven that the directors acted in bad faith. \(^{221}\) Similarly, intervention is appropriate only if the majority is not freezing financial resources, or the directors are undermining the corporation's prospective growth. In _Sinclair_, \(^{222}\) the Delaware Supreme Court convincingly acknowledged that in the absence of fraud or gross overreaching, a parent's decision to achieve expansion through a medium of its subsidiaries, other than the subsidiary in which the plaintiff was a minority shareholder, is one of business judgment with which the court would not interfere.

As the court in _Dodge_ ultimately declared, "judges are not business experts." \(^{223}\) It follows that they are not equipped to decide whether dividends should be declared, whether an additional dividend should be paid, whether a capital reduction is appropriate, or whether a distribution must be prevented. Judges must be granted the authority to detect the oppression of minorities and to provide appropriate remedies. Directors or majorities cannot be asked more than to show that their conduct is plausible. Minorities, on the other hand, should be required to prove that the challenged action or inaction is motivated by wickedness or a cynical disregard of others' interests.

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\(^{222}\)Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971).

\(^{223}\)Dodge, 170 N.W. at 684.
D. Remedies: General Criteria

If unfairness is proven, the legal system owes the minority protection. Different legal systems provide different remedies. Some force the majority to take the action that satisfies the unfulfilled interest; others permit the dissolution of the company. Another legal system compels the buyout of the shares owned by the minority, while others simply allow monetary compensation. In Donahue, the Massachusetts Supreme Judicial Court decided that the corporation must either purchase the minority shareholders' shares or return the shares purchased from the majority shareholder. It is not easy to say which solution best fits each particular legal system.

In my opinion, monetary compensation seems most appropriate because it restores *ex post* a contractual equilibrium that the majority or the directors have undermined. At the same time, the risk of monetary compensation is an adequate incentive for directors or majorities to consider others' interests *ex ante*. Ultimately, it motivates the board to act with fairness in mind. Moreover, if we consider monetary compensation as a cost, we may also consider it a price. Considering monetary compensation as a price for unfair conduct is not contradictory. As one of the examples made in Part VI and the Sinclair case have shown, the majority shareholder should be allowed to pursue her selfish interest, as long as doing so is reasonable and adequate monetary compensation is given to the minority to avoid or prevent oppression. Both German and Italian law allow this remedy when parent corporations prejudice shareholders' value of subsidiaries, when the interest of the group as a whole so requires.

In a Donahue- or Nixon-like case, one can imagine a wider range of remedies. To prevent oppression *ex ante*, a Spanish- or English-like solution may be appropriate. For example, whenever the corporation selectively purchases shares, either all of the non-affected shareholders vote in a special meeting (Spanish solution), or all the affected shareholders have no right to vote in the general meeting (English solution). If preventing oppression *ex ante* may be too costly or even ineffective, remedies against oppression may be granted *ex post*. In these circumstances, buyout rights seem plausible.

The Italian solution also deserves consideration. If the company has infinite life, and there is no market for the shares, any shareholder may withdraw at will, even if no oppression occurs. If the company has a finite life, shareholders may withdraw provided that oppression is proven. Monetary compensation would also work, but only in cases where the corporation has a reasonable termination.

In a Gambotto-, Sihotur-, or Lerner-type case, I think the majority should not have the right to cash-out a minority, as this is akin to blackmailing. The obstructionist should be required to recover the damages that
the bad faith action has caused. But she cannot be squeezed out against others' will unless the articles have granted the majority or the corporation a call option upon the shares of the minority shareholder or the law grants equitable remedies in case of a deadlock.224 The Spanish solution requiring consent of the obstructionist is plainly implausible.

Finally, in a BA Trustee-type case, involving a distribution or a reimbursement in kind, I think the House of Lords should have made it clear that the directors must disclose a reasonable purpose for the unequal treatment, and the minority shareholder must prove that the proposed action was brought in bad faith. All European legislation requires the decision from a shareholders' meeting to be challenged before it is enacted, so the court could order the directors not to perform the action decided at the meeting. In the American system, I would rather require monetary compensation if the transaction has already been performed.

VIII. CONCLUSION

This article's main conclusion is that some decisions entail disparate treatments, but are not implausible. A strong equal treatment rule does not avoid all oppression of minorities, but it restricts the boards and majorities' room to maneuver in situations where no oppression occurs. The softer EU equal treatment rule requiring an equal treatment of shareholders who are in the same position is unclear and vague. If the goal of an equal treatment rule is to avoid oppression of minorities, the law should intervene only when disparate treatment is unfair.

Inequalities should be permitted as long as they achieve economic results, when they are creating value for shareholders. The majority or the directors must meet the requirement of fairness in their business decisions. The duty of fairness does not require best efforts to satisfy the interests of the minority, only good faith consideration of others' interests. Oppression of the minority occurs when the directors or the majority act in bad faith; that

224See, e.g., Companies Act, 2006, c. 46 §§ 994-996 (former Companies Act 1985 §§ 459-461); Belgian Company Code, Art. 636 (formerly Lois coordonnées, Art. 190 (b-c)); Schweizerisches Obligationenrecht [OR] [Code of Obligations], Art. 736(4) (Switz.); see also Jennifer Payne, Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection, 64(3) CAMBRIDGE L.J. 647 (2005) (UK). See also the recent decision of the German Bundesverfassungsgericht [BVG] [Federal Constitutional Court], May 30, 2007, 1 BvR 390/04, available at http://www.bundesverfassungsgericht.de/entscheidungen/rk20070530_1bvr039004.html, which states that the right to squeeze out granted to the bidder in case of successful takeover does not damage the protection of private property granted by the German constitution, as long as a public procedure regulated by the law ensures adequate monetary compensation for the expropriation of the shares.
is, when the majority or directors disregard the interests of the minorities that could be taken into consideration at no cost. Consistent with this approach, the directors or the majority should not bear the burden to prove the validity, legitimacy, or properness of the business purpose on which they rely. Nor should the courts question these issues. Still, directors and the majority must disclose the purpose upon which they make their decisions, and those decisions must be reasonable. The minority may still challenge that an action or, in some cases, inaction is unreasonable.

Ultimately, this article has shown both similarities and differences among the various legal systems. It hopefully contributes to the effort to overcome useless boundaries in an increasingly connected, and unfortunately troubled, global economy.