FIDUCIARY DUTIES OF CONTROLLING SHAREHOLDERS: A COMPARATIVE VIEW

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1. INTRODUCTION

Both directors and controlling shareholders are vested with the power to exercise control over the property of others. While the common law has recognized strict fiduciary duties binding the directors of a company,¹ it has refused to impose a general fiduciary duty on controlling shareholders. The voting power of the majority shareholders has been restricted, on the other hand, by the common law in two categories of cases: where a resolution relates to the alteration of the company's memorandum and articles of association and where a resolution is tainted by "fraud on the minority."

Israeli corporate law, though generally based on English company law,² has recently departed from the English view with regard to the fiduciary duties of controlling shareholders. English law denies the imposition of a fiduciary duty on controlling shareholders to minority shareholders. Israeli law, however, has veered toward the American view, which favours imposing a fiduciary duty on controlling shareholders.

The purpose of this article is to trace the development of Israeli law in this field, comparing it with English and American law. Further, it shall examine the extent to which a general fiduciary duty should be recognized on the part of controlling shareholders in England and in Israel. This examination will explore the underlying rationale for the recognition of a fiduciary duty in this field. By focusing on the relevant statutory provisions of England and Israel, this article will shed light on the attitudes of these countries' legislatures towards a fi-

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² The Israeli Companies Ordinance of 1929, LAWS OF PALESTINE, vol. 1, ch. 22 (1933), is based mainly on the English Companies Act, 1929, 19 & 20 Geo. 5, ch. 23. (The current version of this ordinance is Companies Ordinance (New Version) 1983, Laws of the State of Israel, New Version 37). In various matters not dealt with by the Ordinance, Israeli case law has taken a similar position as English common law. Recently, however, a tendency has developed to prefer United States law on certain topics, including the topics considered in this article.
fiduciary duty on the part of controlling shareholders. Finally, a conclusion in favour of recognizing a general fiduciary duty of controlling shareholders does not address the issue of the scope of such a duty. Should the controlling shareholders' fiduciary duty be equivalent to the fiduciary duty owed by the directors of a company? This question will be considered in the last part of the article, where the scope of the duty regarding the use of control and its disposal will be examined.

2. Justification for Recognizing a General Fiduciary Duty

The law imposes a fiduciary duty on anyone who has the power to control the property of another person. For this reason, fiduciary duties exist in the following relationships: a trustee towards a beneficiary, an agent towards a principal, a guardian towards a legally incompetent person, a promoter towards the company which will eventually come into being, and directors toward a company. As long as the power of control exists, it carries the risk of abuse or exploitation; it may be used in favour of the person in whom it is vested to the detriment of the other parties. Consequently, in such a case, the law imposes a fiduciary duty on those who wield this power. In this way, the law deters fiduciaries from misusing their power and compensates the injured party when deterrence fails.

Controlling shareholders have the power to control the property of others; they may make decisions concerning the company's property and influence the rights of the other shareholders. This power is derived from the democratic principle on which the company's activity is based. The majority can direct the company's actions and may bind the minority by its decisions. Generally, the law imposes a fiduciary duty on anyone controlling another's property. As controlling shareholders effectively control the company's and the minority's property, such a general fiduciary duty should apply to controlling shareholders.

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4 Restatement (Second) of Trusts § 170 (1959); see also P. Pettit, Equity and the Law of Trusts ch. 20 (6th ed. 1989).


6 Restatement (Second) of Trusts § 7 comment b (1959).


8 Id. at § 235.

Have the courts come to the same conclusion? This question shall be examined in regard to the common law systems of England, the United States, and Israel.

2.1. The English Approach

English case law has recognized a shareholder's voting rights as property. The owner of such rights may use them as she wishes. As Jessel, M.R., put it, "[T]hose who have the rights of property are entitled to exercise them, whatever their motives may be for such exercise — that is as regards a court of Law as distinguished from a court of morality or conscience, if such a court exists." Similarly, Justice Walton declared:

When a shareholder is voting for or against a particular resolution, he is voting as a person owing no fiduciary duty to the company who is exercising his own right of property as he sees fit. The fact that the result of the voting at the meeting (or at a subsequent poll) will bind the company cannot affect the position that in voting, he is voting simply in exercise of his own property rights.

Despite this broad enunciation of the law, limitations on the power of a shareholder to use her voting rights have been recognized. Such limitations relate to two categories of cases. The first category of cases involves the alteration of the memorandum and articles of association. English law recognizes limitations on the power of the majority, against the minority's wishes, to alter the terms of the contract enshrined in the company's constitution. The majority's power is subject not only to express statutory limitations, but also to equitable rules laid down by case law. English case law has held that the majority may alter the company's constitution only when this power is exercised in good faith for the benefit of the company.

The second category of cases involves "fraud on the minority." It is established law that the majority cannot pass a resolution involving "fraud on the minority." This term has been clarified by the courts and does not include every case in which the minority finds itself prejudiced. Two specific categories of fraud on the minority have become accepted. The first type of case entails the expropriation of the

10 Pender v. Lushington, 6 Ch. D. 70, 75 (M.R. 1877).
11 Northern Counties Sec. Ltd. v. Jackson & Steeple Ltd., [1974] 1 W.L.R. 1133, 1144 (Ch.).

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company's property by the majority. The classic example of this category is the case of *Cook v. Deeks.*\(^3\) In *Cook*, the directors entered into a contract in their own names, when they should have entered into it for the company. The court held that the act could not be ratified by a majority of the shareholders, since the profits derived from the contract by the directors belonged to the company, under the rules of equity. The majority's decision to ignore the rights of the company amounted to fraud on the minority and hence was invalid.\(^4\)

The second type of fraud on the minority is the expropriation of the minority's property by the majority. The majority cannot make use of its power to take over the shares of the minority. Thus, an alteration of the articles, under which a shareholder would be bound to transfer his shares on written demand by holders of 90% of the issued capital, has been held invalid. In *Brown v. British Abrasive Wheel Co. Ltd.*,\(^5\) the basis for the proposed alteration was the company's urgent need for additional capital. The majority, holding 98% of the shares, was prepared to supply the company capital on condition that it could acquire the minority's shares. Even though it was not alleged that the majority was lacking good faith, the court refused to approve the alteration. The court held that the majority could not use its power to expropriate the shares of the minority.\(^6\) For a similar reason, a resolution to alter the articles which would enable the general meeting to compel the sale of a member's shares at fair value to a person designated by the board of directors was held invalid.\(^7\)

Is it right for the fiduciary duty of controlling shareholders to be confined to these cases only? This author believes that no such limitation should exist. This duty exists in order to restrain the power vested

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\(^4\) *Id.* at 564. This ruling was also accepted by the High Court of Australia in *Ngurli Ltd. v. McCann*, 90 C.L.R. 425, 447-48 (Austl. 1954).

\(^5\) *Id.* at 295-96. *Brown* was distinguished in *Sidebottom v. Kershaw, Leese & Co. Ltd.*, [1920] 1 Ch. 154 (C.A.). In *Sidebottom*, an alteration of the articles was approved, which obligated a shareholder, who belonged to a business in competition with the company, to transfer his shares for a fair value upon the directors' request. In contrast to *Brown*, the court recognized that the alteration in this case was passed in good faith for the benefit of the company as a whole. The alteration enabled the company to rid itself of shareholders belonging to a competing business. It is at least questionable whether it is right to compel a shareholder to transfer his shares just because he holds shares in a competing business, particularly if the company is a large one where the shareholder has a relatively small number of shares.

\(^6\) See *Dafen Tinplate Co. Ltd. v. Llanellty Steel Co.* (1907) Ltd., [1920] 2 Ch. 124. The court distinguished the case before it from *Sidebottom* holding that the *Sidebottom* decision went further than was required to protect the company from shareholders who were able to harm its interests. *Dafen Tinplate Co. Ltd.*, [1920] 2 Ch. at 137-38.
in the controlling shareholders to prevent its misuse. That rationale is not unique to the cases outlined above; it applies to all of the conduct of controlling shareholders.

By examining the reasoning put forth by Lindley, M.R., for imposing a fiduciary duty on majority shareholders in the case of alteration of the memorandum and articles of association, it is clear that all resolutions entrusted to shareholders should be treated the same as the resolutions in this category. Lindley states:

The power thus conferred on companies to alter the regulations contained in their articles is limited only by the provisions contained in the statute and the conditions contained in the company’s memorandum of association. Wide, however, as the language of s. 50 is, the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.

Why should a fiduciary duty be imposed on the majority when it alters the company’s constitution? Such a duty cannot be explained by the importance of such a power. Nor can the possibility of harm to the minority, through the exercise of the power, justify this exception. After all, there are other shareholders’ powers which are just as important and just as potentially harmful. Such powers include: resolutions to wind up the company; resolutions on important matters connected with company policy, where under the company’s constitution these matters are within the jurisdiction of the general meeting; and a declaration or non-declaration of a dividend. In addition to the powers conferred on the general meeting by statute and by the company’s constitution, the general meeting is endowed with the authority to exercise the powers of the board of directors in cases where the latter is unable to function. This situation may arise when the board is unable to obtain a quorum or when it is deadlocked on an issue. Thus, the existence of a fiduciary duty for controlling shareholders in this context was brought about

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19 Id. at 671.
empirically; it is devoid of any legal or logical basis.\textsuperscript{21}

Given these circumstances, the lack of uniformity in English legal literature regarding the question of the fiduciary duty of controlling shareholders is understandable. Gower favors the recognition of a fiduciary duty on the majority towards the minority.\textsuperscript{22} He states:

\[\text{[A]lthough members, unlike directors, are not required to act bona fide in the interests of others, they, like directors, must exercise their powers for a proper corporate purpose. The purpose is proper if it is to benefit the company or the generality of the members or class concerned. It is improper if it is primarily to injure other members, or perhaps, to benefit extraneous interests, whether of the persons voting for the resolution or of third parties.}\textsuperscript{23}\]

As authority for recognition of that duty, Gower cites \textit{Clemens v. Clemens Bros. Ltd.}\textsuperscript{24} The case concerned an aunt and her niece (the plaintiff), who together solely held the company’s outstanding stock. The aunt had control of the company, with ownership of 55\% of the company’s voting stock. Moreover, the aunt, unlike the plaintiff, was a director of the company. The resolution on which the litigation turned increased the company’s capital by 1650 shares. Each new share was to be equal in status, in all respects, to the existing shares. Under the resolution, 850 of the new shares were to be allotted to the employees and 800 were to be equally divided among the four directors of the company. The plaintiff objected to the resolution, arguing that it harmed her in several respects: a) by reducing the dividend to which she was entitled from four-ninths to two-ninths; b) by eliminating a capital profit, following the evaluation of the shares intended to be allotted at a sum lower than their real value; c) by reducing the plaintiff’s voting power in the company from 45\% to 24.65\%; and d) by curtailing her right to acquire the shares in the event of their transfer, thereby perpetuating her minority status.\textsuperscript{25}

The court allowed the claim for annulment of the resolution.\textsuperscript{26} It held that the resolution’s aim was to prejudice the plaintiff by reducing her voting power to below 25\%. In this way, the plaintiff would be deprived of the power to prevent the passage of a special resolution


\textsuperscript{23} \textit{Id.} at 629.

\textsuperscript{24} Clemens v. Clemens Bros. Ltd., [1976] 2 All E.R. 268 (Ch.).

\textsuperscript{25} \textit{Id.} at 276.

\textsuperscript{26} \textit{Id.} at 282.
without her consent.

The court denied the right of the controlling shareholder in the company to vote at her own option, holding that:

Miss Clemens is not entitled to exercise her majority vote in whatever way she pleases. The difficulty is in finding a principle, and obviously expressions such as "bona fide for the benefit of the company as a whole", "fraud on a minority" and "oppressive" do not assist in formulating a principle. I have come to the conclusion that it would be unwise to try to produce a principle, since the circumstances of each case are infinitely varied. It would not, I think, assist to say more than that in my judgment Miss Clemens is not entitled as of right to exercise her votes as an ordinary shareholder in any way she pleases. To use the phrase of Lord Wilberforce, that right is "subject . . . to equitable considerations . . . which may make it unjust . . . to exercise [it] in a particular way." 27

Although the court's statement regarding the limitation on the majority's voting power seems to be couched in general terms it should not be forgotten that this case concerned an alteration of the capital clause, which is part of the memorandum of association. Thus, this court merely returned to the category of alteration of the company's constitution, where the older cases already recognized the fiduciary duty of the majority towards the minority. Indeed, even Gower, who recognizes a certain fiduciary duty of the majority, states elsewhere in his book:

Scattered throughout the reports are statements that members must exercise their votes "bona fide for the benefit of the company as a whole," a statement which suggests that they are subject to precisely the same rules as directors. But it is clear that this is highly misleading, and that the decisions do not support any such rule as a general principle. On the contrary, it has been repeatedly laid down that votes are proprietary rights, to the same extent as any other incidents of the shares, which the holder may exercise in his own selfish interests even if these are opposed to those of the company. He may even bind himself by contract to vote or not to vote in a particular way, and his contract may be enforced by injunction. In all these respects the position of the share-

27 Id.
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holder is in striking contrast with that of the director.\textsuperscript{28}

Gower's conclusion regarding the duty of the majority to act for a proper purpose appears based on how he wishes the law to develop, rather than on the actual development of English case law.\textsuperscript{29}

Pennington states that:

In the absence of contractual restraints, a member may vote as he wishes at a general meeting, and may consult his private interests exclusively, even though they conflict with those of the company. This is so even though the member or a group of members who act in concert can exercise or control a majority of the votes which may be cast. Unlike American law, English law has not developed the principle that a controlling shareholder owes a fiduciary duty to the company or to his fellow shareholders, and that his freedom to consult only his own interests is correspondingly limited.\textsuperscript{30}

Despite the lack of recognition of a general fiduciary duty, Pennington argues that resolutions to alter the memorandum and articles of association and resolutions affecting class rights are valid only if passed in good faith in the interests of the members or class of members as a whole. In addition, the majority is restricted in that it cannot pass a resolution which will be oppressive or unfairly prejudicial to other members.\textsuperscript{31}

Thus, the \textit{Clemens} case did not induce Pennington to alter his view as to the lack of a general fiduciary duty of the majority towards the minority. However, this principle is subject to two exceptions which differ in scope: that of fraud on the minority and that of the duty to act bona fide for the benefit of the company in altering the company's memorandum and articles. \textit{Clemens} is cited by Pennington as an example of the first exception.\textsuperscript{32}

Farrar regards the \textit{Clemens} case as lending "some limited support" to the doctrine developed in the United States of the fiduciary obligations that controlling shareholders owe to the other shareholder-

\textsuperscript{28} L. Gower, \textit{supra} note 22, at 614-15.

\textsuperscript{29} Indeed, in an opinion presented to the Department of Trade in 1980 concerning a company's acquisition of its own shares, Gower points out that at general meetings, in contrast to directors' meetings, members are generally allowed to vote in favour of their own personal interests. \textit{See The Purchase by a Company of its Own Shares, A Consultative Document,} 1980, \textit{CMND.} 7944, \textit{part II, para. 44.}


\textsuperscript{31} Id. at 643-44.

\textsuperscript{32} Id. at 643-44, 660.
ers.33 He stresses, however, that "there is not yet full recognition of fiduciary duties on controlling shareholders as such."34

Within English legal literature, a middle position has been taken between these two opposing views, the one recognizing a general fiduciary duty of the majority towards the minority and the other recognizing its application only in cases of alteration of the company's constitution and fraud on the minority. According to this middle view, whether or not the majority has a fiduciary duty towards the company and towards the minority depends on the nature of the company. In a small, private, or "domestic" company, where the management and the ownership are largely identical, such a fiduciary duty ought to be recognized. However, no such duty should exist in large companies, where the shareholder may take into account his own personal, and even selfish, interests when exercising his voting power in the company.35

The differences of outlook in English legal literature are the result of casuistic decisions in the English law, which are incapable of logical explanation.

The rationale on which recognition of a fiduciary duty is based in cases of alteration of the company's constitution or fraud on the minority is equally applicable to other resolutions passed by controlling shareholders. This notion should bring about a change in the judicial approach to this topic.

2.2. The American Approach

Unlike the English approach, case law in the United States has recognized the existence of a fiduciary duty incumbent on controlling shareholders.36 In order to determine whether the fiduciary duty has been breached, various criteria have been put forward, the most prominent of which are "valid purpose" and "compelling business reason."37 When the majority shareholders indicate a legitimate business aim for their activity, the court will allow the minority to show that it was

34 Id. at 117.
35 Rider, Partnership Law and Its Impact on 'Domestic Companies' 38 Cambridge L.J. 148 (1979). This view is open to criticism. One may argue that it is precisely in a large company that the need for protection is greater, owing to the separation of control and ownership and the typical nonintervention of shareholders in the company's affairs.
37 W. Fletcher, supra note 36, at § 5811.20.
possible to achieve the same legitimate aim in an alternative way, less harmful to the minority.  

In Delaware, it has been held that the breadth of the majority shareholders' fiduciary duty is dependent on the circumstances of each case. Generally, the activities of the majority will be examined by the "business judgment rule." Under this rule, the court will not interfere with those activities that have a rational business aim. Where the minority shareholders (plaintiffs) manage to prove that the activity of the majority involves "self-dealing" (for which the court adopts the "intrinsic fairness" test) the burden of proving the fairness of the transaction shifts to the majority (defendants).

2.3. The Israeli Approach

In Israel, the Supreme Court has recently considered the existence of a fiduciary duty on controlling shareholders concerning the sale of control. The Court adopted the American approach, recognizing the existence of a fiduciary duty on controlling shareholders, in holding that:

[A] controlling shareholder who wishes to sell his shares owes a duty of loyalty to the company with respect to the sale, and must act in good faith and honesty toward it, and he will be in breach of his duty if he sells his shares to a buyer who to the best of his knowledge will strip the company of its assets and lead to its insolvency.

The rationale for this rule lies in the power vested in the controlling shareholders. As explained by Justice Barak: "It is a known, recognized principle in our law that a holder of the controlling interest is subject to a series of duties of loyalty, which are designed to limit the one in control from abusing his power." Although Justice Barak emphasized in his judgment that he was not laying down a general rule

39 W. Fletcher, supra note 36, at § 5811.20.
40 Id.
44 Id. at 285, 7 Selected Judgments of the Supreme Court of Israel at 215.
which imposed a fiduciary duty on controlling shareholders, the rationale for recognizing such a duty in respect to the sale of control is equally applicable to other powers vested in controlling shareholders. This leads to the conclusion that the voting power of controlling shareholders is subject to a fiduciary duty, which they owe to the company and to the minority.

In a later case, the Supreme Court of Israel held that the majority shareholders are bound to exercise their power of control in good faith for the benefit of the company.

3. THE VIEW OF THE LEGISLATURES

3.1. Remedies in the Event of Prejudicial Treatment

Neither the English nor the Israeli legislatures have regulated the duties of controlling shareholders towards the company or towards other members. Nevertheless, the existence of such a duty can be inferred from the statutory provisions, which provide a remedy for unfair prejudicial treatment.

In England, this matter is regulated by sections 459-61 of the Companies Act 1985, and in Israel, by section 235 of the Companies Ordinance (New Version). Both statutes grant an injured member a remedy when the company’s affairs are conducted in a prejudicial manner in relation to some members of the company. The relevant Israeli statutory provision came into force about the same time as the English Act of 1980. The latter introduced the remedy in its present

45 Id. at 284, 7 SELECTED JUDGMENTS OF THE SUPREME COURT OF ISRAEL at 214.
46 Greiber v. Assessment Officer, 39 (2) P.D. 678, 688 (Israel 1985).
47 Additionally, in England directors’ duties are not regulated by the legislature. However, in Israel, a recently enacted amendment to the Companies Ordinance regulates directors’ duties: Companies Ordinance (Amendment No. 4) (Officers’ Liabilities), 1991, Sefer Hahukim no. 1352 at 132.
48 Companies Act, 1985, ch. 6. Similar provisions are to be found in the corporation statutes of most of the common law countries. See, e.g.:
Australia - Companies Act 1989, § 260
Canada - Canada Business Corporations Act, R.S.C. 1985, ch. C-44, § 241(2)
Ghana - Companies Act 1961, § 218
India - Companies Act 1956, ch. 1 §§ 397-409
Malaysia - Companies Act 1956, § 181
New Zealand - Companies Act 1955, § 209
South Africa - Companies Act 1973, ch. 61
51 Companies Act, 1980, ch. 22.
form, replacing the alternative remedy under section 210 of the 1948 Act.\textsuperscript{53}

The aforementioned statutory provisions in England and Israel are not identical. For example, the Israeli provision does not explicitly refer to the making of an order, where the intention is to perform an act or make an omission that has not yet taken place. The Israeli provision does not specifically relate to a single act or omission. An application under the Israeli provision may be brought only by a member, whereas the English statute widens the scope of potential plaintiffs to include the Secretary of State, as well as a transferee of shares even if not registered in his name. The list of remedies specified in the English statute is wider than that enumerated in the Israeli provision. For example, the Israeli section is silent as to the remedy of empowering a shareholder to initiate proceedings on the company’s behalf. Further, the English section refers to the consequences of an order to alter the company’s memorandum or articles, a provision lacking in the Israeli provision.

On the procedural level, there is also a difference between the Israeli and English provisions. The Israeli provision mandates that the applicant deliver a copy of his application, within fifteen days of submitting it, to the registrar of companies. The Israeli statute also requires that the company deliver to the registrar a copy of the court decision, within fifteen days from the time it was rendered. If the court orders alterations to the memorandum or articles of association or to the company’s resolutions, the company must also deliver a copy of the altered documents to the registrar. On the other hand, the English provision requires only that a copy of the order altering the memorandum and articles, or allowing such alterations, be delivered to the registrar within fourteen days from the day it was given.\textsuperscript{53}

Despite these differences, both legal systems recognize a member’s right to apply to the court for a remedy, where the company’s affairs are being conducted in a prejudicial manner. Conduct of the company’s affairs covers activities and resolutions of both the directors and the controlling shareholders.\textsuperscript{54}

Although these provisions are not worded in the form of a duty on shareholders to refrain from prejudicial treatment, the existence of a remedy for prejudicial treatment indicates the legislatures’ views that such a duty does exist. The remedy thus implies the existence of such a duty.

\textsuperscript{53} Companies Act, 1948, 11 & 12 Geo. 6, ch. 38.

The various problems likely to arise in regard to the nature and scope of the remedy for prejudicial treatment go beyond the scope of this article. Succinctly put, the scope of the fiduciary duty of controlling shareholders as mandated by statute will be determined by the way in which the provisions granting the remedy are interpreted.

Both in England and Israel, case law has recognized that prejudicial treatment exists whenever the legitimate expectations of the parties are upset. Such a finding will persist even where the harmful conduct does not amount to an infringement of a right conferred by the company's constitution. A member's right to sue for the infringement of his legitimate expectations implies a correlative duty on those who control the company to refrain from conduct involving such infringement.

3.2. The Duty under Israeli Law to Act "In a Customary Manner and in Good Faith".

The explanation given in the English cases for not recognizing a general fiduciary duty (that is, the right of every person to act as he wishes with respect to his own property), does not apply to Israeli law, where no such right is recognized. Israeli law places restrictions on a person's power to make use of his proprietary rights. Thus the Land Law of 1969 provides that "ownership and other rights in immovable property shall not by themselves justify the doing of anything that causes damage or inconvenience to another." Similarly, the Israeli Contracts Law places a duty on every contractual party to exercise his rights in a customary manner and in good faith. By virtue of that duty, a party to a contract may not act as he wishes thereby ignoring the interests of the other party. That duty applies to contractual and noncontractual obligations, as well as to legal acts under an express statutory provision. Such a provision can serve as an additional basis under Israeli law for recognizing the fiduciary duty of controlling shareholders. The shareholders, in their capacity as parties to the contract embodied in the company's constitution, are bound to act in a customary manner and in good faith.

The significance of this study was spelled out by the Supreme Court of Israel in the following passage:

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68 Id. at § 61(b), 27 LAWS OF THE STATE OF ISRAEL at 127.

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The parties to the contractual relationship are bound to deal with each other honestly and fairly and according to what is customary between honest parties to a contract. True, the parties are not expected to act as angels towards each other, but nor should they behave as wolves to each other.... All parties to the contract should cooperate with each other, acting out of consideration for the common interest which they share in the contract. They should act in order to realize their joint intent, remaining loyal to the purpose they set themselves, and consistent in achieving their common, reasonable expectations.  

The expression "good faith" has been interpreted by the Israeli Supreme Court as having both an objective and a subjective meaning. The objective dimension is measured by examining the conduct in question with standards which society regards as proper. The subjective dimension implies that the acceptable standard of conduct is dependent on the type of transaction, its location and terms, and on the individual characteristics of the parties to the contract.

The criterion for determining what is "the customary manner" is not the manner actually resorted to, but that which ought to be customary. The extent of "the customary manner" obligation may vary according to the nature of the company and the status of the shareholders in the company. Where a controlling shareholder is concerned, his duty is more extensive. The "customary manner" of controlling shareholders is not the same as that of the minority shareholders in the company. Israeli law imposes a less burdensome statutory duty on non-controlling shareholders.

If the approach put forward in this article is accepted, and a fiduciary duty of controlling shareholders is recognized in England, there will still be a difference between English and Israeli law. While Israeli law obliges every shareholder, as a party to the contract contained in the company's constitution, to act in a customary manner and in good faith, English law recognizes no such duty.

4. What is Control?

Recognition of the duty of controlling shareholders raises the question as to defining "control." It is difficult to provide a precise defini-
tion of this concept.61 “Control” should be interpreted in the context in which the question is considered.62 In view of the purpose of placing a fiduciary duty on controlling shareholders, “control” should exist in every case where the shareholders have the power to affect the rights of others. It is not essential for the shareholder to hold a majority of the shares in the company for control to exist. Negative control is also recognized. This situation exists where some shareholders have the power to prevent the passage of resolutions of which they disapprove. This power rests in the holders of 26% of the voting rights whenever the law requires a special resolution of the shareholders. Likewise, control can exist in the holders of an even smaller percentage of shares, where the shares are widely dispersed. This is known as “de facto control.”63

Accordingly, control is defined in the Israeli Securities Law as “the ability to direct the activity of the corporation.”64 This definition indicates that control is not dependent on holding the majority of voting power. However, the statute goes on to provide that “a person is presumed to control a corporation if he holds one half or more of a particular type of means of control over the corporation.” “Means of control” is defined as either “(1) the right to vote at a general meeting of a company or at a corresponding organ of some other corporate body; or (2) the right to appoint the directors of a corporate body or its general manager.”65 In other words, possession of more than half the voting rights creates a presumption of control. Control can exist, however, in holders of a smaller percentage of voting rights.

The definition of “control” under the American Law Institute’s Federal Securities Code is similar:

“Control” means the power, directly or indirectly, to exercise a controlling influence over the management or policies of a company or the activities of a natural person (either alone or pursuant to an arrangement or understanding with one or more other persons), whether through the ownership of voting securities, through one or more intermediary persons, by

62 See generally J. Farrar, supra note 33, at 411-12.
64 Securities Law § 1, amended by Securities Law (Amendment no. 9), 1988, Sefer Hahukim no. 1261 at 188.
65 Id.
contract, or otherwise.\textsuperscript{66}

This definition makes it clear that the expression "control" should not be given a technical or strict meaning; it should be interpreted in a flexible manner. "Controlling influence" is sufficient for control to be recognized.

5. Scope of the Fiduciary Duty of Controlling Shareholders

The power in the hands of controlling shareholders is restrained by means of a fiduciary duty placed on those wielding this power. However, the mere recognition of a fiduciary duty on controlling shareholders does not shed light on the scope of that duty. This was well put by Justice Frankfurter when he stated:

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?\textsuperscript{67}

The scope of the fiduciary duty owed by controlling shareholders to the other shareholders is not equivalent to the duty owed by the directors of the company to the company. Whereas the latter are responsible for the property of others and must therefore act in good faith, taking into account solely the interests of the company, the former act to further their own interests, as owners of the company's capital.\textsuperscript{68} It follows that consideration of their personal interests, as shareholders, should be recognized as legitimate.\textsuperscript{69} The appropriate balance between, on the one hand, the interests of the controlling shareholders and on the other hand, the interests of the company and its shareholders, will be effected according to the specific circumstances of each case. This article shall illustrate the extent of the fiduciary duty of controlling shareholders in two spheres: first, in the use to which the power of control is put, and second, in the sale of control of the company by the shareholder.

\textsuperscript{66} \textit{Federal Sec. Code} § 202(29) (1980).

\textsuperscript{67} Sec. & Exch. Comm'n. v. Chenery Corp., 318 U.S. 80, 85-86 (1943).


5.1. The Use of Control

5.1.1. Restriction on Voting Rights

a. In General

In various matters, company law confers a power on the majority to pass resolutions binding on the minority opposing them. Within this scope are included resolutions for altering the memorandum \(^{70}\) and articles of association, \(^{71}\) for winding-up the company, \(^{72}\) for the company's merger with another company, \(^{73}\) and for other resolutions that the law or the company's constitution have authorized the general meeting to decide upon.

In voting at the general meeting, the controlling shareholders owe fiduciary duties to the company and to the minority shareholders. However, the controlling shareholders are not required to disassociate themselves entirely from their own interests as shareholders in the company. In this respect, the shareholders' duty differs from that of directors of the company.

Limitations on the right of shareholders to make use of their power of control by means of voting in the company shall be illustrated in the following context: first, resolutions for increasing the company's capital; second, for winding-up the company; third, for dismissing a director; and fourth, for voting agreements.

b. Increase of Capital

When the minority demands that the controlling shareholders pass a resolution increasing the capital of the company, and those shareholders refuse to do so, does this amount to a breach of fiduciary duty on the part of the controlling shareholders? If the controlling shareholders have denied the request in order to strengthen their personal interests in a rival business, then their conduct should be regarded as a breach of the fiduciary duty owed to the company and the other shareholders. However, if the controlling shareholders' motivation in voting against the increase of capital is to preserve their voting rights in the company,


\(^{71}\) See Companies Ordinance (New Version) § 15 (1983) (Israel); Companies Act, 1985, ch. 6, § 9 (England).


then no fiduciary breach should exist. The fact that there is no unissued capital left in the company indicates that the parties intended that any further allotment would be conditional on the consent of a majority, the size of which is determined by statute.\textsuperscript{74} If the majority was limited to considering only the needs of the company, there would be no point in placing such a power in the majority, as opposed to the directors. The distinction between the power of allotment, which is conferred on the directors, and the power to increase the registered capital, which the law confers on the general meeting, reinforces this view.

Another possible limitation on voting power in this context arises when controlling shareholders pass a resolution increasing the share capital of the company with the intention of allotting shares in a proportion not reflective of their real value. The controlling shareholders enter this scheme knowing that the minority will not participate. This scenario is a clear breach of fiduciary duty on the controlling shareholders' part, since such an allotment would cause a diminution of the share capital of the minority.\textsuperscript{75}

The fiduciary duty which the majority shareholders owe to the company and to the minority does not require them to extend financial aid to the company when it experiences financial difficulties.\textsuperscript{76} The shareholders of the company may rightfully limit their investment in the company. A breach would not exist even where the controlling shareholders are aware that such a contribution is the only way to save the company from being wound up.

c. Winding Up

Both the English and the Israeli statutes recognize that shareholders may pass a resolution for voluntary winding up of the company. The size of the requisite majority for such a resolution depends on the cause for the winding up. Where the period for the company's existence has terminated (as prescribed by the articles) or where an event has occurred which brings about the company's dissolution (as per the article), an ordinary resolution is sufficient.\textsuperscript{77} A vote by the shareholders in

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\textsuperscript{74} The English statute requires an ordinary resolution of the general meeting. Companies Act, 1985, ch. 6, § 121. The Israeli Ordinance requires a special resolution: Companies Ordinance (New Version) § 144 (1983).

\textsuperscript{75} The Supreme Court of Israel invalidated such an allotment in L. Gluckman Ltd. v. A.M. Barkai Inv. Co. Ltd., 32 (2) P.D. 281 (Israel 1978). \textit{But see} F. O'Neal & R. Thompson, O'Neal's Oppression of Minority Shareholders § 3:20 (2d ed. 1985) (United States approach which permits controlling shareholders to diminish the minority's interest in the corporation by causing the issuance of additional shares).

\textsuperscript{76} See W. Fletcher, \textit{supra} note 36, at § 5810.

\textsuperscript{77} See Companies Ordinance (New Version) § 319(1) (1983) (Israel); Insolvency
support of the winding up, in such a case, is within the scope of their fiduciary duty.

Where the company has liabilities that prevent it from carrying on its business, the company can pass an extraordinary resolution for voluntarily winding up.\(^78\) In that case, a vote by the shareholders in support of the winding up also presents no problem. The third possibility of a voluntary winding up arises when the company passes a special resolution mandating that the company be wound up voluntarily.\(^79\) Thus, when a supermajority of the members want the company dissolved, without a special reason for winding up the company, a special resolution is required.

Clearly, in such a situation one cannot speak of the good of the company, since its dissolution cannot be consistent with its good.\(^80\) A resolution to wind up the company may well encounter the opposition of the minority. Should the majority consider the wishes of the minority, who seek the continued existence of the company, or may the majority act according to its own interests, in favour of dissolving the company?

Where the resolution of the controlling shareholders is not motivated by an intent to harm the company or the minority, their desire to wind up the company should be respected. Thus, the controlling shareholders’ resolution should not be regarded as a breach of duty.\(^81\) The decision of the controlling shareholders to cease company operations is a proper use of the right conferred on them by statute, even if such a resolution may harm the shareholders who oppose dissolution. This precept applies only when winding up is the only solution available to the controlling shareholders of a company. When the controlling shareholders are able to achieve their objective by selling their shares, the exercise of their right to wind up the company will amount to a breach of their fiduciary duty. However, when the controlling shareholders are unable to sell their shares (for example, where the minority shareholders lack the means to acquire the shares and no one outside the com-

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\(^{80}\) However, consider a case where the company suffers heavy losses. In this instance the winding up falls under different provisions. Companies Ordinance (New Version) § 319(3) (1983) (Israel); Insolvency Act, 1986, ch. 45, § 84(1)(c) (England).

\(^{81}\) See Greenfield v. Denner, 199 N.Y.S.2d 899 (1960) (holding that majority stockholders may liquidate a corporation without fear of a fiduciary breach to a protesting minority shareholder).
pany is available to acquire the shares), there would be nothing wrong in a resolution to wind up the company. No fiduciary breach on the controlling shareholders' behalf exists even though their conduct is inconsistent with the good of the company or its minority shareholders.

d. Dismissal of a Director

In determining the extent of the controlling shareholders' fiduciary duty, the nature of the company should be taken into account. Thus, for example, controlling shareholders in companies which are "quasi-partnerships" will be subject to fiduciary duties similar to those of partners in a partnership. The standard as enunciated by United States case law is that of "utmost good faith and loyalty." Accordingly, a United States court held that the termination of a minority shareholder's employment as a director of a "quasi-partnership" company amounted to a breach of fiduciary duty on the majority's behalf. As expressed by the court: "In sum, by terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrates the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment."

English law has recognized that where a director of a quasi-partnership company is dismissed, a winding up is justified for reasons of justice and equity. It is unsettled in England whether a member, who

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82 Such a situation is likely to arise when the company relies heavily on the skill of a controlling shareholder who is leaving the company (for example, a company providing engineering services or a company engaged in specialized art, such as sculpture).

83 These companies were defined by the House of Lords in Ebrahimimi v. Westbourne Galleries Ltd., [1972] 2 All E.R. 492, 500 (H.L.), as follows:

Certainly the fact that a company is a small one, or a private company, is not enough. There are very many of these where the association is a purely commercial one, of which it can safely be said that the basis of association is adequately and exhaustively laid down in the articles. The superimposition of equitable considerations requires something more, which typically may include one, or probably more, of the following elements: (i) an association formed or continued on the basis of a personal relationship, involving mutual confidence - this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all, or some (for there may be "sleeping" members), of the shareholders shall participate in the conduct of the business; (iii) restriction on the transfer of the members' interest in the company - so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.


85 Id. at 850, 353 N.E.2d at 662-63.

is dismissed from his position as a director of the company, is entitled to claim any other remedy. A possible remedy arises under the provisions granting a remedy in the event of prejudicial treatment. In a case that dealt with an application for a remedy under section 210 of the 1948 Act, the application was rejected because the dismissal did not affect the member in his capacity as a director, which was a prerequisite for this remedy. Case law dealing with the remedy, which replaced the "alternative remedy" as provided under sections 459-61 of the 1985 statute, is not uniform as to whether the said limitation also exists under those sections. The more recent cases tend to allow a member to base a claim on those sections for dismissal of a director in a quasi-partnership company. Israeli cases have also recognized that dismissal of a director of such a company serves as a basis for providing a remedy for unfairly prejudicial treatment.

Recognition of a right to sue for a remedy in the event of prejudicial treatment following the dismissal of a director in a quasi-partnership company does not mean that all such dismissals will serve as a basis for imposing liability. Thus, for example, where the articles of the company fairly regulate the disposition of a dismissed director's shares, the dismissed director cannot argue that he was unfairly prejudiced as a result of the enforcement of such an agreement.

Such a situation came up for consideration in England. The articles of association in that case provided that a member who had ceased to serve as director was bound to give notice of the transfer of his shares within fourteen days. Such notice would be deemed given, even if not actually provided. Notice of transfer rendered the company the agent of the seller for the purpose of selling the shares to other members. The articles provided that the sale price should be agreed upon between the seller and the directors. In the event of a dispute, the auditor of the company would determine the fair value of the shares on a sale by a

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87 Companies Act, 1948, 11 & 12 Geo. 6, ch. 38, § 210.
89 Some courts have recognized the continued application of the limitation. See, e.g., In re a Company (No. 004475 of 1982), [1983] 2 W.L.R. 381 (Ch.); In re a Company (No. 008699 of 1985), 1986 P.C.C. 296, 302 (Ch.). However, other courts have recognized the possibility of a remedy for dismissal from a managerial position in quasi-partnership-type companies. See infra note 90.
91 Re Matzot Israel Co. Ltd., 5746 (3) P.M. 221 (Israel 1986); Raviv v. Limat Metal Polishing Ltd., (Tel-Aviv District Court 1985) (unpublished).
92 In re a Company (No. 004377 of 1986), [1987] 1 W.L.R. 102 (Ch.).
93 Id. at 105.
94 Id.
willing vendor to a willing purchaser. The directors were to divide the shares among the members applying to acquire them, and the seller was to transfer the shares accordingly.

The petitioner was dismissed from his position as a director of the company, which initiated the procedure laid down in the articles regarding the transfer of his shares to other members. The seller and directors could not reach an agreement; the price of the shares was therefore determined by the company's auditor. The petitioner based his claim on unfairly prejudicial treatment. The dismissed director argued that he had become a company member on the basis of his legitimate expectation that he would participate in running the company. Thus his dismissal should be regarded as prejudicial treatment entitling him to a remedy. Justice Hoffmann dismissed this argument, holding as follows:

I cannot accept that if there is an irretrievable breakdown in relations between members of a corporate quasi-partnership, the exclusion of one from management and employment is ipso facto unfairly prejudicial conduct which entitles him to petition under section 459. It must depend on whether, if there is to be a parting, it is reasonable that he should leave rather than the other member or members and on the terms he is offered for his shares or in compensation for his loss of employment.

In this case, the articles regulated the relations among the members in the event of a crisis. Since a method for determining the fair value of the shares was provided in the articles, there could be no argument of prejudicial treatment. Of course, the situation would have been different if the articles prescribed an arbitrary or artificial method of valuation, or if bad faith had been proven on the part of some of the members. A provision that requires an objective auditor to determine the fair value of the shares confers on the auditor a function similar to that which the court would exercise in giving a remedy for a holding of prejudicial treatment. There is, therefore, no reason to resort to legal

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95 Id.
96 Id. at 106.
97 Id. at 108.
98 Id. at 109.
99 Id. at 110. See also Justice Hoffman's decision in In re a Company, ex parte Kremer, [1989] B.C.L.C. 365, 367 (holding that a court will not grant a remedy under section 459 where the proper solution is for the plaintiff to sell his shares at a fair price, and the articles include provisions determining that price, or the respondent proposes to refer the determination to objective settlement).
proceedings in such a case. Legal proceedings would merely be more lengthy and more costly than abiding by the procedures laid down in the articles. A claim that the auditor had made an erroneous valuation would not justify an application for a holding of prejudicial treatment. However, a claim of negligence against the auditor or proceedings for annulment of the valuation could exist.\textsuperscript{100} Similarly, it has been held in Israel that the dismissal of a director, effected in compliance with an agreement entered into by the parties and stipulating a fixed period of service in that capacity, did not amount to prejudicial treatment.\textsuperscript{101}

e. Voting Agreements

English common law recognizes the validity of voting agreements among shareholders,\textsuperscript{102} whereas it denies the validity of such agreements when made among directors of a company.\textsuperscript{103} This stance has been adopted in Israeli case law.\textsuperscript{104} Is there any room for a change in the rule that recognizes the validity of voting agreements among shareholders in view of a fiduciary duty on controlling shareholders?

Voting agreements among directors are invalid because such an agreement conflicts with the directors' duty to act in good faith for the benefit of the company. The only considerations that the directors may take into account are those relating to the well-being of the company. The English statute provides that, within this scope, the directors should take into account the good of the shareholders and employees of the company.\textsuperscript{105} In Israel, there is no similar statutory provision. Earlier case law has held that the directors must act solely for the benefit of the company.\textsuperscript{106} This view has been modified by the President of the Supreme Court of Israel. He believes that the directors should take into account the good of the shareholders, the employees of the company, its customers, and the wider public in general.\textsuperscript{107} Under both legal systems, it is clear that the directors are not permitted to take into account their own personal interests within the scope of their activity in the company or other interests beyond those permitted by law. Where the directors' discretion is fettered in advance by a voting agreement, this

\textsuperscript{100} Id. at 111.
\textsuperscript{101} Dolev v. Rav-Bariach Ltd., (Tel-Aviv District Court 1986) (unpublished).
\textsuperscript{102} See L. Gower, supra note 22, at 568-69; R. Pennington, supra note 30, at 643.
\textsuperscript{103} L. Gower, supra note 22, at 582.
\textsuperscript{104} Mann v. Ayon, 11 P.D. 1612 (Israel 1957); Jerusalem Indus. Co. v. Agyon, 6 P.D. 887 (Israel 1952).
\textsuperscript{105} Companies Act, 1985, ch. 6, § 309.
\textsuperscript{106} See, e.g., Jerusalem Indus. Co. v. Agyon, 6 P.D. 887 (Israel 1952).
\textsuperscript{107} Penidar Co. Inv., Dev. & Bldg. Ltd. v. Castro, 37 (4) P.D. 673 (Israel 1983).
undertaking may deprive the director of taking into account only the aforementioned considerations. Hence such an agreement is invalid.

With regard to shareholders, the situation is different because the fiduciary duty of shareholders differs in scope from that of directors. Shareholders may also take into account their interests as owners of proprietary rights, within certain limitations as indicated above. It follows that even after recognizing the existence of the fiduciary duty of shareholders, a voting agreement between shareholders need not be invalidated a priori.

At the same time, such an agreement cannot justify action by controlling shareholders which is contrary to the principles detailed above. It is not the voting agreement that brings about a right of action; it is the use of voting power in a way amounting to a breach of duty that initiates a right of action. The agreement itself may be impugned, when it clearly involves a deviation from the fiduciary duty of the controlling shareholders. However, where the agreement merely regulates the duty to coordinate voting, this does not in itself constitute a basis for impugning the agreement. Indeed, United States law, which recognizes the fiduciary duty of controlling shareholders, validates voting agreements between shareholders of a company.108 The aforementioned limitations are effective, though. Thus in the United States, an agreement among shareholders concerning the election of directors or officers, so as to secure or retain control of the corporation, has been recognized as valid.109 United States case law has held that "[a company's] stockholders may agree to combine their votes. If their purpose is lawful and not against public policy, fraudulent or harmful to creditors, their agreement is binding among themselves."110

Most jurisdictions in the United States acknowledge the validity of voting agreements among shareholders under statutory provisions.111 Section 7.31 of the Model Business Corporation Act, which has been adopted in many states, provides: "(a) Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose . . . . (b) A voting agreement created under this section is specifically enforceable."112

In Israel, the cases which have recognized the validity of a voting agreement among shareholders preceded the recognition of the fiduciary duty of the majority shareholders. Since the recognition of such a duty,

108 W. Fletcher, supra note 36, §§ 2064, 2066.
109 See, e.g., Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967).
111 W. Fletcher, supra note 36, § 2064.1.
the question concerning the validity of a voting agreement has not as yet been revisited. It is the author’s opinion that such an agreement should be acknowledged as valid, subject to the limitations indicated above.

The proposed Fifth European Economic Community Directive denies validity to voting agreements that restrict the freedom of a shareholder to vote. Article 35 of the Directive provides:

Agreements whereby a shareholder undertakes to vote in any of the following ways shall be void:

(a) that he will always follow the instructions of the company or of one of its organs;
(b) that he will always approve proposals made by the company or by one of its organs;
(c) that he will vote in a specified manner, or abstain, in consideration of special advantages.\(^\text{113}\)

5.1.2. Taking Account of Considerations Beyond the Good of the Company

May the controlling shareholders take into account considerations beyond those that are for the good of the company and its shareholders, such as the benefit of the company’s employees, its customers, and the public at large? This question has attracted considerable discussion in the United States in regard to the directors of the company.\(^\text{114}\) The tendency in the United States is to allow these considerations to be

\(^{113}\) Amended Proposal for a Fifth Directive Founded on Article 54(3)(g) of the EEC Treaty Concerning the Structure of Public Limited Companies and the Power and Obligations of Their Organs, 26 O.J. EUR. COMM. (No. C240) 2 (1983).

\(^{114}\) See the well-known debate between Berle and Dodd, as expressed in articles they published on this matter: Berle, Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931); Berle, For Whom Corporate Managers are Trustees: A Note, 45 Harv. L. Rev. 1365 (1932); Dodd, For Whom are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932); Dodd, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?, 2 U. Chi. L. Rev. 194 (1935). Whereas Berle is in favour of considering only the good of the company, Dodd thinks that, in modern society, the good of the public at large must also be considered. See Werner, Management, Stock Market and Corporate Reform: Berle and Means Reconsidered, 77 Colum. L. Rev. 388 (1977); Wetzel & Winokur, Corporations and the Public Interest - A Review of the Corporate Purpose and Business Judgment Rules, 27 Bus. Law. 235 (1971); Note, Herald Co. v. Seawell: A New Corporate Social Responsibility?, 121 U. Pa. L. Rev. 1157 (1973). See also M. Beesley & T. Evans, Corporate Social Responsibility - A Reassessment (1978); B. Longstreth & H. Rosenbloom, Corporate Social Responsibility and the Institutional Investor (1973); Manne, Should Corporations Assume More Social Responsibilities?, in The Attack on Corporate America 3 (1978). This question occupied the central position at a symposium devoted to it, the deliberations of which were published in 30 Hastings L.J. 1247-1462 (1978-79).
taken into account.\textsuperscript{116}

This approach has found expression in Israel through Justice Shamgar, the President of the Supreme Court of Israel. He has stated in obiter dictum: "It would seem that the modern development is that the company and its directors acting on its behalf should take into account not only the good of the shareholders . . . but also the good of the employees of the company, its customers and the wider public at large."\textsuperscript{116} This dictum is worded in the language of duty, in contrast to the conferring of a right on the directors to consider the said interests. Since the statement was made obiter, one cannot, in the author's opinion, derive from it a ruling that a duty exists on the part of the directors to take into account these considerations. At the very least, however, the right of the directors to take these considerations into account is recognized.

English law, since 1980, confers on directors explicit authority to consider the good of employees.\textsuperscript{117} However, the law does not extend its provisions to encompass the good of the wider public. A sound basis exists for the assertion that the English legislature thereby expressed its opinion that such a wide consideration is beyond the directors' authority.

The view which legitimates taking into account the above considerations has been accepted in other legal systems as well. The German Corporations Law of 1937 expressly provided that the board of directors should manage the company in accordance with its needs and the needs of its employees, as well as for the good of the public as a whole.\textsuperscript{118} The German Corporations Law of 1965 omits the groups to be taken into consideration by the directors in managing the company.\textsuperscript{119} However, most commentators are of the opinion that the prin-

\textsuperscript{116} See, e.g., Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972). But see Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (espousing the older view that the corporation should be managed exclusively for the benefit of the shareholders).

\textsuperscript{117} Penidar Co. Inv., Dev. & Bldg. Ltd. v. Castro, 37 (4) P.D. 673 (Israel 1983).

\textsuperscript{118} Companies Act, 1980, ch. 22, § 46 ("The matters to which the directors of a company are to have regard in the performance of their functions shall include the interest of the company's employees in general as well as the interests of its members."). This section now appears in Companies Act, 1985, ch. 6 § 309. Likewise, English law allows a company to grant a benefit to employees when the business ceases to exist or is transferred, even though this is not in the interests of the company. Companies Act, 1985, ch. 6, §§ 659, 719.

\textsuperscript{119} Aktiengesetz [AktG] § 70(1), 1937 Reichsgesetzblatt [RGBI] I (W. Ger.).

\textsuperscript{118} See § 76(1) of the 1965 statute. Aktiengesetz [AktG] § 76(1), 1965 Bundesgesetzblatt [BGBl] I 1105 (W. Ger.). This omission has been explained by the fact that these principles are self-evident. See E. ERCKLENTZ, MODERN GERMAN CORPORATION LAW 197 (1979).
ciple adopted in the 1937 statute remains valid, even after the new statute was enacted.\footnote{120}

In Austria, this principle has survived in the 1965 statute which provides that the directors must run the company for its own good, and must take into consideration the interests of the shareholders, the employees, and the public.\footnote{121}

While in the above legal systems discussion has focused on the fiduciary duties of directors, an analogy can nevertheless be drawn therefrom in respect to shareholders. A common bond exists between both groups: the recognition of a fiduciary duty which stems from the power entrusted to them. Moreover, one can argue a fortiori that if the directors, whose fiduciary duty towards the company is stricter than that of the shareholders, can take those considerations into account, the shareholders are even more justified in doing so.\footnote{122} In this author's opinion, there is room for broadening the considerations that the shareholders in large companies should be allowed to take into account so as to include those involving the good of the public in general. Even the English courts could reach this conclusion, despite the section of the statute which permits the directors to take into account the good of the employees and no other additional considerations besides the good of the company.\footnote{123} This limitation, applicable to directors, does not necessarily have to be applied to the shareholders who, in their activity within the company, may take into account additional interests beyond those in regard to the good of the company.

5.2. The Sale of Controlling Shares

5.2.1. Restriction of the Right of Sale

The Israeli Supreme Court has recognized the existence of the fiduciary duty of controlling shareholders when selling their shares in the company.\footnote{124} As to the scope of that duty, Justice Barak has held

\footnote{120} See authorities cited in: Roth, Corporate Social Responsibility: European Models, 30 Hastings L.J. 1433, 1437, n.11 (1978-79). See also E. Ercklentz, supra note 119, at 197 (stating that these interests of the company — of its shareholders, of its employees and of the public at large — are of equal weight).

\footnote{121} Aktiengesetz [AKtG] § 70(1), 1965 Bundesgesetzblatt [BGBI] IV (Austria). See also Roth, supra note 120, at 1437.

\footnote{122} The dictum of the President of the Israeli Supreme Court, Justice Shamgar, quoted above, refers to a company and its directors. See supra note 116 and accompanying text. The basic organs of a company are the general meeting and the board of directors. In view of the specific reference to the directors, it would seem that when referring to the company, the President meant the general meeting of the shareholders.

\footnote{123} See supra note 117 and accompanying text.

\footnote{124} In regard to the application of fiduciary duties connected with the sale of con-
that:

[T]he controlling shareholder is free to sell his shares to any purchaser, unless he knows that the purchaser is about to acquire control of the company and strip it of its assets. This provides the appropriate balance between the prerogative of ownership on the one hand, and the protection of the good of the company on the other.126

Thus, the sale of control to a purchaser who, to the knowledge of the controlling shareholder, intends to harm the company, amounts to a breach of the fiduciary duty that the controlling shareholder owes to the company and to the other shareholders. Such a breach confers on the latter a right of action against the controlling shareholder for breach of contract.

In Israel, the question of whether in these circumstances, negligence (where a reasonable shareholder should have known of likely harm to the company) on the shareholder’s behalf will suffice for a finding of liability remains open.126 The United States view is that such circumstances raise the suspicion of a breach of the fiduciary duty, unless a reasonable inquiry brings to light facts which would convince a reasonable person that no fraud was intended or expected.127

The imposition of liability where the controlling shareholders merely ought to know that those acquiring control would harm the company appears draconian. However, it can be explained in two ways. First, proof of actual knowledge is difficult, and therefore the law attributes to a person knowledge that a reasonable person in these circumstances would have had. Second, where a reasonable person would have realized that a person acquiring control would harm the company, but the controlling shareholder failed to do so, then his omission amounts to negligence. This standard of culpability is adequate to find liability in this instance.

5.2.2. The Right to a Premium

Who is entitled to benefit from the proceeds of sale of controlling shares? Are controlling shareholders who receive a “control premium”

126 Id.
127 W. Fletcher, supra note 36, at § 5805.
(that is, an amount above the market price for the controlling shares vested in the holders of the shares sold) entitled to keep it for themselves, or should they share the premium with the other shareholders in the company?

This question has not yet been dealt with by Israeli courts, although it has been widely discussed in United States case law and legal literature. The traditional United States view has held that a controlling shareholder may receive and retain a premium for the sale of his shares, without breaching a duty. However, a contrary view has developed in the United States, whereby the vendor of the controlling block of shares is bound to share the premium received with the minority shareholders.

This latter view is based on a number of legal theories. The first legal theory in making the controlling shareholder share the control premium is the breach of fiduciary duty theory. Such liability is based on the notion that controlling shareholders, like directors, are bound to account for profits gained by exploiting their status in the company. Those who support this view argue that one of the fiduciary duties of the controlling shareholders is to select their successors. Sale of the controlling shares is thus an act involving a fiduciary duty, so that any premium paid to the vendor is in the nature of a "bribe" or a profit belonging to the company. The premium should be treated as any other personal profit earned by a trustee in the course of fulfilling his functions.

The second legal theory is the sale of corporate office doctrine. The courts have at times referred to the sale of controlling shares as including, as an integral part thereof, the sale of corporate offices. Such positions, the courts have held, are the property of the company, so that the controlling shareholders cannot exploit them for their own purposes, either directly or indirectly. Thus, if the controlling shareholders make a profit from the sale of those positions, they must disgorge such profit to the general body of shareholders.

A third legal theory to mandate the sharing of a control premium is the diversion of corporate opportunity theory. This concept posits

128 F. O'NEAL & R. THOMPSON, supra note 75, at § 4:02.
129 Id. at § 4:04.
liability if vendors divert from the company an opportunity to sell its assets (the control premium). A similar thrust of this theory would charge the controlling shareholder with fraudulently frustrating some company act which, if carried out, would have benefitted the shareholders as a whole.\(^\text{132}\)

The last legal theory treats control as an asset of the company. In the well-known case of \textit{Perlman v. Feldmann},\(^\text{133}\) a United States court held by a majority that control is an asset of the company. Thus, a controlling shareholder who sold his shares at a higher price than could be obtained for the sale of noncontrolling shares is bound to disgorge to the company the premium he received.\(^\text{134}\) In his dissenting opinion, Justice Swan stated, "Concededly a majority or dominant shareholder is ordinarily privileged to sell his stock at the best price obtainable from the purchaser. In so doing he acts on his own behalf, not as an agent of the corporation."\(^\text{135}\)

The majority ruling in the \textit{Perlman} case has been criticised in legal literature\(^\text{136}\) and later cases have refused to follow it.\(^\text{137}\) As already stated, the question has not yet been discussed in Israel. The author prefers the minority opinion in \textit{Perlman} to that of the majority. Control over the company, deriving from the rights attached to the shares held by a controlling shareholder, can legitimately be regarded as his property. Hence, he is entitled to retain the premium he received from the sale of control. Nor do the other grounds for justifying the view that the controlling shareholder should share the control premium stand up to criticism. There is no reason to regard the sale of the shares as a breach of a fiduciary duty by the controlling shareholder, unless the sale was to "looters" who are likely to harm the company. The profit derived by the controlling shareholder on the sale of control is not ac-

\(^\text{132}\) By selling the control shares, the controlling shareholders frustrate an offer for acquisition addressed to all shareholders. See Dunnett v. Arn, 71 F.2d 912 (10th Cir. 1934); F. O'NEAL & R. THOMPSON, \textit{supra} note 75, at § 4:04; Note, 20 CORNELL L.Q. 101 (1934).
\(^\text{133}\) 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955).
\(^\text{134}\) See Berle, 'Control' in Corporate Law, 58 COLUM. L. REV. 1212, 1220-22 (1958); Berle, \textit{The Price of Power: Sale of Corporate Control}, 50 CORNELL L.Q. 628 (1965). Some consider that the true basis for the decision is the diversion of an opportunity away from the company, and not the sale of its asset. See F. O'NEAL & R. THOMPSON, \textit{supra} note 75, at § 4:05.
\(^\text{135}\) \textit{Perlman}, 219 F.2d at 179 (Swan, J. dissenting).
\(^\text{137}\) \textit{See}, e.g., Delano v. Kitch, 663 F.2d 990 (10th Cir. 1981); Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962); Honigman v. Green Giant Co., 309 F.2d 667 (8th Cir. 1962); Thompson v. Hambrick, 508 S.W.2d 949 (Tex. Civ. App. 1974).
quired through exploitation of that shareholder's status in the company, but from the sale of an asset belonging to him. Even though a purchaser can be appointed to a managerial position in the company after control is acquired, the sale of the shares, by itself, cannot be regarded as the sale of a position belonging to the company. Likewise, the author refuses to accept the third line of reasoning, referred to above, in justification of the opposite view. The mere sale of the shares cannot be regarded as a diversion of a corporate opportunity. Such a diversion may exist when a purchaser seeks to acquire the company's assets and the controlling shareholder causes the buyer to purchase control instead of the company's assets.\footnote{138} However, in the ordinary situation, no fault can be found in the sale of controlling shares. The right of a shareholder who has sold control to benefit from the proceeds of sale has been acknowledged as advantageous to the company, because the sale of the control benefits the company.\footnote{139} Recognizing the controlling shareholder's right to retain the proceeds of the sale of control will encourage that shareholder to sell control, which results in a better allocation of resources. In this way, the company and all its shareholders will benefit.

6. Conclusion

Currently, English law does not recognize a general fiduciary duty of controlling shareholders. Restrictions on the power vested in the majority are recognized, under the common law, in two categories of cases: alteration of memorandum and articles of association, and fraud on the minority. United States law recognizes a general fiduciary duty of controlling shareholders and following this lead, Israel now recognizes such a duty.

Recognition of a general fiduciary duty of controlling shareholders in a company follows inevitably from two sources: first, from legal principles that impose a fiduciary duty on anyone having control over the assets of another; and second, from statutory provisions conferring on every member of the company the right to apply for a remedy against the controlling shareholders for conduct prejudicial to the minority. Such recognition does not amount to the imposition of a fiduciary duty on controlling shareholders to the extent of that imposed on


\footnote{139} Easterbrook & Fischel, Voting in Corporate Law, 26 J. Law & Econ. 395 (1983); Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698 (1981-82).
directors of the company. In view of the special status of the shareholder in the company, he must be allowed to take into account his own personal interests, albeit to a limited extent.

The common law, which has always adjusted itself to changing realities, ought to deviate from the ruling that recognizes the right of the shareholder to vote as he wishes, subject to well-defined exceptions. Instead, the common law should adopt a general fiduciary duty of the controlling shareholders of a company.

In Israel, in addition to the fiduciary duty of controlling shareholders, the duty of every shareholder to act in a customary manner and in good faith exists. This latter duty is not as extensive as the fiduciary duty of the controlling shareholders. Both duties are directed towards instituting reasonable and fair rules of conduct in the relations between company shareholders.