

FOUNDATION PRESS

CORPORATE LAW STORIES

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FOUNDATION PRESS

2009



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The Story of *Dodge v. Ford Motor Company*: Everything Old is New Again

On November 2, 1916, the day after his son Edsel's wedding,¹ Henry Ford received a copy of the complaint that instigated one of the most famous lawsuits in the history of American corporate law. The case, *Dodge v. Ford Motor Company*,² was about minority shareholders' ability to challenge the authority of the board of directors to make business decisions that were alleged to be serving interests other than maximizing the value of plaintiffs' shares. The plaintiffs, John and Horace Dodge, were not strangers to Henry Ford: they were his longest and most important business partners, they were fellow board members for over a decade (1903 to 1913), and they had celebrated together at Edsel's wedding the night before. The Dodges, who had recently founded their own firm to compete with Ford, objected to a decision by the board to withhold special dividends and spend the millions of dollars to build the world's largest auto manufacturing facility. Their claim was that the decision was based on Henry Ford's idiosyncratic preferences about doing social good for workers and customers as opposed to making the most money for shareholders.

¹ There is a division of opinion about the timing of the suit that reflects the various opinions on the merits of the case. According to one historical account, the suit's "timing seemed a calculated insult. . . . They had conversed congenially with the entire Ford family and said nothing about filing the suit." See Steven Watts, *The People's Tycoon* 255 (2005). Another book takes a more benign view:

The Dodges had already filed their suit when the invitations to Edsel's wedding arrived. They knew that the timing would upset Ford and they originally planned not to attend, but Edsel's fiancée, Eleanor Clay had been John Dodge's neighbor for six years, and she convinced the brothers to attend.

See Carol Gelderman *Henry Ford: The Wayward Capitalist* 72 (1989).

² 204 Mich. 459 (1919).

The Michigan courts struggled. Ford was emphatic in both his pretrial comments and his testimony that the decision to build the factory was about doing "as much good as we can, everywhere, for everybody concerned . . . [a]nd incidentally to make money."³ Faced with Ford's candor about using someone else's money to achieve his personal goals, the trial court ordered the payment of a large dividend (about \$19 million), and enjoined construction of the factory.

The intervention by the trial court was a radical and outrageous result. Courts generally do not interfere with business decisions—deciding to build a factory is a quintessential one—even in the face of allegations they are not profit-maximizing decisions. As long as the board considered the issue seriously and there is some plausible claim the decision is in the best interests of the firm, courts defer to the business judgment of management. This test was met here: regardless of Henry Ford's rhetoric, expanding manufacturing capacity may reduce costs and help increase profits. But Ford's comments made deference difficult for the trial court.

The Michigan Supreme Court corrected the mistake. Focusing less on Ford's silly comments and more on the policy implications of the ruling, the Supreme Court lifted the injunction. Declaring that "judges are not business experts," the Court announced the widely accepted rule that courts generally will not substitute their judgment for those of boards.⁴ It did not, however, give a complete victory to Ford. Splitting the baby, it held the suspension of dividends allegedly needed to fund construction was an arbitrary and unlawful action by the board. Since there were other ways in which the company could fund the construction—for example, Ford himself was to receive about 60% of the dividend, which he could then re-invest⁵—this Solomonic decision could send a signal that firms are about shareholder wealth creation, without inhibiting the firm from taking actions that might, after all, be good for shareholders in the long run. It did cost Ford personally, however, since tax rates on the forced dividend were quite high (about 70%), and therefore impressed on him and other business leaders the importance of shareholder wealth maximization. Viewed in this way, the Court's approach was arguably a smart one.

³ See Allen Nevins & Frank E. Hill, *Ford: Expansion and Challenge, 1915-33*, at 99-100 (1957) (quoting interview).

⁴ *Dodge*, 204 Mich. at 508-09.

⁵ As discussed below, this would have been tremendously inefficient since tax rates on dividends increased to nearly 70%, which means less than a third of the dividend would have been available to reinvest. Ford had other options, however, including issuing new equity or borrowing from a bank.

But there is much more to this case than meets the eye. Many of the practices common today in venture capital transactions and corporate reorganizations appear vividly in the back-story of this case and show students of law that seemingly new ideas are not always so. The case's history also foreshadows the nature of ubiquitous conflicts between majority and minority investors that would animate corporate law litigation for decades to come. In addition, it demonstrates how modern techniques for allocating control rights separately from economic rights would have helped the parties here avoid costly and acrimonious litigation. Perhaps most interestingly, however, the backstory of the case shows that it is not clear at all that the parties *wanted* to avoid litigation. Both the Dodges and Henry Ford used the legal process as a tool in what was at base a business dispute. To paraphrase von Clausewitz, litigation is business by other means. The history of this case provides a prototypical example.

This essay examines the background of the litigation in an attempt to shed new light on the wisdom of what the *Dodge* court did, and to offer a new way of thinking about where the case fits in our modern understanding of corporate law.

I. The Beginning: Lessons Ford Learned from Failure

Like most entrepreneurs, Henry Ford was originally and repeatedly a failure. His first two companies, the Detroit Automobile Company and the Henry Ford Company, made no cars and no profits.⁶ They lasted less than three years combined and lost over \$200,000 in equity capital for investors.⁷ After these failures, Ford's prospects did not look good. He had no obvious comparative advantage over hundreds of rivals racing to make the first commercially successful automobile. Ford was not the inventor of the automobile nor did he hold any valuable intellectual property rights in the new technology—in fact, he openly flouted purported patents held on the automobile by others. His failures also alienated wealthy individuals in Detroit who were funding new automobile companies.

Ford's failures, however, taught him lessons about corporate governance and law that ultimately enabled him to build one of the most successful companies of all time. Ford learned that majority shareholders (like the proto-venture capitalists who backed him) are tough taskmasters that demand results and profits. Like many entrepreneurs, Ford was stubborn, arrogant, and fiercely independent. Although he needed other people's money to turn his ideas into reality, Ford, like most inventors,

⁶ As discussed below, the Henry Ford Company was a failure for Ford but it survived him, took a new name, and became an incredible success.

⁷ Watts, *supra* note 1, at 53–57.

didn't want their opinions or their oversight—just the money. This is not the way things work. Entrepreneurs who use other people's money must account to those other people, often in disagreeable ways.

Investors demand control rights in return for their investments, lest the entrepreneur take the money and divert it into self-serving ends, such as shirking, stealing, or merely following a self-utility maximizing, but not profit-maximizing, path. The backers of Ford and his first attempts to build a "horseless carriage" acted just as investors in start-ups do today: they took board seats; they installed managers of their choosing to supervise work; they contracted for the ability to bring in outsiders to monitor at certain times or under certain conditions; and they preserved their rights to control how the firm would grow or die. Control rights do not always work, however, and the history of Ford's businesses shows this clearly. Notwithstanding explicit and implicit control rights, Ford did not do what his backers wanted, and without his final designs delivered, the investors cut their losses and put the companies out of business.

Examining the history of the failure of Ford's first two companies sheds light on his actions that led to litigation by the Dodges: in each case, Ford the inventor bristled and was ultimately forced out of what he viewed as "his" firms under the pressure of majority investors to deliver production cars and profits quickly. In short, Ford learned from his failures the perils of being a minority shareholder. Later, after *Dodge*, he would learn not to be a majority shareholder either. But we are getting ahead of ourselves. Let's start at the beginning.

A. *The Detroit Automobile Company*

Ford's first company, the Detroit Automobile Company, was a total failure. Ford blamed this on the investors who financed the company—they demanded cars be made and sold, while Ford was busy perfecting his design. Ford bristled under shareholder supervision, and he actively subverted efforts of the managers to generate immediate profits. This caused delays, frustration on both sides, and eventually shutdown.

Many entrepreneurs raise their first capital from "friends and family." Borrowing from family has its own perils, but for entrepreneurs, the ability to remain in control despite using other people's money is more likely when the other people are family. Ford had a troubled relationship with his father, however, so instead, he turned to the Detroit business community and individuals he worked with at the Edison Illuminating Company, where he was a mechanic.⁸

⁸ David L. Lewis, *The Public Image of Henry Ford: An American Folk Hero and his Company* 17 (1976).

George Peck, president of Edison, let Ford use a workshop to develop his first prototype, in return for a small equity stake. The Mayor of Detroit, William Maybury, provided loans, facilitated other loans with friendly banks, and greased the legal works, such as providing a license for Ford's first test vehicle when some citizens complained about the noise. Three other wealthy individuals Ford knew from prior work and social experiences invested \$500 to help Ford build his second prototype in 1899.⁹ It was a success.

With a workable car built and a fawning treatment by the local press,¹⁰ Ford began to attract the attention of the local business community beyond his personal contracts. Ford's key fundraiser was William Murphy, a wealthy Detroit businessman who acted as a proto-venture capitalist. The first step for Murphy, as for any start-up investor then or now, was to determine the technology to bet on. It was far from obvious at this time that Ford and his horseless carriage was the one. Ford was an unknown mechanic working at a power company, and although he had built a successful prototype, he did not have any valuable intellectual property, his design was not unique or especially novel, and he was not alone in pursuing the technology—there were over 500 nascent car companies in Detroit at the time.¹¹

Murphy's due diligence on Ford and his vehicle was an eighty-mile test drive. It went well, and after he said to Ford: "We will now organize a company."¹² Murphy planned to take a large stake in the new firm in return for his money, his business expertise, and access to his rich friends. Several famous Detroiters, including business owners, a United States Senator, life insurance executives, and wealthy heirs, invested a total of \$15,000 and received 1500 shares in the Detroit Automobile Company, which was incorporated on August 5, 1899.¹³ Ford, as is typical in start-up firms today, invested no money but took a minority share of the equity in the firm in return for his designs and ideas.

Things started promisingly, as they always do. The firm made investments in a workspace and a small workforce of thirteen. There was energy and hope on the floor of the firm's manufacturing space on Cass Avenue in Detroit. But hope was not enough for the investors who had put money on Ford and his prototype. To protect their investment, holders of a large percentage of the shares dominated the board and

⁹ Watts, *supra* note 1, at 51.

¹⁰ *Ford's Automobile Has New Features and Is a Novel Machine*, Detroit J., Jul. 29, 1899.

¹¹ Charles E. Duryea, *Motor's Historical Table*, Motor, Mar. 1909.

¹² *The Moran Family: 200 Years in Detroit* 126 (1949).

¹³ Watts, *supra* note 1, at 51.

installed their agents in senior management positions. These managers were supposed to supervise Ford closely to protect the shareholders' investments. The governance protections, which resemble those in modern venture capital transactions, did not work.

There were numerous problems. Ford went through several designs (including a truck), and he was constantly tinkering with the design. This made it difficult to begin production. At this point, Ford was simply much better at designing cars than producing them, and his interests were in creating one design that would last rather than producing cars from an inferior design. The battle lines here were short-term versus long-term interests, and entrepreneur (a belief in the thing partially for its own sake) versus investor (a belief in the thing only for the cash it produces).

Ford's initial car design was also not a good one, and no amount of management skill or corporate governance can save a company from a bad product. It is for this reason that successful venture capitalists today bet on the horse (the product) and not the jockey (the management) when funding startups.¹⁴ Murphy and the other investors bet on a bad horse—according to one of Ford's engineers, Ford's first car that investors wanted to force into production rarely worked and when it did it had few virtues.¹⁵

Another problem was that Ford was not then interested in the manufacturing process, nor was he highly skilled in the machining of all necessary parts. Ford had shown he could make one car, but his short time running the shop at the Detroit Automobile Company showed he did not know how to mass-produce it to tight specifications. Ford would eventually solve this problem through outsourcing—yet another seemingly modern phenomenon—and then through a revolutionary manufacturing process, but that was years away. There is a deep irony here: the thing Ford was the worst at—assembly—would become his most enduring legacy.

Ford also bristled under the supervision of investors and their manager agents. Aggressive governance had a high cost. Ford was still tinkering with his design, and he resisted pressure by the shareholders to finalize the design so that production could begin. Here we see the first signs of the schism between entrepreneur and investor that was to plague Ford until after the *Dodge* case. Ford was still a designer and not yet a businessman, and he did not understand the pressure for profits and that majority shareholders demand control.

¹⁴ See Steven N. Kaplan, et al., *Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies*, 64 J.Finance — (Feb.2009).

¹⁵ Watts, *supra* note 1, at 55.

Ford's resistance to shareholder control took several forms, not the least of which was trickery. For example, when Ford heard that the investors were sending the company president, an investor-appointed stooge in his view, to visit the workshop to gauge progress and pressure Ford to move toward production, he ordered work done that would have the appearance of progress but was just obfuscation. The ruse worked, and the axles Ford ordered built during the visit were discarded as junk.¹⁶

Sometime later when the investors started to panic, several arrived at the factory for inspections. As recounted by one of Ford's engineers, Ford ordered workers to pretend as if work was being done toward making a final version of the car:

We had parts for about a half-dozen automobiles. We had a long bench, and all the parts we had finished were on it. [The investors] would come along and see all these parts on the bench . . . and it looked wonderful.¹⁷

The success of these tricks would not last long. After several months without progress, investors with small stakes, little information, and no control began to look for ways of exiting. The lead investors were the only willing buyers, and as a result consolidated their ownership interests.

Consolidation in times of financial distress is another modern phenomenon the history of this case shows existed long ago. It was sensible here since the lead investors were wealthy and could afford the rising risk profile of the firm. Consolidation also reduced the collective action problem among investors in terms of monitoring. Fewer holders means lower decision costs on questions like whether to make additional investments, whether and how to monitor, and what should be done to dispose of assets in the event of a failure. This is a common feature of modern corporate reorganizations,¹⁸ but it is also evident in the failure of the Detroit Automobile Company.

When the fate of the firm was clear, investors Murphy and Mayor Maybury moved quickly and with force impossible with dispersed ownership. They called Ford to a meeting in November 1900 to discuss the lack of progress, demanding immediate action towards completion of a production version of the car. Ford refused to attend and kowtow before

¹⁶ *Id.* at 56.

¹⁷ *Id.*

¹⁸ See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209 (2006) (showing how creditors today routinely cash out minority investors or creditors on the eve of bankruptcy in order to reduce barriers to efficient decision-making during this period).

what he viewed as speculators and people only interested in money. Shortly thereafter in January 1901, the board dissolved the firm.

B. The Henry Ford Company

Some of the investors who steered the Detroit Automobile Company toward dissolution bought its assets in order to try again. They turned again to Ford, who they still believed had the best extant design. The investors, led by Murphy, funded Ford's work for about a year, at which point he had a new design. Murphy was willing to take a longer-term view, while the other remaining shareholders of the defunct Detroit Automobile Company would not. Murphy's patience appeared to pay off. Ford developed a new prototype, and Murphy and Ford incorporated the "Henry Ford Company" in November 1901 to prosecute the design. Ford took a 17% equity interest in the firm in return for his contribution of his human capital and the new design.¹⁹ Although the ideas behind the firm were 100% Ford's, his interest was, again, subordinated to those who were putting up the money to finance the firm.

At this point, Ford was still an inventor and a car man; he had yet to realize that his contribution to world history and his path to self-made wealth would be the production process for and marketing of cars, rather than in their design. In fact, Ford believed so strongly his future success was tied to car design, he focused much of his energy at this time in developing racing versions of his cars to compete in the growing local auto racing circuits. Murphy and the other investors knew of Ford's interest in racing, but believed it was a dalliance. Ford, who again did not like being a minority shareholder, especially one whose name was on the corporate charter and the sign out front, shirked more and more, putting almost all of his energies into designing a racing car instead of a consumer one. Frustration again mounted under the strain of a classic principal-agent problem.

As the Henry Ford Company spiraled toward failure, the lead investors turned to an outside expert to help turn the struggling firm around. They brought in mechanical expert, Henry Leland, to spy on Ford. This is another modern practice—bringing in an outside expert, known as a Chief Restructuring Officer—that the history of the *Dodge* case shows is nothing new. Leland, who had earned a great reputation making engines for rival automaker Ransom Olds (as in Oldsmobile), was supposed to inspect Ford's facility and report back to the board and majority shareholders on ways in which the firm could improve the design of the car or structure of the firm. Ford did not react well to what he viewed as meddling by the board. The strongly independent Ford

¹⁹ Watts, *supra* note 1, at 57.

considered the monitoring and restructuring efforts of Leland a personal and professional insult.²⁰

Throughout his entire career, Ford viewed the board of directors as elitists and speculators who knew nothing about machines, cars, or manufacturing. He despised not only their meddling, but also their motives and who they were. Part of this was his populist preference for Main Street (people who made things) over Wall Street (people who made money with money). Years later, Ford's newspaper mouthpiece—the *Dearborn Independent*—published a series of articles on this subject, with give-away titles such as “Speculation vs. Production: Which Creates Wealth?”²¹ From his earliest days until his end, Ford idolized those who worked with their hands to create. He even built a sort of theme park, known as Greenfield Village, which was dedicated to showcasing the virtues of simple life, the outdoors, and working with one's hands.

Ford's rabid anti-Semitism also may have contributed to his distrust of investors and money men on the board. In an interview around the time of the *Dodge* case, he said: “The Jew is a mere huckster, a trader, who doesn't want to produce, but to make something out of what somebody else produces.”²² His newspaper also published a series of articles—known as the “The International Jew”—that made this point and other negative ones about Jews over and over.²³ These articles, available then and now in a pamphlet form, revealed not only his anti-Semitism, but also his dislike of shareholders or investors as a class. This aversion to shareholders, who Ford would later call “parasites” and “idle drones,”²⁴ foreshadowed his conflict with the Dodges.

Whatever the reasons, Ford could not tolerate shareholders hiring another mechanic to spy on him. He quit (or was fired by) the eponymous firm only three months after it was incorporated. The board agreed to pay Ford a small sum for his shares (about \$1000), to give him the drawings for a racing car he designed, and to discontinue using the name “Henry Ford Company.”²⁵ Lead-investor Murphy quickly reorganized the firm, replacing Ford with Leland and re-naming the firm the “Cadillac Automobile Company.”

Although for Ford this was another failure, Cadillac became a fantastic success. Ford designed a great car but it took someone else—in

²⁰ *Id.* at 58.

²¹ Neil Baldwin, *Henry Ford and The Jews: The Mass Production of Hate* 85–86 (2001).

²² Watts, *supra* note 1, at 382.

²³ Jeffrey S. Gurock, *Anti-Semitism in America* 470 (1998).

²⁴ Watts, *supra* note 1, at 256.

²⁵ Lewis, *supra* note 6, at 102.

this case, Leland—to make the product a success. History again supports the horse theory of venture capital investing. A good product can survive mismanagement precisely because investors have control rights that give them the power to change management, even when the manager is the entrepreneur without whom the company would not even exist.²⁶

The story of the failure of the Henry Ford Company is not so much about the evils of overbearing investors, as it was Ford's inability to work constructively with them. The investors realized that Ford was not capable of leading a team of machinists or commercializing his design. In this situation, the power and value of control rights become evident. Investors did not act irrationally in ousting Ford, but rather used their rights to maximize the profitability of the firm. It is a textbook case of outside investors exercising control rights deftly.

Ford found success in his next venture in part because outsourcing of manufacturing was forced on him. Ford was able to focus on his strengths (mostly design) while having others, specifically the Dodges, do the things that Ford did not do well. Ford, however, had a different take on the failure and its causes.

C. *The Ford Motor Company*

Ford's assessment of the cause of the failure of his first two firms was clear from his public statements. In his autobiography, he criticized the directors and shareholders of his first two firms as wanting only to get as much money as possible from each car.²⁷ Viewing money as a benefit tangential to other forms of success, Ford decided to create his own firm without moneymen and speculators telling him what to do. Ford promised at the time of the second failure: "From here in, my shop is always going to be my shop. . . . I'm not going to have a lot of rich people tell me what to do." He was "determined never again to put [himself] under orders."²⁸

As nice as this sounded, it was impossible. Ford was not wealthy, and he needed someone else's money to fund his operations. No one stepped forward. Stung by his business failures and the inability to raise money for his next business, Ford turned from trying to commercialize the auto to racing it. Ford and his friends built a racecar, raced it, and Ford became famous. His racer, the "999," won the then-famous Challenge Cup in record time, and then later, on a frozen Lake St. Clair and with Ford at the wheel, set the world speed record at over 100 miles per

²⁶ For a similar argument, see Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 *Stan. L. Rev.* 1309 (2008).

²⁷ Henry Ford, *My Life and Work* 36 (1922).

²⁸ *Id.*

hour.²⁹ He used these exploits to make "Ford" a household name synonymous with automobiles.

Trading on this fame, he convinced another wealthy Detroit, Alexander Malcomson, to bankroll a third effort at manufacturing automobiles for the public. Given the failure of the last two corporate efforts, Ford and Malcomson decided to work together as partners, with Malcomson agreeing to fund the creation of a new prototype and Ford agreeing to invest his intellectual property and energy in the new enterprise. In the summer of 1902 they started work, agreeing that if they could build a successful prototype they would seek out additional investors and form a new corporation.

Ford had a design, but he needed to build the car in large quantities to make it a success. His failure to manage effectively the machining and construction of vehicles for his first two firms taught him the importance of outsourcing the manufacturing to others. He was a designer, not a builder. The Dodges, well-regarded machinists who had, like Leland, success building engines for Ransom Olds, were hired to build the entire mechanical vehicle (engine plus transmission). Other firms were employed to provide finished chasses and tires. Their work quickly yielded a workable prototype, known as the "Model A." Based on this success, Malcomson, Ford's new venture capitalist, recruited ten additional investors, and incorporated the "Ford Motor Company" on June 16, 1903.³⁰ It would become one of the greatest achievements of all time.

Two of these investors were the Dodges. Their investment was not a cash infusion for equity, but a complicated investment of two \$5000 promissory notes in return for a contract to build 650 vehicles. In addition, the Dodges demanded a \$10,000 upfront payment, covering their initial investment, as an advance on the machines they were to build. According to one account, Ford was forced into giving an equity stake to the Dodges because he was habitually late in making payments to them and was short of cash.³¹

Unlike the two earlier ventures, success came quickly and in bunches for the Ford Motor Company. Although like most start-ups its funds dwindled to nearly zero (in this case, about \$200), after its first sale of a Model A to a Chicago dentist on July 15, 1903 (just one month after incorporation), sales and profits came in droves. In its first two years,

²⁹ The historical accounts about the actual speed differ. According to a Ford biography, the speed was over 100 m.p.h. See Watts, *supra* note 1, at 81. Other sources confirm that Ford set the record, but report a speed of around 90 m.p.h. Available at http://www.speedace.info/land_speed_record_history.htm.

³⁰ Richard S. Tedlow, *Giants of Enterprise: Seven Business Innovators and the Empires they Built* 178 (2003).

³¹ Charles K. Hyde, *The Dodge Brothers: The Men, the Motor Cars and the Legacy* 33 (2005).

the Ford Motor Company had revenues well in excess of \$3 million, and paid out about \$200,000 in dividends to shareholders.³² At this point, the Dodges' \$10,000 investment gave them a spectacular return over and above the profits they made on their exclusive contract to build all of Ford's cars. Had the Dodges received nothing else from their investment, they would have earned a return of about 100% per year.

Success, however, did not change Ford's views about investors. He referred to board members and other employees of the Ford Motor Company who did not work on the design or manufacture of the cars as "not contributing and . . . parasite[s]."³³ The board quickly divided along these lines, with the engineers on one side and the money on the other.

Not satisfied with a divided board and the existence of other large shareholders who were not "real" workers, Ford and his inner circle of manufacturing associates cooked up a clever scheme to force out Malcolmson and the other "parasite" investors. Ford created a new corporation, the "Ford Manufacturing Company," on November 22, 1905.³⁴ This company, which was organized without the participation of Malcolmson and the other passive investors, would get the exclusive rights to manufacture the engines and other parts for the new Ford "Model N."

The Dodges stood to lose their exclusive manufacturing contract, but curiously John Dodge joined the board of the Ford Manufacturing Company. This is not something he would have done if the plan were to take business from his firm. In fact, it would have created an obvious conflict of interest that would have disabled him from serving on the board. The scheme to squeeze out the other shareholders was plain. One shareholder in the new firm said: "I have Mr. Ford's promise that when things get straightened out with Mr. Malcolmson, the Ford Manufacturing Company is to be taken into the Ford Motor Company, just as if it never existed."³⁵

Malcolmson responded by forming his own company to manufacture automobiles—the Aerocar Company. Since setting up a rival firm was a clear breach of his loyalty to the Ford Motor Company, the board forced him out. Ford took nearly complete control of the firm with his name on it, buying out Malcolmson's shares for \$175,000 and those of his friends on the board who were offended by Ford scheme.³⁶ After the freezeout

³² Lawrence H. Seltzer, *A Financial History of the American Automobile Industry* 111 (1928).

³³ Watts, *supra* note 1, at 98.

³⁴ See Harry Barnard, *Independent Man: The Life of Senator James Couzens* 62 (2002).

³⁵ *Id.*

³⁶ See Reginald M. Cleveland & Samuel T. Williamson, *The Road is Yours: The Story of the Automobile and the Men Behind it* 198 (1951).

and shakeup, Ford held 54% of the shares of the Ford Motor Company, with his head of operations, James Couzens, holding another 10%. Through some deception and corporate machinations, they were now firmly in control. Within a few years control was further consolidated; nearly half of the original thirteen stockholders sold their stock to Ford. In 1908, the shareholder list looked as follows:

Table 1: Shareholders of the Ford Motor Company, circa 1908³⁷

Shareholder	Number of shares	Percent ownership
Henry Ford	585	59
James Couzens	110	11
The Gray Estate	105	11
Horace Dodge	50	5
John Dodge	50	5
J.W. Anderson	50	5
H.H. Rackham	50	5
	1000	

The remaining few shareholders held small minority stakes, and would no longer be able to pressure Ford to run the Ford Motor Company in a way he did not like.³⁸ Or so Ford thought.

II. The Run-up to Dodge: Litigation as a Business Tactic

Ford's first masterpiece, the "Model T," arrived in 1909; his second, the "assembly line" arrived in 1913. The latter helped increase production by over 700% in two years.³⁹ Production rose from less than 2000 cars per year in 1905 to over 2 million by 1923.⁴⁰ At this time, more than half of the vehicles on the roads were Fords. This was in part because the economies of scale from the new production methodology allowed Ford to reduce the price of the Model T by almost half in the span of a few years, all while adding more features and better materials to its construction.

³⁷ Seltzer, *supra* note 32 at 94.

³⁸ Ford famously said that his goal was a business with "no stockholders, no directors, no absentee owners, no parasites." Ford R. Bryan, *Beyond the Model T: The Other Ventures of Henry Ford* 17 (1997).

³⁹ The assembly line was only one of the ways in which Ford was able to cut costs and make production more efficient. He also innovated with design, manufacturing techniques, and materials. For example, Ford deployed single-purpose machine tools to automate much production. Ford also learned that vanadium steel had a much higher tensile strength and could be machined more easily than conventional steel, so he used it to make "better, lighter, and cheaper car[s]." See Charles E. Sorensen, *My Forty Years with Ford* 141 (1962).

⁴⁰ Seltzer, *supra* note 32, at 104.

This revolution in production capacity and efficiency brought the Ford Motor Company and all of its shareholders unprecedented wealth. For example, the Dodges' \$10,000 investment returned more than \$35 million over thirteen years, an almost 100% constant annual return. This is extraordinary beyond any imagination, and for Ford was enough. Ford believed investors did not deserve the incredible returns the firm was generating year after year, especially when they, unlike he, did nothing to contribute to the success other than their initial investment.

The company's success was fed by populist accounts of Henry Ford as a new kind of robber baron. While Carnegie, Mellon, and Rockefeller were portrayed as aloof, highfalutin, and otherworldly in their wealth and privilege, Ford cast himself as everyman. He spoke in a folksy tone, praised the virtues of the common man, and famously said that he would not give "five cents for all the art in the world."⁴¹ An article in a California newspaper captured the public sentiment at the time:

Personally there is not much outward difference between Henry Ford, maker and dispenser of millions, and many of his workmen. Money has not made the slightest difference in his habits, his manner of life, or his friendships.⁴²

The various biographies of Ford give us little reason to doubt Ford's sincerity in the image he projected, but the public relations spin is evident nevertheless. According to one biographer, Ford's behavior was highly calculated: "Quite self-consciously, Henry Ford set about making himself a sensation."⁴³

Perhaps the most famous example of this is when Ford doubled employee wages (creating the so-called "Five-Dollar Day") in 1914 under the guise of having the interests of workers above all else. Ford characterized it as a "sort of dividend" to workers to share the wealth that the workers helped create.⁴⁴

This is, of course, fanciful. The Five-Dollar Day was a response to business pressures and was brilliant competitive strategy. The problem it addressed stemmed from the unintended consequences of the assembly line. While it greatly increased productivity, it made workers miserable, since the work was boring and repetitive. As one laborer described the problem: "If I keep putting on Nut No. Eighty-six for about eighty-six

⁴¹ Watts, *supra* note 1, at 160.

⁴² *Millionaire Ford's Tastes Are Worker's*, San Francisco Bull., Jan. 17, 1914. This trait or tactic is practiced today too. Sam Walton, the founder of Wal-Mart and once the richest man in the world, famously drove a run-down truck and shared hotel rooms when traveling for business.

⁴³ Watts, *supra* note 1, at 169.

⁴⁴ *Henry Ford Explains Why He Gives Away \$10,000,000*, N.Y. Times, Jan. 11, 1914.

more days, I will be Nut No. Eighty-six in the Pontiac bughouse."⁴⁵ Consequently, employee turnover increased dramatically, reaching nearly 400% per year in the year before the wage increase.⁴⁶ Absenteeism also was high, reaching over 10% per day, with the result that Ford had to employ over 1,500 replacement workers each day just to maintain production levels. The doubling of wages was merely a profit-maximizing move to constrain total labor costs and increase efficiency.⁴⁷ It worked, as turnover fell to about 50% almost immediately after the introduction of the plan, and to 15% within one year.⁴⁸ Ford later claimed that it was "one of the finest cost cutting moves we ever made."⁴⁹

The wage was also tied to at least two prerequisites, both of which show the plan, which wasn't even Ford's idea, was not done as an act of charity or friendly feelings towards the workingman. First, the new wage required a vesting period. Workers did not get five dollars per day, but rather that was an average amount, and only for those who worked at least six months.⁵⁰ This supports the claim that it was really about reducing turnover.

Second, Ford set up a vast "Sociological Department" to ensure the pre-condition that workers "not debauch the additional money [they] receive[]." ⁵¹ Workers who drank, did not save, or otherwise did not comport with Ford's views of the good life, would not qualify for the wage. The Department published pamphlets offering advice on a range of topics, and, somewhat shockingly, sent "investigators" to workers homes to "observe[] firsthand the tidiness and hygiene of the home."⁵² Ford believed strongly in paternalism for his workers, and used the Sociological Department to "shape the character, domestic life, and financial habits of Ford workers."⁵³

⁴⁵ Stephen Meyer, *The Five Dollar Day: Labor Management and Social Control in the Ford Motor Company, 1908-1921*, 40 (1981).

⁴⁶ In 1913, Ford had to hire over 50,000 workers to maintain a workforce of just over 13,000. See Sumner Slichter, *Turnover of Factory Labor* (1921).

⁴⁷ Daniel M.G. Raff & Lawrence H. Summers, *Did Henry Ford Pay Efficiency Wages?*, 5 J. Labor Econ. S57, S69 (1987) (arguing that the increase was largely about increasing productivity and efficiency of employees).

⁴⁸ See Slichter, *supra* note 46, at 244.

⁴⁹ Ford, *My Life and Work*, *supra* note 27, at 147.

⁵⁰ *Id.*

⁵¹ Meyer, *supra* note 45, at 125.

⁵² Watts, *supra* note 1, at 201-205.

⁵³ *Id.* at 205.

The idea that firms would take an active role in the personal life of workers is another modern (or perhaps, post-modern) notion that the history of this case shows existed long ago. At the beginning of the twenty-first Century, firms, who typically pay the bulk of employee healthcare costs, began to become increasingly active in policing behaviors outside of the workplace. For example, in 2004, Weyco Inc. told employees who smoked that they had 15 months to quit, and when four employees refused to submit to a breath test, the firm fired them.⁵⁴ The trend toward greater paternalism is evident and likely to continue to grow.

Strategically, Ford's plan increased wage costs for potential competitors, who were all much smaller and less wealthy. This also gave Ford unrivaled access to all labor, especially semi-skilled and experienced workers. The day after the plan was announced, 10,000 men came to the gates of Ford's Highland Park factory looking for work, and the police had to threaten the crowd with fire hoses to get them to disperse after more than half were turned away without hopes of working for Ford.⁵⁵ Firms like the new General Motors Corporation increased wages a bit to compete, but none had the wealth of Ford and so it was years before they were competitive for certain types of auto labor again.⁵⁶

The increase also helped preempt unionization of Ford's factories by seemingly radical elements. The Industrial Workers of the World (better known as the "Wobblies") were threatening to unionize the firm's workers, and a dramatic and unprecedented pay raise was a way of blunting the union's arguments.⁵⁷ In an interview, Ford argued that labor unions "have never succeeded in organizing our factory" and have not given him "a particle of trouble," because "[w]e pay better than anybody else. . . ."⁵⁸

Whatever the exact mix of reasons for Ford's decision, the myth developed and persevered that Ford was doing this out of benevolence for workers. So much so that he became the first capitalist to be embraced by the political left in America and his picture even famously hung next to Lenin's in Soviet factories.⁵⁹ The virtuous circle Ford

⁵⁴ Marisa Schultz, et al., *Workers fume as firms ban smoking at home*, Detroit News, Jan. 27, 2005, available at <http://www.detnews.com/2005/business/0501/27/A01-71823.htm>.

⁵⁵ Henry Ford Explains, *supra* note 44.

⁵⁶ Sorensen, *supra* note 39 at 141.

⁵⁷ See J. Bradford DeLong, *Slouching Towards Utopia?: The Economic History of the Twentieth Century (XIII. The Roaring Twenties)*, (1997).

⁵⁸ Henry Ford Explains, *supra* note 44.

⁵⁹ A parade of left-leaning journalists, including Upton Sinclair, Ida Tarbell, and John Reed, praised Ford. Watts, *supra* note 1, at 195-198.

developed, however, depended entirely on a mythology Ford fostered. Workers who believed in Ford's politics bought his cars, which made his firm ridiculously profitable, which afforded him the luxury of having his politics. It doesn't make sense to ask what Ford really believed, since what he believed was tied inexorably to the context of his situation. About the only thing we can say for sure is that Ford knew that his rhetoric fed his success, and therefore even purely self-serving or profit-maximizing decisions were couched in charitable terms.

This tactic—putting competitive strategy in the guise of benevolence—is something Ford would do successfully over and over, with tremendous benefits for the Ford brand. (As we will see, these tactics also lead to litigation with his friends the Dodges.) Ford was an unrivaled master of public relations, and his actions and statements were carefully crafted into a message about the virtues of the automobiles he was selling. Buying a Ford meant not only buying a particular car, but also buying an idea and an image.

One of the crucial components of Ford's public relations strategy was his use of litigation. Ford built a brand (for himself and his firm) through a series of famous lawsuits, not only in terms of what was litigated but how and what was said during the litigation. Ford's first success using this tactic involved an alleged patent held on the automobile by a New York lawyer named George Selden. The lawsuit made him a "folk hero" and "a beloved figure" in the public mind.⁶⁰

Selden and the Electric Vehicle Company, which licensed the patent from him, filed suit against the Ford Motor Company in 1903, alleging that it infringed a patent granted in 1895 for an internal combustion engine used to power a four-wheeled car.⁶¹ Prior to the suit against Ford, a group of car companies, called the Association of Licensed Automobile Manufacturers, negotiated a royalty of about 1% on all vehicles sold by its members. ALAM agreed to pay royalties in order to establish a cartel that would try to restrict entry by issuing "official licenses" to produce and sell cars.

In 1903, Ford approached ALAM about joining the cartel, but they refused to license him as an authorized manufacturer. Then ALAM took out advertisements threatening new entrants like Ford with patent infringement in the event they tried to go around the cartel. This sowed the seeds of Ford's life-long antipathy toward consolidated business power, known then as "trusts."

⁶⁰ Watts, *supra* note 1, at 160.

⁶¹ Selden based his invention on the large internal combustion engine that George Brayton presented at the Philadelphia Centennial Exposition of 1876.

Ford responded by running his own advertisements, trumpeting the cost advantage of his new car compared with those of the ALAM manufacturers: "[The Ford car] costs only \$900. The Trust car that compares with it costs \$1500."⁶² Ford also sold cars without a license from Selden or EVC. This invited a lawsuit on the validity of the patent, which was the only means of enforcing of the cartel. The suit lasted about eight years and created a media sensation. The trial court returned a verdict for the patent holders. Ford appealed, however, and on January 10, 1911 the Second Circuit Court of Appeals ruled that the automobile in all of its potential forms and types was not capable of being patented.⁶³ According to Ford, "Perhaps nothing so well advertised the Ford car . . . as did this suit."⁶⁴ The link between litigation and publicity was a lesson Ford would not forget.

Another lawsuit that brought Ford fame was his libel suit against the *Chicago Tribune*. In an editorial on June 25, 1916, the paper described Ford as "an ignorant idealist [and] an anarchistic enemy of the nation," because of his anti-war efforts. Ford sought \$1 million in damages on the grounds the editorial "sought to bring [Ford] into public hatred, contempt, ridicule, and financial injury."⁶⁵ Ford's testimony was the stuff of legend—he flubbed easy question after easy question on basics of current events and history, finally admitting "I am ignorant about most things."⁶⁶ The freak-show atmosphere and the laying bare of Ford's simple ways shocked elite opinion makers. He was uniformly branded a simpleton. A New York paper editorialized that he was "a joke" and a leading magazine declared that "[h]e has achieved wealth but not greatness."⁶⁷

Ford did not care about elite opinion, since they made up only a small fraction of the potential customers for Ford vehicles. To average Americans, his suit, although it won him only \$0.06 in damages, was an enormous victory. Ford stood up to the powerful interests who were backing the war in Europe and control of America's industries. As one paper wrote: "A few less smart-aleck attorneys and a few more Henry Fords, and the world would have less troubles. . . ."⁶⁸ The demand for Ford cars soared.

⁶² Watts, *supra* note 1, at 163-4.

⁶³ See *Columbia Motor Car Co. v. C.A. Duerr & Co.*, 184 F. 893 (1911).

⁶⁴ Ford, *My Life and Work*, *supra* note 27 at 103.

⁶⁵ Watts, *supra* note 1, at 266.

⁶⁶ Peter Collier & David Horowitz, *The Fords: An American Epic*, 89 (1987).

⁶⁷ Lewis, *supra* note 8 at 106.

⁶⁸ Watts, *supra* note 1, at 270-71.

This is the conventional wisdom gleaned from Ford's biographies—Ford's man-of-the-people manner endeared him to potential customers and helped sell cars. This is somewhat strange, since one would not generally expect someone making an enormous investment to be moved by whether Ford was a humble robber baron or an effete one. But branding is powerful precisely because it creates abnormal attachments between people and objects. One need only examine the rivalry between drivers of Chevrolet and Ford trucks to understand that one's transportation is often about much more than getting from here to there.⁶⁹

As part of his branding and publicity strategy, Ford also learned not to be afraid of the uncertainty of litigation. In his hands lawsuits, win or lose, were good public relations, and therefore good business. Ford could safely reason that legal expenses and even a large monetary defeat would likely be offset by the increase in demand for his cars, so long as Ford continued to choose legal fights where he could portray his battle and himself as on the side of workers and average citizens.

This may have been on Ford's mind on September 28, 1916, when he received a letter from the Dodges threatening to sue him and the Ford Motor Company. The letter read in part:

We have for some time, as you know, been endeavoring to make an appointment to see you, for the purpose . . . of discussing the affairs of the Ford Motor Company from the standpoint of our interest as stockholders and with a view to securing action by the board of directors looking to a very substantial distribution from its cash surplus as dividends. . . . The conditions shown by your recent financial statement—showing approximately \$60,000,000 of net profits for the past year and cash surplus in bank exceeding \$50,000,000—it seems to us would suggest . . . the propriety of the board taking prompt action to distribute a large part of the accumulated cash surplus as dividends to the stockholders to whom it belongs. While we would be sorry to have any controversy over the matter, we feel that your attitude toward the stockholders of the company is entirely unwarranted.

Here again we see what we might think of as the thoroughly modern practice of activism by minority shareholders. Letters like this one (sent over ninety years ago) are common today from activist investors like Carl Icahn and Nelson Peltz, often from minority positions of about 10%.

⁶⁹ An Internet search reveals dozens of web sites devoted to the virtues of one brand and the vices of the other. Passions clearly run very deep. On my own family's farm, Hendersons drove Fords; they always did. I didn't get a chance to ask my great-grandfather why, but I have no doubt given the family politics that Ford's public relations spin was a factor. For my old-time farmer relatives, there was something about being a Ford man.

Like the Dodges before them, these letters often demand that the firm distribute cash on hand to shareholders.

Ford rebuffed the Dodges' demand without response or acknowledgement.⁷⁰ This is unusual and seems designed to invite conflict. The Dodges were not only 10% shareholders—whom firms ignore at their peril—but they were also crucial to the success of the firm. The reaction from firms today is typically like that of Ford, and for the same reason: a dislike of meddling by shareholders and a concern the request is in the best interests of the particular shareholders but not shareholders as a whole. Ford had another reason for his chilly reaction: the request was merely part of a gambit by the Dodges to create a rival firm.

The Dodges wanted to make their own fame by selling "Dodge" vehicles instead of making cars for Ford, so they started their own eponymous automobile company in 1913. Since this was a clear conflict of interest with their role as directors of the Ford Motor Company, they resigned their positions on the board the same year. As permissible under corporate law then and now, the Dodges held onto their shares, hoping their investment would help fund their rival business.

It did, but the nascent Dodge firm needed more than money to compete with Ford. This was especially true in light of Ford's plans to add capacity and reduce costs by building a giant new factory. This plan threatened to make rival firms, especially small ones without scale, incapable of competing on any terms. The Dodges needed to stop or delay the plans in order to give their firm a chance to succeed. What they wanted, and what the complaint they filed only about a month later asked for, was an injunction to prevent Ford from increasing his manufacturing base.

The reason the dividend they demanded did not really matter to the Dodges is they could (and did) easily raise funds from other sources to build out their capacity. As shown from their performance during the time before and during the duration of the litigation, their firm was not desperate for funding. Over the period from 1915 to 1919 (before the final verdict), production increased from about 18,000 to over 120,000 cars, sales increased from about \$11 million to over \$120 million, and profits increased from under \$300,000 to over \$24 million. These results suggest a firm that was far from needing a cash infusion to survive.⁷¹

⁷⁰ According to Ford, the letter was not the first demand the Dodges made. Ford claimed that the Dodges demanded he buy their shares for \$35 million to fund the expansion of their business, and, if he refused, they would use their position as minority shareholders to harass him. Watts, *supra* note 1, at 256. "They put a price of \$35 million on their stock, and they told me unless I bought they would harass me in anything I tried to do." *Id.* Ford refused to pay anything, however, and the Dodge litigation followed quickly thereafter.

⁷¹ Hyde, *supra* note 31 at 113.

There is also some historical support for a claim the injunctive relief sought was motivated by larger political and economic concerns. In the two years before the suit, Ford began to alienate powerful interests with his political rhetoric. His "political crusade" included: an unsuccessful run for the United States Senate, a denunciation of Wall Street financiers, a campaign against World War I, and a tirade against corporate privilege.⁷² John Reed, made famous for modern Americans by Warren Beatty's portrayal in the movie *Reds*, corroborated this claim. In an article entitled "Why They Hate Henry Ford," Reed claimed that Ford's Five-Dollar Day ploy made capitalists hate him as a traitor to his class: "That is why the Steel Trust would like to cut off his steel—and Wall Street curb his power."⁷³ A contemporary news account offered another, less political reason why powerful steel firms would support the Dodges' suit. The article quoted a "man high in the inner circles of Detroit's manufacturing and financial world":

Back of the demand of the Dodges . . . is the grim determination of the steel kings that Henry Ford shall not erect a huge blast furnace. . . . The successful putting into operation of that plan would be a staggering blow at the commercial and industrial domination of the steel [trust].⁷⁴

Ford also may have generated ill will among steel firms and other trusts when he criticized them for their role in pushing America to war—what President Eisenhower would warn about when he described the "military industrial complex" some four decades later. Whether the Dodges were a stalking horse for the steel barons or merely pursuing their own self-centered strategy, litigation knocking Ford down was a plausible means of achieving the desired business end.

III. The Case

So the stage was set. The players were all rich but with hopes of getting richer. They were all savvy. Ford, for one, was predisposed to think of shareholders, even his long-time friends and business associates, as greedy and opportunistic. Ford also knew they were trying to build a firm to compete with him, and given their experience at and wealth earned from the Ford Motor Company, they no doubt had the tools to do so. In light of this, Ford obviously wanted to deny them funds. Litigation would also give Ford a soapbox from which he could again portray

⁷² Ford spoke out repeatedly against the war, saying that all war did was "tear [a worker] away from his home and family to send him forth to a death against his will" Henry Bourne Joy, *Millions for Tribute, Not One Cent for Defense: A Reply to Henry Ford*, 15 (1915).

⁷³ Watts, *supra* note 1, at 194.

⁷⁴ See *Sees Dodge Fight on Ford Smelter Backed by Trust*, Detroit J., Jan. 10, 1917.

himself as looking out for workers and average consumers instead of the self-interested shareholders. Ford knew that even if he lost the suit, he would likely still prevail, both because of the alternative means of achieving the same ends and because of the publicity the case would bring him and the Ford Motor Company.

A. *The Trial Court*

The complaint filed by the Dodges asked the trial court to do two things: first, to require the Ford Motor Company to establish a dividend policy requiring the firm to "distribute all of the earnings of the company except such as may be reasonably required for emergency purposes in the conduct of the business," including the immediate issue of dividends amounting to 75% of retained earnings (cash on hand was over \$50 million)⁷⁵; and second, to enter an injunction forbidding the proposed construction of a new manufacturing facility on the River Rouge near Detroit. The two were related. Ford claimed that he needed to eliminate the dividend to fund the construction of the factory. As we will see, this was certainly not the case.

As shown on Table 2, the revenue and profitability growth of the Ford Motor Company was increasing tremendously, with plenty of cash on hand. Dividend policy varied widely over time. The level for the decade leading up to the litigation, however, showed a fairly constant level averaging about 45% of profits.⁷⁶ In the year before the Dodges filed suit (1916), the dividend rate fell to about 5% despite the firm's profits nearly doubling from the prior year. It was this deviation from the traditional payout levels and Ford's plan to deploy these funds (as well as the excess profits from prior years) to build a new factory to build cars that the Dodges sued to stop.

Table 2: *Performance and Payouts of the Ford Motor Company (1904-1919)*⁷⁷

Year	Revenues (\$ MM)	Profit (\$ MM)	Dividends paid (\$ MM)	Percent of profits distributed
1904	1.3	0.3	0.09	30
1905	1.9	0.3	0.1	33

⁷⁵ *Dodge*, 204 Mich. at 474.

⁷⁶ If this same ratio had been used during 1916-1918, the total payouts would have been about \$53 million instead of the nearly \$18 million paid out. The final court ruling in *Dodge* did not require quite this amount. As can be seen in the dividend payout for 1919, the year when Ford paid the forced dividend out, the firm would have expected to pay a dividend of about \$11 million (45% of \$24.9 million), but paid out about \$13 million more, far less than the \$35 million shortfall in dividends over the period in question.

⁷⁷ Seltzer, *supra* note 32, at 111.

Year	Revenues (\$ MM)	Profit (\$ MM)	Dividends paid (\$ MM)	Percent of profits distributed
1906	1.5	0.1	0.1	100
1907	5.8	1.1	0.1	9
1908	4.7	1.2	0.6	50
1909	9.0	3.1	1.8	58
1910	16.7	4.5	2.0	44
1911	24.7	6.3	3.0	48
1912	42.5	13.1	5.2	40
1913	89.1	25.0	11.2	45
1914	119.5	30.3	12.2	40
1915	121.2	24.6	16.2	66
1916 (suit filed)	206.9	60.0	3.2	5
1917	274.6	26.7	9.2	34
1918	308.7	30.3	5.2	17
1919	305.6	24.9*	24.2**	97

* Estimate based on 5 months of data.

** Includes about \$19.3 million paid as required by court ruling in *Dodge*.

In terms of legal arguments, the Dodges grounded their claims in a curious mix of the irrationality of the board decision and the implications it would have on competition in the auto manufacturing business. The first argument was the board's decision to build a new factory made no business sense, and therefore was motivated by something other than maximizing profits:

(27) In the face of the increased labor and material cost and the uncertain conditions that will prevail in the business world at the termination of [World War I], the policy of said Henry Ford, in continuing the expansion of the business of [the Ford Motor Company], is reckless in the extreme and seriously jeopardizes the interest of . . . stockholders in said corporation.⁷⁸

In other words, the complaint alleged the board's strategic forecasting was erroneous. The Dodges believed the demand for cars would be less than what the board believed, and converting shareholder cash to fixed assets was evidence of something other than profit-maximizing behavior. As seen below, their claim was supported by statements by Ford in the press and at trial to the effect that he viewed the firm first as a means of doing social good (in this case, providing work and cheap cars for the masses) and only second as a means of making money.

The Dodges' argument was preposterous, and every court presented with it today would dismiss under the business judgment rule. Decisions

⁷⁸ *Dodge*, 204 Mich. at 473.

about supply and demand are pure business decisions, and absent a showing of a breach of the duty of loyalty or care are completely protected, even if they turn out to be disastrous. Whatever information the board had about supply and demand would surely be superior to the plaintiffs, who were outsiders at this point, and the costs of involving courts in these decisions (both decision costs and error costs) would have a huge chilling effect on business decisionmaking.

The Dodges' other claim was the construction of a factory on the scale contemplated by Ford would have the effect of creating a monopoly in the low-priced car market. Although not styled as an antitrust claim, this is clearly the rhetorical force behind their complaint:

(28) . . . That if the said Henry Ford is permitted to continue the policy that he has inaugurated and announced he is determined to carry out, of increasing production, reducing the price of cars, and increasing the capital investments in the conduct of such business by withholding the dividends from stockholders to which they are entitled, the necessary result will be the destruction of competition on the sale of [low-priced cars] manufactured by [the Ford Motor Company] and the creation of a complete monopoly in the manufacture and sale of such cars. . . .⁷⁹

In other words, Ford was cutting off dividends to kill one competitor (the Dodges) and building a huge new factory to threaten the competitive position of it and others. In 1916, the Ford Motor Company produced about one out of every three cars sold in America, and manufactured over four times more than the second biggest company.⁸⁰ According to the complaint, ensuring competition in the nascent but thriving automobile market required limiting Ford's power in every way possible.⁸¹

The trial began on May 21, 1917. The central issue was Henry Ford's motivation for his chosen direction for the firm. Had Ford just claimed that there were perfectly good business reasons for the dividend cancellation and the factory construction—increasing production to meet demand, creating economies of scale, ensuring raw material supply during the war,⁸² etc.—he undoubtedly would have won. Ford's judgment

⁷⁹ *Id.*

⁸⁰ Nevins & Hill, *supra* note 3, at 8-9, 92.

⁸¹ This alone is not a legitimate anti-trust claim. Doing well is not a violation of the Sherman Act. There is, however, an anti-trust claim that might fit. If one firm builds an inefficiently large plant (and incurs large sunk costs) in order to deter new entrants, it may be covered by the doctrine of preemption and strategic commitment. Although plausible, it seems a rough fit on these facts. It is not clear that there were large capital investments that were sunk in building the River Rouge plant. The factory could be used for any type of manufacturing activity, and was in fact originally used for making boats.

⁸² As the demands of the war effort increased, raw material supplies of steel, rubber, iron, plastic, wood, oil, and other materials became uncertain. The plan to integrate

was strategically sound, but that is not even required. It was at least plausible the strategy would maximize shareholder profits,⁸³ and that is all that is legally required. (Even the Dodges knew that the decision to vertically integrate was sensible. While the case was pending, they pursued plans to build their own version of River Rouge.)⁸⁴

Ford, however, desperately did not want to be viewed as a robber baron. To blunt this perception, he made ridiculous comments to the media and at the trial that forced the trial court into overreaching. In an interview with the *Detroit News* before the trial, Ford gave his views on the purpose of his firm and its new strategy:

I do not believe that we should make such an awful profit on our cars. A reasonable profit is right, but not too much. So it has been my policy to force the price of the car down as fast as production would permit, and give the benefits to users and laborers....⁸⁵

This sounds silly to modern corporate ears. Any CEO who believed this (as opposed to just saying it for effect) would quickly be looking for work. Shareholders do not invest in companies to give economic profits or surplus to workers or consumers, unless, of course, it is part of a plan to maximize long-term profits. Amazingly, Ford went even further during the trial. Under cross-examination by the Dodges' lawyer Elliott G. Stevenson, he gave what must be among the worst testimony given by any corporate defendant in any trial at any time:

Counsel: Do you still think those profits were awful profits?

Ford: Well, I guess I do, yes.

Counsel: And for that reason you were not satisfied to continue to make such awful profits?

vertically the firm's supply chain was one of the major purposes of the River Rouge factory. The factory would include facilities to create all of the products needed to build a Model T, including steel mills, oil refineries, and even sheep farms for the wool needed for seat covers. Ford's plan was to have "raw materials coming in on one end of the Rouge plant and the finished cars going out the other end." Sorensen, *supra* note 39, at 159.

⁸³ In retrospect, it is not obvious that the River Rouge plant would be a good thing for shareholders or hurtful for competitors like the Dodges. It turned out that there were not great economies of scale with respect to assembling cars during this period and the assembly of Model Ts was in fact done in a number of different places across the country. There seemed to be gains from making parts in a single place, but doing this did not require all the parts to be made under a single roof, nor did it require that the firm do its own smelting. This is, of course, legally irrelevant, as all that is required is a plausible (and not self-interested) reason for the decision to ensure protection of the business judgment rule. Any other rule would overly chill corporate risk taking and regularly substitute the decisions of courts for those of boards.

⁸⁴ Hyde, *supra* note 31, at 114.

⁸⁵ Ford, *My Life and Work*, *supra* note 27 at 162.

Ford: We don't seem to be able to keep the profits down.

Counsel: Are you trying to keep them down? What is the Ford Motor Company organized for except profits, will you tell me, Mr. Ford?

Ford: Organized to do as much good as we can, everywhere, for everybody concerned. And incidentally to make money.

Counsel: Incidentally to make money?

Ford: Yes, sir.⁸⁶

This doesn't make any sense, especially coming from a businessman as savvy as Ford.⁸⁷ In fact, Ford's rhetoric was just public relations, and his reasoning was not as silly as it seems.

Whether Ford's motives were benevolent or instrumental,⁸⁸ the effect, which is all shareholders would care about, was plain. In the language missing in the ellipsis in the *Detroit News* interview above, Ford makes clear that his do-good philosophy of corporate management was a great way of doing well. The complete quotation continues:

So it has been my policy to force the price of the car down as fast as production would permit, and give the benefits to users and laborers with surprisingly enormous benefits to ourselves.⁸⁹

This is a perfectly sensible profit-maximizing strategy.⁹⁰ Ford set out his business strategy plainly: "[People should] go into business with the idea that they are going to serve the public and their employees as well as themselves, [and] they would be assured of success at the very start."⁹¹ This is not a view of the firm as eleemosynary institution or existing to maximize social good, but rather a belief that the best way to ensure profit maximization is through a broad view of the firm's mission.

⁸⁶ Alexander R. Crabb, *Birth of a Giant: The Men and Incidents that Gave America the Motorcar* 359 (1969).

⁸⁷ Ford espoused a theory of firm as "steward" of monies generated in part by investors but largely by workers. "The money I have gathered together is not mine to do with altogether as I please. I do not own it. It is mine to control simply as the steward of it. The men who have worked with me have helped to create it." Watts, *supra* note 1, at 184.

⁸⁸ The most widely accepted view is that of the Ford family minister, Samuel S. Marquis: "Ford's folk-hero image was partly genuine and partly contrived, accurate in its essence yet self-consciously magnified." Watts, *supra* note 1, at 176.

⁸⁹ Ford, *My Life and Work*, *supra* note 27, at 162 (emphasis added).

⁹⁰ Ford did virtually the same thing when he declared the Five-Dollar Day: he transferred enormous wealth from shareholders to workers for sound business reasons, but couched it in charitable terms.

⁹¹ Henry Ford, *How I made a Success of My Business*, in *System: The Magazine of Business* 448-49 (1916).

Corporate law then and now permits tremendous leeway for firms to decide how to organize firms and what strategies to follow because outsiders (shareholders and courts) are unlikely to have better information or better incentives to get the right answer. There is also the potential for certain shareholders to misuse judicial scrutiny for self-serving and opportunistic ends that actually may destroy firm value.

But Ford's testimony was too much for the trial court to bear. After all, if a firm as large and important to the American economy were permitted to pursue an overtly socialist strategy, the political impact and the effect on other firms could be enormous. The geopolitical context of the trial made this point clear. Amid the war raging across Europe, socialism as a political ethos was being seriously considered by many nations, and the Russian Revolution was already in motion. It is not fantastic considering the prevailing social forces to think that trial court viewed the *Dodge* case as a test case of the foundations on which American capitalism would be built.

Ford expounded his contrarian corporate philosophy in a famous and widely read interview with the *New York Times*.⁹² Ford disavowed a policy of "sharing other people's money without [the recipients] doing any work," but declared that the Five-Dollar Day plan was about giving profits to workers: "[I]t is not higher wages we are going to pay our employes [sic], but profits."⁹³ Discussing the role of businesses in improving social welfare, Ford rejected the trickle-down approach and praised a direct role for businesses in improving the lives of workers. Ford made his preference for worker interests over owner interests clear:

I believe it is better for the nation, and far better for humanity, that between 20,000 and 30,000 people should be contented and well fed than that a few millionaires should be made.⁹⁴

Ford's progressive rhetoric was thus not limited to the courtroom; he spoke widely and loudly about how he was going to lead a transformation of the way in which American business conceptualized its relationship with workers. The trial court may have believed that if a business genius such as Henry Ford declared profits were bad and workers rights prevailed over investor rights, the money flowing to new businesses might be dramatically curtailed, with dire consequences for those very workers he intended to protect.

Judgment was rendered on December 5, 1917 (about a year after the complaint was filed). The trial court entered an injunction prohibiting the Ford Motor Company from building the factory. In addition, it

⁹² *Henry Ford Explains*, *supra* note 44.

⁹³ *Id.*

⁹⁴ *Id.*

ordered the payment of a special dividend of about \$19 million, of which the Dodges would get only \$1.9 million. Despite a rather small sum for them, especially in light of their intended use of the funds, the Dodges did not appeal. They had their injunction.

For Ford, both outcomes were big losses. Although he and his operations head, James Couzens, would receive over 70% of the dividend (about \$13 million), which they could immediately reinvest in the firm, tax rates at this time meant that the government would take over two thirds of their dividends in taxes. Although this would be highly inefficient, there were other ways, absent the injunction, Ford could have built his factory. Ford could have turned to other sources of funding, such as raising money from new shares or borrowing from a bank. Ford was trying to reduce or even eliminate the role of investors in his firm, however, so these were not desirable from a corporate governance perspective.

The injunction was an even bigger loss. Ford viewed the River Rouge factory as essential to the future success of the Ford Motor Company, and without an order from the Michigan Supreme Court removing the injunction it would not be built. This legal imprimatur on shareholder meddling could not have sat well with Ford or portended a bright future for how he planned to run his firm. Ford appealed.

B. The Supreme Court

The decision from the Michigan Supreme Court did not come for 18 months. When it did, Chief Justice Strander's opinion seemed to deliver victory to both sides. The Dodges would get their special dividend, which the Court said was arbitrary for the board to deny them, but Ford would get to build his factory. An injunction to prevent construction was just too risky given the importance of the Ford Motor Company to the American economy and given the possibility that the Court could get the answer wrong. But the Court was obviously troubled by Ford's testimony, and took the opportunity to chastise him and his firm for following a seemingly non-profit maximizing path. It did so by forcing the dividend and, in powerful and memorable dictum, telling Ford and all other firms that the purpose of corporations is profits. The message from the split decision was clear—do what you want, but make sure that there is a plausible link with making money.

The Court began, where it should have, with the business judgment rule: courts will not substitute their judgment on purely business matters for that of a well considered and not conflicted decision of the board. Applying this to Ford's decision to refuse to pay a special dividend after the firm's most profitable year, the result of which was to increase retained earnings to well over \$60 million, the Court held that the

refusal was arbitrary.⁹⁵ A board might decide to withhold distributions to shareholders (at the time, the only way in which shareholders of a closely held firm like the Ford Motor Company could easily profit from their investment), but only if it was based on a clear plan to increase shareholder profits. This is a key point. So long as the board's decision could plausibly be tied to a rational business purpose, it would be shielded from judicial review.

The Court reasoned, somewhat speciously, that it was not, and that Ford was running (or was going to run) the Ford Motor Company as "a semi-eleemosynary institution and not as a business institution."⁹⁶ This incredible decision was based on two related things. First, the Court looked to the business plan laid out by Ford's defense. The Court simply multiplied the initial capacity increase from the proposed factory by the planned selling price (a reduction from \$440 to \$360), and determined that the net profits in the future would be less than in the current year. With this cartoon picture of the business plan, the Court wrote:

In short, the plan does not call for and is not intended to produce immediately a more profitable business, but a less profitable one; not only less profitable than formerly, but less profitable than it is admitted it might be made.⁹⁷

This sort of second-guessing is completely foreign to modern corporate law.⁹⁸ It isn't even sensible. As the Court itself acknowledged later in the opinion, capacity could always be increased, thus offsetting the price reduction with increased volume, and this was in fact the plan as made clear from Ford's other contemporaneous statements.

Second, the Court looked to the "attitude and to the expressions of Mr. Henry Ford."⁹⁹ It quoted Ford's testimony:

My ambition . . . is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help

⁹⁵ "Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders." *Dodge*, 204 Mich. at 500.

⁹⁶ *Id.* at 504.

⁹⁷ *Id.*

⁹⁸ The dividend ruling is no longer good law.

⁹⁹ *Dodge*, 204 Mich. at 504.

them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business.¹⁰⁰

The Court went on to note that Ford dominated the firm and had the view that "shareholders . . . should be content to take what he chooses to give," and that his "sentiments, philanthropic and altruistic . . . had large influence in determining the policy to be pursued."¹⁰¹

The Court observed that it is okay for a firm to donate to charitable causes, as later cases and statutes would make crystal clear,¹⁰² but emphasized that this must be secondary to the main purpose—making profits for stockholders. The Court's most famous passage (notably in dictum) sets forth the *standard of conduct* for firm officers and directors:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.¹⁰³

The concern here is about a majority shareholder diverting firm resources to self-serving ends. So, while courts generally will not enforce a strict shareholder wealth maximization on all firm decisionmaking—the maximization norm from *Dodge* is not a *standard of review*—they will intervene in cases in which directors or majority shareholders engage in conduct that is clearly not in the interests of shareholders.

The Court was able to make this rhetorical point on the dividend issue because, as noted above, it was a red herring. The firm's dividend policy was irrelevant to its ability to follow the strategic plan laid out by Ford. Nearly three-quarters of the dividend would be paid to Ford and his allies, who could then simply re-invest these monies in the firm. This would have been inefficient from a tax perspective, however, since Ford and the others would have been taxed on the unnecessary dividend transaction. Marginal tax rates on income (including dividends) rose from 7% in 1913 to over 70% by 1920, so the use of retained earnings to fund the factory construction was in part driven by tax avoidance considerations. It is not unreasonable for the Court to have considered

¹⁰⁰ *Id.* at 505.

¹⁰¹ *Id.*

¹⁰² See Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, in *The Iconic Cases in Corporate Law 1* (Jonathan R. Macey, ed. 2008).

¹⁰³ *Dodge*, 204 Mich. at 507.

these issues since it potentially impacted the firm's cost of capital unnecessarily. But there was a way around this problem.

The firm could simply have raised the money for the construction through a debt or equity offering. Surely a syndicate of banks would loan to the highly successful firm, and investors would clamor for a stake in the firm. But Ford's experience with shareholders and his anti-Wall Street sentiments biased him against looking to anyone outside the firm for financing. In a famous *New York Times* article, Ford was emphatic on this point: "We don't borrow money. When we first started business we decided we would be our own bankers."¹⁰⁴

This was not just rhetoric or a litigation position. Over the three-year period leading up to the lawsuit, the Ford Motor Company's average retained earnings (specifically, its ratio of cash to sales) was nearly double the average of the largest 15 firms in the United States. Ford held almost 30% of yearly sales in cash, compared with 18% for the United States Steel Corporation and 15% for the General Motors Corporation.¹⁰⁵ Unlike the tax issue, which the Court might reasonably consider as an inefficiency worthy of its consideration of the policy issues in the case, Ford's idiosyncratic views about shareholders were obviously irrelevant.

The forced dividend was also not likely to raise the firm's costs or imperil its competitive position, something the Court should have certainly considered. Unlike other potential legal requirements, such as a minimum wage or safety regulations, the obligation to make payouts to shareholders does not necessarily raise a firm's marginal costs. In this light, it is curious that the Dodges did not sue Ford when he raised the wages of workers under the Five-Dollar Day plan. This strategy, which was motivated by practical business concerns but couched in strongly socialist rhetoric, resulted in the effective transfer of \$10 million in shareholder wealth to workers. The inaction here also underscores the point that they had ulterior motives for challenging the River Rouge plan.

Today, the Court's holding on the dividend issue is not good law: courts will not compel dividends, probably even in the face of silly and over-the-top testimony. Instead, the typical case is whether firm in financial trouble may issue a dividend, not whether it must. Thus case law plus state statutes that limit dividend size—such as Delaware's "nimble dividend test"—serve as a crude creditor protection device.

Although the law of dividends would not allow the Dodges to credibly sue on this issue today, their tactics are still widely deployed.

¹⁰⁴ Henry Ford Explains, *supra* note 44.

¹⁰⁵ Seltzer, *supra* note 32, at 131.

The Dodges' initial strategy in sending a letter to Ford is commonly used today. Instead of relying on litigation as the leverage, however, minority shareholders use the pressure of public securities markets, in the form of threats to sell, negative publicity, and information to traders about management competency. For example, in 2005 famed corporate raider Carl Icahn took a 10% stake in video retailer Blockbuster in an attempt to change the firm's strategic direction. Instead of spending millions to build a new online business, Icahn pressed the board to issue a large dividend to shareholders. This should sound familiar, as it is fundamentally the same goal the Dodges were pursuing. Icahn did not sue, however, but instead led a proxy fight for a seat on the Blockbuster board. He and two other dissidents succeeded. Icahn chose his method of attack largely because any legal claim would undoubtedly have failed. The decision to withhold dividends and invest in new businesses is, under current law, unassailable.

Icahn also had at his disposal the tools of the market for corporate control that have been developed in the past decades. A public firm, like Blockbuster, is subject to this sort of market pressure in ways that private firms, like Ford's firm in the early 20th Century were not. In those cases, the only efficient solution to these disputes was clear contracting over economic and control rights. The shareholder agreements in the Ford Motor Company did not have these. In this light, the Dodges' only choice was to sue.

* * *

The injunction issue was, in contrast to the dividend ruling, not a place where the Court could afford to make a policy statement, since the costs of its decision were much higher here. Starting with two unassailable truths—that “judges are not business experts” and “[t]he experience of the Ford Motor Company is evidence of capable management of its affairs”¹⁰⁶—the Court deferred to the board's decision to expand capacity through building a new factory. Deference was justified for two reasons: first, the uncertainty of the inquiry into what would be best for the firm;¹⁰⁷ and second, the concern shareholders, like the Dodges, might be focused on short-term rather than long-term interests.¹⁰⁸ Here we see the traditional justification for a board-centered approach to governance. Shareholders have heterogeneous preferences and imperfect information, and courts will respect their delegation of decisionmaking to the board in all cases absent self-dealing by board members or, in very rare cases, a grossly negligent decisionmaking process.

¹⁰⁶ *Dodge*, 204 Mich. at 508.

¹⁰⁷ “[T]he ultimate results of the larger business cannot be certainly estimated.” *Id.*

¹⁰⁸ “It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture.” *Id.*

Though the legal verdict went against him in part, Ford once again emerged utterly victorious. He was praised as establishing a new, enlightened business philosophy characterized by one editorial as "the only one upon which great and enduring success can be established."¹⁰⁹ Although his testimony about looking out for workers—"giving labor its just reward" as the New York *Evening Mail* opined¹¹⁰—forced the courts to hand him a partial legal defeat and a good scolding, he won the "hearts of ordinary American citizens."¹¹¹ This enhanced the Ford legend and therefore expanded the market for "Ford" cars.

Despite these various victories, Ford learned being a majority shareholder was potentially as perilous as being a minority shareholder. But for the intervention of the Michigan Supreme Court, his plan for his company would have been foiled. Ford decided it was time to get rid of shareholders all together.

IV. *The Aftermath: Ford Finally Wins Control*

Ford had experience squeezing out shareholders, including majority shareholders like Murphy and Malcolmson, so getting rid of minority shareholders like the Dodges was easy. In fact, he pulled almost the same scheme. While traveling in California after the opinion was handed down, he gave an interview with the *Los Angeles Examiner* in which he announced plans to start a new company to make even better and cheaper cars. The Dodges issued a threatening statement—"Henry Ford is under contract to the Ford Motor Co. and he will not be allowed to . . . start a competitive business"—but it did not allay shareholder panic.¹¹² Anticipating this panic, Ford sent agents to shareholders to inquire about them selling their shares. According to some accounts, "they sold out for a lower price than they would have gotten under normal conditions."¹¹³ The Dodges got \$25 million for their 2000 shares (\$12,500 each), which was about \$10 million less than they demanded from Ford in 1917 to avoid litigation.¹¹⁴ Overall, the Dodges earned over \$32 million from their relationship with the Ford Motor Company.¹¹⁵

¹⁰⁹ Watts, *supra* note 1, at 258.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Argument Centers About the Fordlet*, Automobile Topics 655, Mar. 15, 1919.

¹¹³ See Booton Herndon, *Ford: An unconventional biography of the men and their times* 117 (1969).

¹¹⁴ Hyde, *supra* note 31, at 83-84.

¹¹⁵ The total includes: \$25 million from the sale of the stock; \$5 million in dividends; and about \$2 million in profit on sales to the firm. See *id.* at 84.

To accomplish the acquisition and consolidation of shares, Ford incorporated two new firms, Henry Ford & Son, Inc. (a New York firm) and Eastern Holding Company (a Delaware firm). These firms, with funds from Ford's contribution of his personal stock, purchased the remaining shares from the minorities. As of July 31, 1919, the stockholders of Ford were as follows:

Table 3: *Shareholders of the Ford Motor Company, circa 1919*¹¹⁶

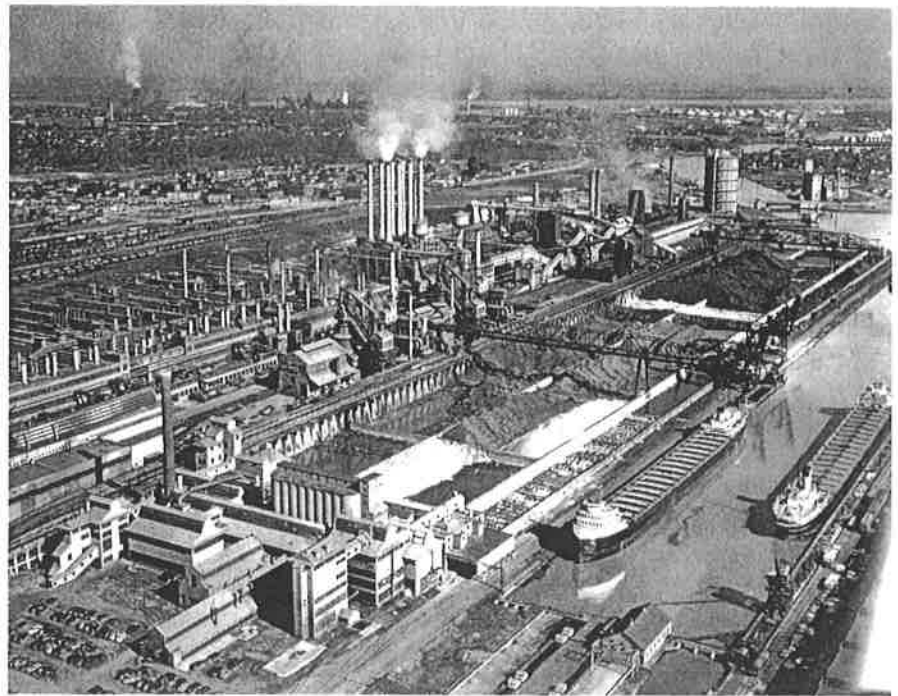
Shareholder	Number of shares	Percent ownership
Henry Ford & Son, Inc.	11,697	58
Eastern Holding Co.	6100	31
James Couzens	2180	11
Mrs. A.P. Hauss	20	<1
Henry Ford	1	<1
Edsel Ford	1	<1
F.L. Klingensmith	1	<1
	20,000	

Eastern Holding Company then amended its charter to change its name to the Ford Motor Company, and then, with a loan from a banking syndicate led by Chase National Bank, bought the remaining shares of the Michigan company of the same name. Ford proceeded to buy out his long-time friends and collaborators, acquiring the shares of Couzens and his sister in September 1919. He had had enough with all shareholders, even when they were dear and trusted friends.

As required by the Court's decision, the Ford Motor Company paid the \$19 million dividend. And, as permitted by it, went on to build the River Rouge factory, which the firm still operates today. (See Figure 1.) A two square-mile facility that would eventually employ over 100,000 workers and produce about 4000 cars per day, the River Rouge factory would be the largest manufacturing facility built until then or since. It would be so large, in fact, that Ford would describe it as "so big it's not fun any more."¹¹⁷

¹¹⁶ Seltzer, *supra* note 32, at 111.

¹¹⁷ "Mr. Ford Doesn't Care," *Fortune*, Dec. 1933, at 134.

Figure 1: Aerial view of the River Rouge Facility, Jan. 19, 1947

Copyright © 2005 The Henry Ford, available at thehenryford.org.

The squeeze out and consolidation of power also transformed the Ford Motor Company. The innovative company that rose from Ford's failures to unprecedented success became "more like the court of an oriental monarch in its combination of sycophancy and ruthlessness" after Ford took total control.¹¹⁸ Ford "was not an organization man" and wanted to "call all the signals and carry the ball."¹¹⁹ The new governance model Ford felt was essential to the early success of his firm did not serve it well when competitors, like General Motors, responded with their own counter strategy. Model T sales started to fall by the 1920s as GM head Alfred P. Sloan built an auto conglomerate, which offered customers a range of vehicles for every price range. Ford also faced a serious rival in the new Chrysler firm, which took market share as Ford stubbornly resisted innovating beyond the Model T. The spirit and total control needed to start the company was not conducive to its continued flourishing. Recognizing this eventually, Ford stepped aside and turned the reigns over to his son, Edsel.

¹¹⁸ Robert Little, "Henry Ford," *New Republic*, 304, Nov. 14, 1923.

¹¹⁹ Watts, *supra* note 1, at 515-16.

The Ford Motor Company remained private and family owned from 1920 to 1956, when Henry Ford's grandson, Henry II, took it public. Even then, the Ford family retained effective voting control (about 40% of the vote) by holding Class B shares with super-voting rights. Hank the Deuce, as he was known, used sophisticated corporate finance contracts to separate economic ownership from voting control, solving in part the dilemma his grandfather faced. This ownership structure still exists, and as of the end of 2008 Henry Ford's great grandson, William Clay Ford, Jr., remained chairman of the board.

* * *

Things did not turn out as well for the Dodges. Although Henry Ford made them fabulously wealthy and their new firm was having tremendous success, they would not enjoy it for long. While attending the New York auto show in January 1920, the brothers contracted influenza. John died within weeks. He was 55. Horace buried his brother, retreated to Florida, but was dead within the year. He was 52.¹²⁰ The rivalry between Ford and the Dodges was so passionate rumors quickly circulated, and even persist, the brothers were poisoned at the auto show, and Ford was the perpetrator. Modern biographers of both Ford and the Dodges dismiss these accusations outright,¹²¹ but the existence of them shows the nature of the battle between these powerful families.

The brothers' widows put the firm on the market in 1925. The investment banking firm Dillon, Read & Company bought the firm for \$146 million in cash, the largest cash transaction in history at that time. This offer topped that of General Motors, which offered \$124 million in cash and securities.¹²² Dillon, Read quickly replaced Dodge management with their own men in the hopes of bringing more rigorous analytically thinking and management to the company. (Here we see the precursor to the modern private equity movement in which investors replace managers of private or public firms in the hopes of reducing agency costs and extracting value from mismanaged assets.) The investor-appointed managers were not good car men. Dodge faltered dramatically over the next few years, with sales falling from over 260,000 in 1926 to less than 150,000 in 1927. Sensing an opportunity, Walter Chrysler and his eponymous auto firm bought Dodge in a stock-for-stock deal in 1928. The Dodge brand is still part of Chrysler today.

¹²⁰ Hyde, *supra* note 31, at 117-22.

¹²¹ See *id.* at 123.

¹²² See *id.* at 178.

V. Conclusion

Although the Court's dictum about the shareholder wealth maximization norm is the most widely cited part of the *Dodge* opinion, it is not the most interesting or illuminating aspect of the case. As this essay has shown, *Dodge* is about much more than it appears on first reading.

First, the case demonstrates how corporate litigation often is one battle in a broader business battle between the parties. *Dodge* allows students of the law to explore how ancillary or hidden issues often drive litigation, and to consider the difficult position of courts in these instances. The case presented to the courts was motivated by multiple factors on both sides: for the Dodges it was a ploy in their ongoing attempt to start a rival auto company to Ford, but was also an attempt to prevent a majority shareholder from diverting firm profits for seemingly personal ends; for Ford it was about denying potential rivals cash and avoiding taxes, but it was also about following what was at least plausibly a smart and profit-maximizing business strategy.

Courts often face such mixed motives in business litigation. Neither party comes with clean hands or pure motives, and the relief sought is often not about making the plaintiff whole or the defendant secure in its rights, but about something else. Courts are in a difficult position, since looking behind the complaint and the defense, they will see a complicated battle in which the litigation is a small part. Ignoring these issues risks having the law serving instrumental ends of opportunistic parties and establishing legal rules that allow other parties to exploit the law in ways unanticipated by the parties at the time of contracting. Paying full attention to them, on the other hand, also has risks, since a highly contextual decision may not translate easily to other cases, and therefore may create inefficiencies in contracting or dispute resolution.

Given this tension, the Michigan Supreme Court did about as well as could be expected in *Dodge*. Whether it saw the whole picture painted above or not, the Court crafted a holding that made a bold policy statement, while recognizing the limits of courts and law in resolving what are fundamentally business disputes. The decision of the board to invest in a new factory was not an act of charity, and the Court recognized this. But Ford's rhetoric could not be left unanswered. Drawing on the expressive function of law, the Court took an opportunity to announce a standard for firms to use in decisionmaking—that firm's exist to make profits—while simultaneously limiting the role of courts in policing this standard to extreme cases of self-dealing or grossly negligent decisionmaking.

Second, *Dodge* shows how explicit contracting over control rights is essential to the success of any business organization. Getting corporate governance right is not only something that can help firms make better

decisions, but can also be used defensively to prevent certain shareholders from holding up the firm and extracting economic rents. The tools and techniques used by Ford were crude by our modern understanding, but the problems are very familiar to corporate lawyers, executives, and investors today.

Ford's vision was actually thoroughly modern, and yet another example of how this case foreshadowed by almost a hundred years our modern corporate world. He claimed to "not want stockholders in the ordinary sense of the term" as they limited his ability to do what he thought was in the best interest of the Ford Motor Company.¹²³ A similar concern about shareholder meddling was seen in the 2004 initial public offering of stock in Google, Inc. The entrepreneurs who invented the Internet search engine, Larry Page and Sergey Brin, wanted what Ford wanted when he first approached William Murphy in 1899—other people's money but full control. Their solution to the problem of control rights typically following risk was a contractual one. Page and Brin issued two classes of stock: Class A shares, which would be sold to the public and would contain very limited voting rights, and Class B shares, which they would hold and would have super voting rights. Shareholder advocacy groups, like proxy voting advisor Institutional Shareholder Services, criticized this governance model: "[It] guaranteed that insiders will have 'carte blanche' authority in running the company over the near term."¹²⁴ Shareholders thought differently, as Google's share price soared from the moment of its IPO, and three years later was about eight times its initial price.

Ford would have preferred this model, but it was unavailable to him for a variety of reasons. For one, so-called dual class shares were a fairly sophisticated financing technique, and would have likely been foreign to him when he started his initial firms. In addition, the market for venture capital and public financing of start-ups, which the Google founders exploited, was non-existent. There was no standard technique for investing in new firms, no venture capital industry with experienced players and valuable reputations, and no robust market for pricing public shares in firms with innovative governance models. In short, Ford was faced with a problem that has been largely solved by the free contracting and robust markets that we have today.

In this light, we can view the decision of the Michigan Supreme Court as an attempt to force consideration of precisely these questions about control rights. By narrowly defining the role of law, the Court forced parties to negotiate over control rights. "Don't come to us to write

¹²³ Watts, *supra* note 1, at 257.

¹²⁴ See Dawn Kawamoto, *Google gets low marks for governance*, available at CNET News.com, Aug. 24, 2004.

your bargains after the fact," the Court seemed to say, but bargain for control and cashflow rights at the time of investment. This is especially appropriate because the parties in these cases are sophisticated, knowledgeable, and represented by counsel. Forcing these parties to define their rights and responsibilities clearly by contract is a move in the direction of efficiency that the *Dodge* Court seemed to get about right. And it set the theoretical framework in which Hank the Deuce, the Google founders, and others solved these problems.

The period in which Ford and the Dodges battled over control of the Ford Motor Company looked a lot like our modern world, but not so much like the world that would exist between then and now. We see the roots of venture capital contracts, shareholder activism, modern bankruptcy concepts like consolidation and restructuring specialists, and litigation as a business tactic. When Ford solved the problems that animated the *Dodge* case, he led the move toward a model of managerial capitalism and insulation of firms from shareholder pressure that would persevere for decades until the takeover battles of the 1980s. *Dodge* tells us much about our modern world that was lost for decades.

The *Dodge* case is often misread or mistaught as setting a legal rule of shareholder wealth maximization. This was not and is not the law. But the case is a part of the canon because it is about much more than this. This essay shows how the opinion can help us understand the difficult task for courts in these cases and how many of prominent aspects of corporate law and practice have long and underappreciated histories.

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CORPORATE LAW

SECOND EDITION

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CONCEPTS AND INSIGHTS SERIES

FOUNDATION PRESS
2009

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Chapter 9

THE LIMITS OF FIDUCIARY OBLIGATION

§ 9.1 Introduction

What is the social role of the corporation? What goals should corporate directors and managers pursue? Managerialist schools of thought claim that managers are autonomous actors free to pursue whatever interests they choose (or society directs). Shareholder primacy theorists believe that corporations should be run so as to maximize shareholder wealth. Proponents of corporate social responsibility argue that directors and managers should consider the interests of all corporate constituencies in making corporate decisions. Hence, stakeholderists define the "socially responsible firm" as "one that becomes deeply involved in the solution of society's major problems."¹ In particular, they emphasize the corporation's obligation to consider the impact of its actions on nonshareholder corporate constituents, such as employees, customers, suppliers, and local communities.

§ 9.2 Corporate Social Responsibility and the Law

In general, corporate law does not mandate corporate social responsibility. Instead, the question is whether the law even permits corporate social responsibility. Put another way, to what extent do the fiduciary duties of corporate directors permit them to consider nonshareholder interests when making corporate decisions?

A. Case Law

Despite the obvious centrality of this problem to the operation of business corporations, there are surprisingly few authoritative precedents on point. The law's basic position on corporate social responsibility famously was articulated in *Dodge v. Ford Motor Co.*¹ In 1916, Henry Ford owned 58% of the stock of Ford Motor Co. The Dodge brothers owned 10%. The remainder was owned by five other individuals. Beginning in 1908, Ford Motor paid a regular annual dividend of \$1.2 million. Between 1911 and 1915 Ford Motor also regularly paid huge "special dividends," totaling over \$40 million. In 1916, Henry Ford announced that the company would stop paying special dividends. Instead, the

1. Robert Hay and Ed Gray, Social Responsibilities of Business Managers, in *Managing Corporate Social Responsibility* 8, 11 (Archie B. Carroll ed. 1977).

1. 170 N.W. 668 (Mich.1919).

firm's financial resources would be devoted to expanding its business. Ford also continued the company's policy of lowering prices, while improving quality. The Dodge brothers sued, asking the court to order Ford Motor to resume paying the special dividends and to enjoin the proposed expansion of the firm's operations. At trial, Ford testified to his belief that the company made too much money and had an obligation to benefit the public and the firm's workers and customers.

The plaintiff Dodge brothers contended an improper altruism towards his workers and customers motivated Ford. The court agreed, strongly rebuking Ford:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Consequently, "it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others."

Despite its strong rhetoric, *Dodge* does not stand for the proposition that directors will be held liable for considering the social consequences of corporate actions. To be sure, having found that Ford had failed to pursue shareholder wealth maximization, the court ordered Ford Motor to resume paying its substantial special dividends. Invoking the business judgment rule, however, the *Dodge* court declined to interfere with Ford's plans for expansion and dismissed the bulk of plaintiff's complaint. The shareholder wealth maximization norm set forth in *Dodge* thus can be understood as a standard of conduct, while the business judgment rule remains the standard of review. Consequently, *Dodge* does not stand for the proposition that courts will closely supervise the conduct of corporate directors to ensure that every decision maximizes shareholder wealth. As the court's refusal to enjoin Ford Motor's proposed expansion illustrates, courts generally will not substitute their judgment for that of the board of directors. If a proposed course of action plausibly relates to long-term shareholder wealth maximization, courts will not intervene. Ford's proposed expansion plans did so, and thus were allowed to go forward. Ford's refusal to pay a special dividend, while simultaneously lowering prices, compounded by his anti-profitmaking trial testimony, did not. Accordingly, the court ordered him to pay the requested dividend. As always, authority and accountability are in tension. We have consistently argued that, absent self-dealing or other unusual circumstances, authority should prevail. Ford's conduct lay at

the outer boundary of defensible exercises of authority and the court appropriately slapped his wrist.

As the law evolved, corporate altruism began to be seen as proper so long as it was likely to provide direct benefits to the corporation and its shareholders. Applying the business judgment rule, moreover, many courts essentially presumed that an altruistic decision was in the corporation's best interests. *Shlensky v. Wrigley*² exemplifies this approach. Recall that Shlensky, a minority shareholder in the Chicago Cubs, challenged the decision by Wrigley, the majority shareholder, not to install lights at Wrigley Field. Shlensky claimed the Cubs were persistent money losers, which he attributed to poor home attendance, which in turn he attributed to the board's refusal to install lights and play night baseball. According to Shlensky, Wrigley was indifferent to the effect of his continued intransigence on the team's finances. Instead, Shlensky argued, Wrigley was motivated by his beliefs that baseball was a daytime sport and that night baseball might have a deteriorating effect on the neighborhood surrounding Wrigley Field.

Despite Shlensky's apparently uncontested evidence that Wrigley was more concerned with interests other than those of the shareholders, the court did not even allow him to get up to bat. Instead, the court presumed that Wrigley's decision was in the firm's best interests. Indeed, the court basically invented reasons why a director might have made an honest decision against night baseball. The court opined, for example, "the effect on the surrounding neighborhood might well be considered by a director." Again, the court said: "the long run interest" of the firm "might demand" protection of the neighborhood. Accordingly, Shlensky's case was dismissed for failure to state a claim upon which relief could be granted.

The rhetorical emphasis shifted significantly between *Dodge* and *Shlensky*. Where *Dodge* emphasized the directors' duty to maximize profits, *Shlensky* emphasized the directors' authority and discretion. Ultimately, however, they are consistent. The Illinois Appellate Court did not reject the profit-maximizing norm laid down by *Dodge*, but rather followed *Dodge* in holding that the business judgment rule immunized the directors' decision from judicial review.

To be sure, a few cases posit that directors need not treat shareholder wealth maximization as their sole guiding star. *A. P. Smith Manufacturing Co. v. Barlow*, the most frequently cited example, upheld a corporate charitable donation on the ground, inter alia, that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within

2. 237 N.E.2d 776 (Ill.App.1968), see § 6.2. Accord *Ella M. Kelly & Wyndham, Inc. v. Bell*, 266 A.2d 878, 879 (Del.1970);

Union Pac. R.R. Co. v. Trustees, Inc., 329 P.2d 398, 401-02 (Utah 1958).

which they operate.”³ Ultimately, however, the differences between *Barlow* and *Dodge* have little more than symbolic import. As the *Barlow* court recognized, shareholders’ long-run interests are often served by decisions (such as charitable giving) that appear harmful in the short-run. Because the court acknowledged that the challenged contribution thus could be justified on profit-maximizing grounds, its broader language on corporate social responsibility is arguably mere dictum.

In any event, *Dodge*’s theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time. Almost three quarters of a century after *Dodge*, the Delaware chancery court similarly opined: “It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders.”⁴

In sum, the law governing operational decisions has a somewhat schizophrenic feel. In most jurisdictions, courts will exhort directors to use their best efforts to maximize shareholder wealth. In a few, courts may exhort directors to consider the corporation’s social responsibility. In either case, however, the announced principle is no more than an exhortation. The court may hold forth on the primacy of shareholder interests, or may hold forth on the importance of socially responsible conduct, but ultimately it does not matter. Under either approach, directors who consider nonshareholder interests in making corporate decisions, like directors who do not, will be insulated from liability by the business judgment rule.⁵

B. Nonshareholder Constituency Statutes

Over thirty states have purported to address the corporate social responsibility debate by adopting so-called nonshareholder constituency statutes. Typically, these statutes amend the existing statutory statement of the director’s duty of care. They commonly authorize the board of directors, in discharging its duty of care, to consider the impact a decision will have on not only shareholders, but also on a list of other constituency groups, such as employees, suppliers, customers, creditors, and the local communities in which the firm does business. In addition to the laundry list of constituency factors, some statutes more generally authorize directors to consider both the long-and short-term effects of the decision.

Most nonshareholder constituency statutes are permissive. Directors “may,” but need not, take nonshareholder interests into account. There

3. 98 A.2d 581, 586 (N.J.1953). See also *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 404 (Del.Ch.1969) (opining that corporate social responsibility is a desirable goal).

4. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del.Ch.1986).

5. The principal exception to this rule is where directors rely on nonshareholder interests to justify takeover defenses, which do not necessarily get business judgment rule protection. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del.1985).

are no express constraints on the directors' discretion in deciding whether to consider nonshareholder interests and, if they decide to do so, which constituency groups' interests to consider. As a result, the statutes should not be interpreted as creating new director fiduciary duties running to nonshareholder constituencies and the latter should not have standing under these statutes to seek judicial review of a director's decision.⁶

Beyond this, however, the nonshareholder constituency statutes uniformly are silent on many key issues. Among the issues left open by almost all statutes are such critical questions as: How should directors decide whether particular claimants fall into one of the protected constituent categories, some of which, such as customers and communities, are very amorphous? What weight should directors assign to shareholder and nonshareholder interests? What should directors do when those interests cannot be reconciled? What should directors do when the interests of various nonshareholder constituencies conflict amongst themselves? What standards should courts use in reviewing a director's decision not to consider nonshareholder interests? What standards of review apply to director action claimed to be motivated by concern for nonshareholder constituents? Nor is there, as yet, any significant guidance from the courts. The statutes have rarely been cited outside the takeover setting, and even there they have not received authoritative interpretation. To the contrary, the decisions generally are limited to the not very startling observation that the statutes permit director consideration of stakeholder interests.⁷ The waters thus remain quite murky.

Plausible interpretations of nonshareholder constituency statutes fall on a spectrum between two extremes. At one end of the spectrum is a reading that allows directors to ignore shareholder interests in making corporate decisions. At the other end is a reading under which the statutes simply codify the pre-existing common law, including an unmodified shareholder wealth maximization norm. Neither extreme seems likely to emerge as the prevailing interpretation. Instead, we will end up somewhere in the middle. But where?

At a minimum, if the statutes do anything beyond merely codifying present law, they presumably permit directors to select a plan that is second-best from the shareholders' perspective, but which alleviates the decision's impact on the firm's nonshareholder constituencies. In other words, the directors may balance a decision's effect on shareholders

6. Although most statutes are silent on this point, the New York and Pennsylvania statutes explicitly state that they create no duties towards any party. N.Y. Bus. Corp. Law § 717(b); 15 Pa. Cons. Stat. § 1717. Where statutes are silent, it is important to note that at common law the board of directors has no duty to consider nonshareholder interests. See, e.g., *Local 1330, Unit-*

ed Steel Workers v. U.S. Steel Corp., 631 F.2d 1264, 1280-82 (6th Cir.1980). Accordingly, judicial creation of such a duty should require a clearer legislative statement.

7. See, e.g., *Keyser v. Commonwealth Nat'l Fin. Corp.*, 675 F.Supp. 238, 265-66 (M.D.Pa.1987); *Baron v. Strawbridge & Clothier*, 646 F.Supp. 690, 697 (E.D.Pa.1986).

against its effect on stakeholders. If the decision would harm stakeholders, the directors may trade-off a reduction in shareholder gains for enhanced stakeholder welfare.

This interpretation is virtually compelled by the statutory language. What purpose is there in giving the directors the right to consider nonshareholder interests if the directors cannot protect those interests? Without the right to act on their deliberations, the right to include stakeholder interests in those deliberations is rendered nugatory. If the statutes are to have any meaning, they must permit directors to make some trade-offs between their various constituencies.

How then might these statutes change the outcome of specific cases, if at all? Assume the XYZ Company operates a manufacturing plant nearing obsolescence in an economically depressed area. XYZ's board of directors is considering three plans for the plant's future. Plan A will keep the plant open, which will preserve the jobs of two hundred fifty workers, but will reduce earnings per share by ten percent as long as the plant remains open. Plan B will close the plant immediately, which will put the two hundred fifty plant employees out of work in an area where manufacturing jobs are scarce, but will cause earnings per share to rise by ten percent. Plan C contemplates closing the plant, but implementing a job training and relocation program for its workers as a supplement to state-provided programs. Plan C will cause a ten percent reduction in earnings per share for one year.

A shareholder threatens to bring a derivative action against the directors charging breach of their duty of care if they pick any plan other than Plan B. Under traditional corporate law principles, as espoused by *Dodge*, XYZ's board is required to choose the plan that maximizes shareholder wealth: Plan B. However, because the statutes permit directors to balance shareholder and stakeholder interests, the board should be free to adopt either Plan A or Plan C without fear of liability if a shareholder challenges the board's decision.

As a practical matter, however, the result would be no different under traditional common law rules. The business judgment rule undoubtedly would preclude judicial review of the board's decision. In *Shlensky v. Wrigley*,⁸ Wrigley's stubborn opposition to lights probably cost the shareholders money over the short term, but the business judgment rule prevented Shlensky's lawsuit from going forward. In *Dodge v. Ford Motor Co.*,⁹ Ford's concern for his workers and customers likewise may have harmed the other shareholders, but again the business judgment rule shielded him from liability in connection with the plant expansion decision. Just so, the business judgment rule would shield our hypothetical XYZ board's decision from judicial review. In theory, of course, absent a nonshareholder constituency statute, a share-

8. 237 N.E.2d 776 (Ill.App.1968).

9. 170 N.W. 668 (Mich.1919).

holder might be able to rebut the business judgment rule's presumption of good faith and hold directors liable for considering nonshareholder interests. In practice, however, cases in which the business judgment rule does not shield operational decisions from judicial review are so rare as to amount to little more than aberrations. In sum, the probability of holding directors liable for operational decisions was so low before the nonshareholder constituency statutes came along that the statutes could not further lower it.

§ 9.3 Extra-Contractual Duties to Bondholders

As with any long-term relational contract, bond indentures inevitably prove incomplete. In a world characterized by uncertainty, complexity, and bounded rationality, it cannot be otherwise. Where the bond indenture is silent, should the law invoke fiduciary duties or other extra-contractual rights as gap fillers?

The majority view is that neither the corporation itself nor its officers and directors owe fiduciary duties to bondholders, as the leading cases hold.¹ Instead, "the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature."² The indenture thus both defines and confines the scope of the corporation's obligations to its bondholders.

To be sure, a few cases purportedly hold to the contrary. The leading precedents, however, relate to insolvent corporations.³ Outside the insolvency context, there is little support for fiduciary duties to bondholders.⁴ Most of the cases opining to the contrary involved fraudulent schemes or conveyances actionable outside the bounds of corporate fiduciary obligation.⁵ Other cases in this genre involve recharacterization of nominal debt securities as equity.⁶ Still others are mere dicta.⁷

1. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504, 1524-25 (S.D.N.Y.1989); *Simons v. Cogan*, 549 A.2d 300, 304 (Del.1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del.1985).

2. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del.Ch.1986).

3. See *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir.1982) (stating that "when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"); *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 790-91 (Del.Ch.2004) ("When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors. This is an uncontroversial proposition...."); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del.Ch.1992) (ob-

serving that "when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors").

4. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del.2007), the Delaware supreme court resolved a longstanding debate by holding that directors of a corporation in the "zone of insolvency" do not owe direct fiduciary duties to creditors.

5. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504, 1524 (S.D.N.Y.1989) (analyzing cases).

6. Cf. *Eliassen v. Green Bay & W.R.R. Co.*, 569 F.Supp. 84 (E.D.Wis.1982) (discussing theory and cases). In *Eliassen*, the Class B debentures in question had economic rights more closely resembling those of common stock than normal debt. The Class B debentures had no right to regular payment of interest, but were paid interest

The limited extra-contractual rights of bondholders are provided by the implied covenant of good faith found in all contracts. *Katz v. Oak Industries*, for example, held that the implied covenant is breached when it is clear from the express terms of the indenture that the parties would have prohibited the challenged act if they had thought to negotiate about it:

[T]he appropriate legal test is not difficult to deduce. It is this: is it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.⁸

The oft-cited *Met Life* decision likewise invoked an implied covenant of good faith, although its treatment of that covenant differed somewhat from *Katz*.⁹ In the latter, the chancery court suggested that an implied covenant of good faith is part of every contract. In *Met Life*, however, the court suggested that a covenant of good faith is implied only when necessary to ensure that neither side deprives the other side of the "fruits of the agreement." The court then seemingly limited the fruits of the bond indenture to regular payment of interest and ultimate repayment of principal. In any case, the court made clear that "the implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligation which would be inconsistent with other terms of the contractual relationship." Consequently, the implied covenant will not give bondholders any extra-contractual rights inconsistent with those set out in the indenture.

Assuming the two tests are different, does the difference matter? *Katz* seems a bit broader, perhaps applying the covenant to conduct that does not directly threaten either the repayment of principal or regular

only when the board chose and only after the nominal stockholders had been paid, and the debentures came last in a liquidation. The court nevertheless declined to treat the debentures as the equivalent of stock because the Class B debentures had no voting rights and, moreover, were originally issued in a reorganization of an insolvent debtor to creditors who would have been entitled to nothing in a liquidation. *Id.*

7. The classic example is *Green v. Hamilton Int'l Corp.*, 437 F.Supp. 723 (S.D.N.Y. 1977), in which the court held that "[a]s holders of convertible debentures, plaintiffs were part of 'the entire community of interests in the corporation—creditors as well as stockholders' to whom the fiduciary duties of directors and controlling shareholders

run." *Id.* at 729 n.4 (quoting Justice Douglas' famous dictum in *Pepper v. Litton*, 308 U.S. 295, 307 (1939)). The passage from *Green* is mere dicta because the court simply determined that plaintiff's claim of fraud under Securities Exchange Act Rule 10b-5 could survive a FRCP 12(b)(6) motion to dismiss. In addition, while *Green* purported to interpret Delaware law, the Delaware supreme court specifically disavowed *Green* in *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del.1988).

8. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 880 (Del.Ch.1986).

9. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504 (S.D.N.Y. 1989).

payment of interest. In particular, *Katz* seemingly allows the covenant of good faith to address matters that affect the market price of the bonds. In order to do so, of course, the court would require express terms in the indenture addressing such matters, because only then could one draw the inferences necessitated by the decision's hypothetical bargain-like standard.

Despite this potential difference, however, the two cases are quite similar in a number of respects. In particular, both *Katz* and *Met Life* constrain the implied covenant of good faith by reference to the express terms of the contract. Taken together, the two decisions reflect a basic principle, which can be expressed colloquially as "you made your bed, now you have to lie in it."

§ 9.4 Extra-contractual Duties to Preferred Shareholders

Unlike bondholders, who are creditors of the corporation, holders of preferred stock are nominally shareholders. In addition, while bond indentures tend to be lengthy and highly detailed, the organic documents governing preferred stock tend to be bare-bones affairs. To what extent are preferred stockholders therefore entitled to the benefits of fiduciary duties or other extra-contractual protections?

Jedwab v. MGM Grand Hotels, Inc.,¹ split the baby in an interesting way. A prospective buyer of MGM, Bally Manufacturing, made a total offer for the company, leaving to MGM's board the task of dividing the proceeds between the common and the preferred. The preferred shareholders objected to the division set by the board. Did the board owe the preferred shareholders fiduciary duties of care and loyalty with respect to division of the deal?

The chancery court's opinion acknowledged a number of prior Delaware decisions holding that "preferential rights are contractual in nature."² The chancellor rejected, however, the defendants' asserted corollary that all rights of preferred stock are contractual in nature. Instead, the chancellor drew a distinction between the preferential rights and special limitations associated with preferred stock, which are created by the articles of incorporation or other organic corporate documents, and rights that both the preferred and common shares possess by virtue of being stock. The former are contractual in nature and, as such, the board's sole obligation is to give the preferred their contract rights. The latter, however, may give rise to fiduciary obligations. The disputed merger implicated none of the relevant preferential rights or special limitations of MGM's preferred. Accordingly, the court identified three aspects of the preferred holders' complaint as implicating fiduciary duties: "(a) to a 'fair' allocation of the proceeds of the merger; (b) to

1. 509 A.2d 584 (Del.Ch.1986).

2. See, e.g., *Rothschild Int'l Corp. v. Liggett Group, Inc.*, 474 A.2d 133, 136 (Del. 1984).

have the defendants exercise appropriate care in negotiating the proposed merger; and (c) to be free of overreaching by Mr. Kerkorian [a controlling shareholder]...."

Jedwab has a certain superficial plausibility, but proves unpersuasive on closer examination. First, a number of Delaware supreme court precedents in fact suggest that all of the rights of preferred stockholders are contractual in nature, not just those relating to their preferential rights and special limitations.³ The supreme court's holding in *Wood v. Coastal States Gas Corp.*⁴ seems particularly problematic for *Jedwab*'s viability. In *Coastal*, plaintiff-preferred shareholders challenged a spin-off transaction as violating the provision of *Coastal*'s articles of incorporation governing conversion of their stock to common. Holding that its duty was to interpret the contract created by the conversion provision, the court concluded that the preferred stockholders' rights were not violated. To be sure, *Coastal* involved a preferential right and thus fell into the category of rights that even *Jedwab* acknowledges to be contractual in nature. The *Coastal* court, however, used very broad language in defining the rights of preferred stockholders: "For most purposes, the rights of the preferred shareholders as against the common shareholders are fixed by the contractual terms agreed upon when the class of preferred stock is created." The qualifier, "for most purposes," does not leave a lot of wiggle room for *Jedwab* to sneak through. Even more significantly, however, the *Coastal* court expressly rejected the plaintiff-preferred shareholders' claim that the spin-off unjustly enriched the common stockholders. In so holding, the court opined that whatever participation rights the preferred stockholders possessed must be created by the articles of incorporation. By thus rejecting an extra-contractual remedy, the *Coastal* court further confirmed the essentially contractual nature of preferred stockholders' rights.

Second, *Jedwab* depends on the proposition that preferred stock is granted certain rights by statute and common law even where the corporation's organic documents are silent. The chancellor cited two such examples: Where the contract is silent, preferred stock get the same voting rights as common stock. Where the contract is silent, preferred stock participates pro rata with the common in a liquidation.⁵ Neither of these examples, however, rise to the same level as conferring the benefits of fiduciary obligation on preferred stockholders. Neither entails the sort of open-ended inquiry required by fiduciary obligation, nor does either entail the same risk of conflicting interests.

3. See, e.g., *Judah v. Delaware Trust Co.*, 378 A.2d 624, 628 (Del.1977) ("Generally, the provisions of the certificate of incorporation govern the rights of preferred shareholders, the certificate ... being interpreted in accordance with the law of contracts, with only those rights which are

embodied in the certificate granted to preferred shareholders.").

4. 401 A.2d 932 (Del.1979).

5. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593-94 (Del.Ch.1986).

Finally, from a policy perspective, several objections to *Jedwab* can be noted. First, *Jedwab* does not eliminate potential conflicts of interest between the holders of preferred and common. Whose interests must the board maximize when those interests clash? On a related note, the *Jedwab* opinion makes clear that the preferred are not entitled to an equal share in the merger consideration—only to a fair share. Yet, how does the board decide what is fair ex ante? Even if the board makes a good faith effort to set a fair price, the indeterminacy of valuation means that reasonable people could differ. Conversely, if the prospective buyer proposed the division to be made between the common and the preferred, the board likely would escape liability. Among other things, the board could defend itself on causation grounds—i.e., whether or not the board breached its fiduciary duties, that breach was not the cause of plaintiff's injuries.⁶ Finally, *Jedwab* implies that the preferred may have greater rights with respect to nonpreference issues than with respect to preferences, which seems odd at best.⁷

In fairness, *Jedwab* wrestled with a persistent problem in the preferred stock area. As noted, bond indentures are hundreds of pages long and deal with virtually every conceivable contingency. In contrast, preferred stock certificates of designation tend to be relatively short and to deal with only a few issues. Which leaves unresolved a nagging question; namely, how do you deal with issues that come up that the contract does not cover? The answer, by analogy to the bond setting, is to use an implied covenant of good faith rather than fiduciary duties. In this context, such a covenant would preclude the board from taking action that deprives the preferred of the benefit of their bargain. To the extent that covenant fails to provide adequate protections, portfolio theory teaches that the preferred stockholders should engage in self-help by diversifying their portfolio.

§ 9.5 The "Special" Problem of Corporate Philanthropy

As we have seen, *A. P. Smith Manufacturing Co. v. Barlow*,¹ is often cited as a leading corporate social responsibility decision. Ironically, however, the specific question presented therein—the validity of corporate philanthropy—has been resolved in a more narrow way. Corporate charitable donations are subject to attack under two doctrines: ultra

6. See, e.g., *Dalton v. American Inv. Co.*, 490 A.2d 574 (Del.Ch.), aff'd, 501 A.2d 1238 (Del.1985) (declining to reach issue of fiduciary obligation to preferred stockholders as there was no causal link between alleged breach and alleged injury).

7. The Delaware chancery court continues to follow *Jedwab*. See, e.g., *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386-87 (Del.Ch.1999) ("fiduciary duties as well may be owed to preferred stockholders in limited circumstances....

Whether a given claim asserted by preferred stockholders is governed by contract or fiduciary duty principles, then, depends on whether the dispute arises from rights and obligations created by contract or from a right or obligation that is not by virtue of a preference but is shared equally with the common") (footnotes and internal quotation marks omitted).

1. 98 A.2d 581, 586 (N.J.1953).

vires and breach of fiduciary duty. Neither is likely to succeed, so long as the amount in question is reasonable and some plausible corporate purpose may be asserted.

Virtually all states have adopted statutes specifically granting corporations the power to make charitable donations,² which eliminates the ultra vires issue. Although these statutes typically contain no express limit on the size of permissible gifts, courts interpreting the statutes require corporate charitable donations to be reasonable both as to the amount and the purpose for which they are given.³ The federal corporate income tax code's limits on the deductibility of corporate charitable giving are often used by analogy by courts seeking guidance on whether a gift was reasonable in amount.

As for breach of fiduciary duty claims, the principles announced in *Dodge v. Ford Motor Co.*⁴ arguably require that corporate philanthropy redound to the corporation's benefit. As *Shlensky v. Wrigley*⁵ suggests, however, reasonable corporate donations should be protected by the business judgment rule.⁶ Consequently, *Barlow's* discourse on corporate social responsibility properly is regarded as mere dicta.

2. See, e.g., DGCL § 122(9); MBCA § 3.02(13).

3. See, e.g., *Memorial Hospital Ass'n v. Pacific Grape Products Co.*, 290 P.2d 481 (Cal.1955); *Kahn v. Sullivan*, 594 A.2d 48 (Del.1991); *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del.Ch.1969); *Union Pac. R. Co. v. Trustees, Inc.*, 329 P.2d 398 (Utah 1958).

4. 170 N.W. 668 (Mich.1919).

5. 237 N.E.2d 776 (Ill.App.1968).

6. See, e.g., *Ella M. Kelly & Wyndham, Inc. v. Bell*, 266 A.2d 878, 879 (Del.1970); *Union Pac. R. Co. v. Trustees, Inc.*, 329 P.2d 398, 401-02 (Utah 1958).