MINORITY SHAREHOLDERS IN CLOSE CORPORATIONS

— Ways and Limits of Protection in
their Dilemma of No Control
and No Ready Market—

by

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ABSTRACT

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The topic of this thesis is the peculiar situation of minority shareholders in close corporations. Recent legislative and judicial improvements towards the recognition of this situation are studied and the need for further improvements is emphasized.

Statutes and judicial decisions, especially before 1960 generally laid down the same rules for the governance of both public-issue and close corporations, although the nature and methods of operation of the two kinds of corporation differ to a great extent. Since 1960, a legislative breakthrough has occurred, with many states adding to their corporate statutes provisions designed to meet the problems and needs of the close corporation. In some states, however, little or nothing has been done even in recent years to modify statutes and decisional law unfavorable to close corporations, which has an especially disadvantageous impact on minority shareholders.

The approach of the study is to show two possible ways to protect the minority shareholder in his "dilemma of no control and no ready market;" first, to facilitate a fair share in the control of the corporation for the minority shareholder; and second, to provide a substitute for the minority shareholder for the not existing ready market. For both of these general solutions, the thesis recognizes the same three operational devices with which to protect the shareholders:

1. Statutory provisions;

2. Allowance of charter and bylaw provisions, shareholders' agreements;

3. Judicial protection under equity.

A main problem arises out of the fact that all these devices deviate from two fundamental corporate principles: the majority rule and the principle of the separation of ownership and management.

Another main point of discussion is the legal basis which gives the minority a right against the majority, that is, the basic question of fiduciary duties owed by shareholders in a close corporation.

The study concludes that considerable legislative and judicial progress has been made in recent years recognizing the distinct problems and the needs of the close corporation, but that further improvement is desirable, especially by the adjudication of broader contractual freedom and the implementation of a close scrutiny of majority behavior under the fiduciary concept.

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PART ONE: THE FACTUAL AND LEGAL SITUATION OF THE CLOSE CORPORATION AND ITS MINORITY SHAREHOLDERS

I. WHAT IS A CLOSE CORPORATION?

— Legal Character and Actual Situation —

With respect to the legal structure of a corporation, only one type of corporation is acknowledged by law: the type of corporation which the legislators had in mind in setting up the general corporation laws is characterized as a legal entity which has its own existence separate and apart from its shareholders and where liability is restricted to the assets of the corporation ("limited liability.") This one type of corporation, so characterized, in reality covers a wide range of underlying business situations which are all treated by the same corporate principles and rules.

The broadest distinction differentiates between publicly held corporations and close corporations (see below for a definition of the close corporation). The publicly held corporation has a great number of shareholders whose exclusive interest lies in the money invested in the corporation. Their relation to the corporation is a passive one: the management of the corporation is undertaken by an independent administration. Because of this separation of ownership and management power, membership in a publicly held corporation is largely exchangeable, which means that there is a market

for its shares. Distinct from that type of corporation, the characteristics of a second type of corporation, of which a great number exist, will be described. I will later attempt to find a definition for that "close corporation."

However, at this point, I will only address myself to the different business situation of the "close corporation" in comparison to that of the publicly held corporation. In this second type of corporation, there are typically only a few (and often only two or three) shareholders. The shareholders know each other well; they know their mutual abilities and skills, and, mostly for those reasons joined to do business; for example, a Harvard M.B.A. and an MIT Technician join into a corporation to economically make use of an invention. Because of this characterisitic of personality involvement between the shareholders, the free exchangeability which exists in the publicly held corporation does not exist in this type of corporation. There is a strong interest to keep the corporation "closed" which is technically insured by the often existing restrictions on the transferability of the shares of the corporation.

Out of this follows another characteristic— distinct from the publicly held corporation— the <u>not existing market</u> for the shares of such a corporation, which creates one of the main problems for minority shareholders, and it is discussed in a subsequent section.

The importance of the personality of the shareholder is also expressed by the fact that the shareholders predominantly serve as management. The principle of the separation of ownership and management, which is valid in a publicly held corporation, is not realized in such a corporation. "Ownership and management are in the same hands, and the owners are quite dependent on one another for the success of the enterprise." Many of these corporations are "really partnerships, between two or three people who contribute their capital, skills, experience and labor."[1] Such an "incorporated partnership"[2] does not lose its separate legal personality "merely because all of its stock is held by two or three persons,"[3] by the members of a single family or even by only one individual.[4] Such a corporation, just as any other corporation, holds property, enters into contracts, executes conveyances, and conducts litigation in a capacity separate and distinct from its shareholders.[5,6]

This existence of the corporation as a separate legal entity and the limitation of liability with respect to the

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1 Kruger v. Gerth, 16 NY 2d 802, 805, 263 NY 2d 1,3,210 NE 2d 355, 356 (1965).

2 Hornstein, "Judicial Tolerance of the Incorporated Partnership," 18 Law and Contemporary Problems, p. 435 (1953).

3 Elliot v. Smith, 47 Mich. App. 236, 209 NW 2d 425 (1973).

4 Gordon Chemical Co. v. Aetna Casualty and Surety Co., 266 NE 2d 653 (Mass 1971).

5 US v. Certain Parcel of Land, Wayne County, Michigan, 466

corporation's assets may be the main reason of taking this form for the business. The existence of a separate legal entity also has the effect of perpetuity because a member can give up his membership without causing liquidation of the business. The opposite is true in principle in a partnership. The stockholders of a close corporation "clothe" their partnership with the benefits peculiar to a corporation: limited liability, perpetuity and the like.[7]

This study addresses itself to this second type of corporation. For the purpose of this study I will use one definition for a "close corporation" that is given by the Supreme Court of Massachusetts[8] and which seems quite well to cover the described business situation. That court defines a "close corporation" as typified by:

1. A small number of stockholders;
2. No ready market for the corporate stock; and
3. Substantial majority stockholder participation in the management, direction and operations of the corporation.

I will use this definition of a close corporation, disregarding the discussion about a "right" definition (see below),

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F 2d 1295 (6th Cir. 1972).

6 O'Neal, Close Corporations, Law and Practice, Vol I, ch. 1.09 with further reference, (1971).

7 Surchin v. Approved Bus. Mach. Co., Inc. 286 NYS 2d 580, 581 (Sup. Ct. 1967).

8 Donahue v. Rodd Electrotype Co. of N.E., Inc. Mass. 328 NE 2d 505, 511 (1975).

but rather relating this definition in my study to the business situation described above.

II. WHAT IS THE SPECIFIC INTEREST AND MOTIVATION OF A SHAREHOLDER IN A CLOSE CORPOATION?

A. The Interest of a Shareholder in a Close Corporation Compared to a Shareholder in a Publicly Held Corporation.

The business situation described in Section I, which underlies the existence of a close corporation, is the reason why the shareholders of a close corporation are strongly interested in getting away from some of the provisions of the general corporation law which rules all corporations.

(1) Because the shareholders of a close corporation are not mainly interested in the investment but are bound to each other by any personal relation, the shareholders of a close corporation seek to deviate from the generally applicable norms and want to set up a pattern which takes into consideration this personal relation between the shareholders. They are specifically interested in restricting the transferability of corporate shares to keep out undesired shareholders.

(2) Because of the factual identity of stock ownership and active management in the close corporation, the shareholders are interested in overcoming the controversial prin-

ciple which rules corporate law (i.e. the separation of both these functions), so that the shareholder-directors are not forced to separate these functions in conducting their business, which is quite impossible. For the same reason and because the "owners" often do not even realize that they are a corporation and not a partnership, there is great interest to dismiss the formal requirement for the formation of the corporation (the necessity of three founders and of three directors in the Board of Directors) and to neglect certain formalities concerning the actual management of the corporation (e.g. the directors of a corporation can only legally function if they hold a director's meeting, which requires many formalities.)

In a public-issue corporation, the reason for those formal requirements is to insure a correct and supervisable conduct of the business in favor of all the shareholders. In a close corporation, where only a small number of shareholders exists, (who are also predominantly the directors) there is a strong interest to abolish these requirements. Otherwise, there is the big danger that many actions of shareholder-directors in close corporations are invalid, because they did not observe, in their opinion formalistic formalities.

(3) Because there exists no market for close corporation shares, all the shareholders (disregarding whether they

are minority or majority shareholders) are specially interested in an easier way to dissolve the corporation than is provided in the general laws for the corporation. (The possibility of separating from the company is also an issue of special interest for the minority shareholder and will be discussed in that context later.)

B. The Interest of a Minority Shareholder as Opposed to that of a Majority Shareholder.

In the foregoing section, the interest of a shareholder in the close corporation compared to that of a stockholder in a publicly held corporation was pointed out. This study is only concerned with the close corporation.

The underlying business situation of that type of corporation was described. In this section, I will examine the impact of this underlying business situation on the minority shareholder which leads to some areas where a minority shareholder has specific interests compared to, or mostly opposed to, the interests of a majority shareholder:

(1) Fundamental changes in the structure of a corporation generally influence the position of the shareholders to a not small extent. Mergers, transfer of assets or dissolution may disadvantageously influence the ratio and the value of the interest in the corporation.

(2) The issue of new shares has a similar "fundamental" effect. (The Corporation Law, however, does not include the issue of new shares as part of that category in which it would have the consequence that decisions would which belong to the shareholders' function). Majority shareholders controlling a close corporation sometimes cause the management of the corporation to issue new shares in a manner that diminishes the proportionate voting rights of the minority or their proportionate claims on the corporation's earnings and assets.

Generally the minority shareholder participates according to his interest in the corporation (preemptive right.) This right, however, will not always protect him, because there are often exceptions to this right. This right is not attached to stock issued in exchange for property for the company or in satisfaction of a preexisting debt. And it can also happen that the minority shareholder may not have sufficient funds available to exercise his preemptive rights[9] at the time of the issue.

(3) The distribution of dividends, which belongs to the function of the Board of Directors, has a direct impact on the financial situation of the shareholders. But the inter-

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[9] O'Neal, Close Corporations, Law and Practice, Vol II, ch. 8.09, (1971).

est in the declaration of dividends is typically controversial for minority and majority shareholders. The minority shareholder who is not director or officer, is strongly interested and sometimes even depends on a distribution of the profits in form of dividends.

Opposed to that interest, the majority shareholder, being director or officer and having the possibility to pay himself a high salary, is not interested in the declaration of dividends. The majority stockholder instead, wants the corporation itself to retain the profits; with that, the value of his interest appreciates. For the majority that is real value, whereas the minority (whose shares get more valuable too, but in absence of a market which reflects such an appreciation) cannot make use of it, because the minority cannot sell his shares for that appreciated price. A further motivation for the majority shareholder not to earn dividends but rather to make use of his investment by getting a high salary, is to avoid a double taxation of dividends.

(4) Besides the aforementioned possibility, the majority shareholder can obtain earnings through influence on the management, so that the company enters into a contract with himself or with another corporation (where he is full owner). This places him in a position to set the conditions of the contract in a way which is advantageous for him as a third party, but damaging to the corporation, (which means that it

is also damaging to the minority shareholder.) Examples of this are: the company granting a loan without interest to a majority shareholder[10] and a majority shareholder living in a house owned by the company without paying rent.[11]

Similar to those cases in which the damage is a direct effect of a transaction, is the case in which directors, who are also shareholders, enter into a contract, although the corporation was entitled to do so; through this, the corporation misses an opportunity to make a profit. This disregarding of the so-called "corporate opportunity" is highly opposed to the minority shareholder's interest, i.e., that the corporation is managed so as to make the highest profit.

C. The "Squeeze-Out" Situation of a Minority Shareholder.

Having shown in section B how the interests of minority and majority shareholder generally differ, I will now describe some typical cases where the majority uses its majority position and power to prevail their interest and goals to the disadvantage of the minority shareholders who have an opposite interest.

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[10] Perry v. Perry, 160 NE 2d 97 (Mass. 1959).

[11] Holden v. Lashley-Cox Land Co., 316 Mich. 478, 25 NW 2d 590 (1947).

O'Neal[12] defines such a "squeeze-out" as a manipulative use of corporate control or inside information to eliminate minority shareholders from the enterprise, or to reduce to relative insignificance their voting power or claims on corporate earnings and assets or otherwise to deprive them of corporate income or advantages to which they are entitled. A "squeeze-out" usually does not contemplate the payment to minority interests of fair value for the right and power which they lose.

These "squeeze-out" cases — one of the most significant areas where minority shareholders need protection against majority shareholders— are described because "at that point, the true plight of the minority shareholder in a close corporation becomes manifest."[13] To show that wide range of "squeeze-out" possibilities, I will summarize the squeeze out techniques which O'Neal and Derwin discuss in their book:[14] "withholding of dividends, eliminating minority shareholders from the directorate and excluding them from company employment, siphoning off earnings by high compensation to majority

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[12] O'Neal, Close Corporations, Law and Practice, Vol 11, ch. 8.07 (1971).

[13] Donahue v. Rodd Electrotype Co. of N.E. Inc., Mass, 328 NE 2d 505, 514 (1971).

[14] O'Neal and Derwin, Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises (1961).

shareholders and their relatives, squeeze outs through charter amendment, making common stock redeemable and then redeeming it, alteration and destruction of preferences or other rights of preferred shareholders, squeeze out through mergers and consolidation, merging without honoring minority shareholders' appraisal rights, sale of corporate business and assets, squeeze outs through dissolution, coupling sales of assets with dissolution and other transactions, use of bankruptcy proceedings to get rid of minority shareholders, dilution of minority shareholders' interests through the issuance of new stock, siphoning off corporate profits, leases or other contractual arrangements, splitting off the most profitable part of the corporation's business and transferring it to the majority shareholder, appropriation of corporate assets or credit, usurping corporate opportunities, eliminating or circumventing cumulativ voting."

By showing so many areas in which the majority, on the grounds of being the majority, is able to use its power to the disadvantage of the minority, it shall be domonstrated how various the effects are if the minority is not given protection to avoid that "dilemma" of having no control but also of not having the possibility to escape for a fair price.

D. Focusing on the Topic of this Study.

Those "squeeze-outs" described in section C pointedly illustrate the dilemma the minority shareholder is in: on the one hand he does not always have sufficient influence and power to control decisions disadvantageous to him, which means that he does not have a progressive way (while remaining in his position as a shareholder) to prohibit these actions of the majority.

But on the other hand, he also does not have the alternative which exists for a stockholder in a public-issue corporation who is oppressed or dissident: to sell his shares! As already stated previously: there is no ready market for the shares of a close corporation!

This "dilemma" of the minority shareholder, in which his investment interest is not satisfied by being a member of the corporation but in which there is also no opportunity to get out of the corporation without losing because of his inability to obtain a fair price for his shares, will be the topic of this study.

The approach is to presume two general, possible solutions:

(1) To guaranty the minority shareholder's

control; or

(2) To create a substitute for the lack of the existence of a ready market.

Some important devices to actualize those two ways will be discussed: these are:

(1) Statutory provisions;

(2) Charter and bylaw provisions, shareholder's agreements; and

(3) Judicial protection under equity.

A principle problem arises out of the fact that these devices force a deviation from two main corporate principles: the majority rule and the principle of the separation of ownership and management.

Another main point in the discussion will be the legal basis for the protection of minority shareholders' rights, that is, the basic question of fiduciary duties owed by shareholders of a close corporation.

However, before beginning Part Two, I will present an overview of the number and variety of definitions which exist for the "close corporation."

In spite of already having given the definition that will be adopted for the purpose of this study (or more exactly, having given the underlying business situation that that definition is related to), that overview will be presented

in order to clearly specify the various factual criteria that are involved and to show how difficult it is to fix all those facts with one exclusive definition. And following that, a general evaluation of the development of the close corporation in the statutes will be discussed in section IV.

III. A SUMMATION OF ATTEMPTS TO DEFINE "CLOSE CORPORATION" AS A LEGAL TERM.

There exists no unanimity about a single precise definition of the "close corporation." Also, courts were always reluctant to define the characteristics in a determinative fashion.

Three principle significant characteristics have been pointed out to distinguish a close corporation from a public-issue corporation: the number of shareholders, the existence or non existence of a market and the identity of ownership and management.

In one of the few existing judicial definitions, the close corporation is defined as "a corporation in which the stock is held in few hands or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."[15] A popular, quite broad definition states a close corporation to be a corporation the shares of which are not

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[15] Brooks v. Willcuts, 78 F 2d 270, 273 (8th Cir. 1935). Galler v. Galler 32 Ill 2d 16,27,203 NE 2d 577,583 (1965).

generally traded in the security market.[16] The Maine Business Corporation Act[17] only distinguishes it by the number of shareholders (no more than 20). Also, Subchapter S of the Internal Revenue Code,[18] for its purposes, defines a "small business corporation" in relation to the number of shareholders (no more than 10). Delaware, Pennsylvania and Texas[19] define it by the following three characteristics:

(1) Stock held by a specified number (Delaware and Pennsylvania: 30, Texas: 15);

(2) Restriction on the transfer of stock; and

(3) No public offering within the meaning of the United States Securities Act of 1933.

Some authorities take a different, more economic approach and define a close corporation to be one in "which management and ownership are substantially identical.[20] Rohrlich[21] defines the close corporation as a corporation

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16 O'Neal, Close Corporations, Law and Practice, Vol I, ch. 1.02, (1971).

17 Me Rev Stats Ann Tit 13-A §102(5) (1973).

18 IRC Sec 1371(a)(1) (1954).

19 Del Code Am Tit 8 §342
Pa Stat Am Tit 15, §§1371-72
Tex Bus Corp Act Art 2.30-1 (1974 Supp).

20 Kruger v. Gerth, 16 NY 2d 802, 806-807, 263 NYS 2d 1,4, 201 NE 2d 355, 357 (1965).

21 Rohrlich, Organizing Corporate and Other Business Enterprises, § 4.19 (4th ed. 1967).

where all the outstanding stock is owned by the persons who are active in the management and conduct of the business.

A very recent decision of the Supreme Court of Massachusetts[22] for the first time gives a determinative definition which combines the above cited characteristics. This court deems a close corporation as typified by:

(1) A small number of stockholders;

(2) No ready market for the corporate stock; and

(3) Substantial majority stockholder participation in the management, direction and operations of the corporation.

For purposes in this study, this last broad definition is used, but as discussed above, in relation to the underlying business situation.

IV. THE DEVELOPMENT OF THE CLOSE CORPORATION IN THE STATUTES.

Although the nature and the methods of operation in a publicly held and a close corporation differ, statutes, especially until 1961, laid down the same rules for both corporations. As early as the 1880's, Professor Williston[23] observed that "the most striking peculiarity found on first

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22 Donahue v. Rodd Electrotype Co. of N.E., Inc. Mass, 328 NE 2d 505, 511 (1971).

23 Williston, "History of the Law of Business Corporations Before 1800" (Part 1-2) 2 Harvard Law Review 105 (1880).

examination of the history of the law of business corporations is the fact that different kinds of corporations are treated without distinction, and, with few exceptions, as if the same rules were applicable to all alike."

Great Britain and other European countries had established special statutes governing the private company[24] long ago, and strong pleas to enact similar statutes which meet the special needs of a close corporation began in the United States around 1930.[25] The main arguments for the enactment of a special close corporation law were that the existing possibilities of setting up charter or bylaw provisions were not sufficient, because it was never certain to what extent they would be held valid by the courts. The enactment of a special law could abolish that uncertainty. A special law also would hinder the big corporations' abuse of possible deviations of the regular statutory form.

The reasons for the rejection to enact special statutes were as follows: it was argued that a satisfactory, precise definition for a close corporation could not be found. Another point against a special statute was the fear that it would hinder the gradual evolution of the more successful of the close corporations into public-issue corporations.

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[24] For example, in Germany, the GmbH Statute enacted in 1892.

[25] Weiner, 27 Michigan Law Review 273 (1929); Note, the Need for Legislative Recognition of Utah's Close Corporation, 1970 Utah Law Review 270.

Another pressure against separate legislative treatment of the small businesses might have come from the side of giant companies fearing a separation might lead to a separate, more severe regulation and taxation for the giant corporations.[26]

Thus, in North Carolina and in New York, the question of enacting a special statute for the close corporation was expressively discussed but denied on the grounds that a satisfying definition could not be found; a separation of different sorts of corporations would not solve the problems arising out of the existence of such various and changing forms of corporations; it was decided that it would be more helpful to give, within the existing corporation law, more freedom to deviate from the general norm.

New York, South and North Carolina and Delaware, which were the earliest to recognize the distinctive needs of the close corporation, then introduced two different groups of norms into their general corporation laws. First, provisions which are not expressively limited to close corporations, which means that they also apply to publicly held corporations, but in practice apply largely, if not exclusively, to close corporations. Those statutes include (for example):

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[26] O'Neal, Close Corporations, Law and Practice, Vol I, ch. 1.13 (1971).

In the South Carolina Business Corpration Act, enacted in 1962, shareholders' voting agreements.[26]

In New York, the possibility of charter provisions stating high vote requirements for shareholders' and directors' action.[27]

In the North Carolina Business Corporation Act, the possibility of informal decisions in the Board of Directors.[28]

In the Delaware General Corporation Law provisions which allow high vote requirements in the Board of Directors and restrictions on the transferability of stock.[29]

The second group of provisions in those states are exclusively applicable to close corporations; and in each of the states some definition for the close corporation is given (see above Part One, III.) All of the mentioned states that include those special close corporation provisions also include a very important ability — to restrict the discretion or the power of the Board of Directors.[30] The other most

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[26] SC Code Ann §12-16.15 (Supp. 1967).

[27] NY Stock Corp Law §9, NY Sess Laws 1948 ch. 862, §1; superseded by NY Bus Corp Law §616, 709.

[28] NC Gen Stat §55-29 (1965).

[29] Del Code Ann §102(b)(4), §202.

[30] SC Code Ann §12-16, 22(c) (Supp 1967)
NC Gen Stat §55-73(b) (1965)
NY Bus Corp Law §620(c) (1963)
Del Code Ann Tit 8, §350.

important provisions (for example in Delaware stated in the form of a subchapter of the Delaware Corporation Law,[31] which is the one which gives the most freedom) — are: the ability to set up a provision in the charter that the business shall be managed by the shareholders instead of by a Board of Directors, and that any or a specific number of shareholders have an option to have the corporation dissolved at will. Another very important provision is that no written agreement among stockholders shall be invalid on the grounds that it is an attempt by the parties to treat the corporation as if it were a partnership.[32]

Kansas has enacted a Corporation Code[33] containing provisions exactly modeled on those of Delaware. A similar approach has been taken recently by Maine, which enacted a new Business Corporation Act containing a number of provisions expressively applicable to the close corporation.[34] Texas has added five new articles dealing with the close corporation to its Business Corporation Act,[35] and Kentucky enacted a new corporation statute patterned on the Model

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[31] Del Code Ann Tit 8, Subchapter XIV.

[32] for example, Del Code Ann Tit 8, §§351, 355, 354.

[33] 3 P-H Corp (Kan) §§125-40 (1972).

[34] Maine Bus Corp Act Me Rev Stats Ann Tit 13-A, §102(5) (1973).

[35] Tex Bus Corp Act Art 2.30-1 et sequ. (1974).

Business Corporation Act.[36] The Michigan's new Business Corporation Act does not have an integrated chapter on the close corporation but does contain, scattered through the act, numerous provisions designed to cope with close corporation problems.

The only state which enacted a special statute applicable exclusively to close corporations is Florida.[37] But the regulations are essentially similar to those mentioned within the general corporation laws above.

The different approach which was taken in the Maryland Close Corporation statute[38] should also be mentioned. It is characterized by a consistent requirement of unanimous shareholder approval for an action that installs or modifies structural or management arrangements of fundamental importance. In addition to that, it also contains some of the above mentioned provisions dealing with management and control.

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[36] CF. Model Bus Corp Act Ann 2d §35.2, "Special Comment—Close Corporations," (1971).

[37] Fla Stats Ann §§608.70-608.77.

[38] Md Ann Code Art 23, §§100-109.

PART TWO: TWO WAYS OUT OF THE DILEMMA: SHARING THE CONTROL OF THE CORPORATION OR SUBSTITUTING A READY MARKET FOR ITS SHARES

The situation and the interests of a minority shareholder in a close corporation were described in Part One. On examination of these facts, one sees how his special problems and needs arise, and knowing the facts, one can thus attempt to find devices which might solve those problems and thus protect him. For example, it was seen that it is not only the mere fact of being in the minority that places a minority shareholder in a weak position against the majority, but that in addition, because of being a minority, interests in certain areas within the business are controversial so that the effect of not being able to effectively influence those decisions makes his position even worse.

The basis of this study is to presume two general theoretical approaches which give the minority in a close corporation protection in these situations:

The first approach is to strengthen his control in order to insure his influence on all the decisions which have an impact on his special interests. (In this area, the traditional minority protection discussion takes place.)

I consider the second approach to follow logically out

of the special situation of the minority shareholder in a close corporation: if he cannot satisfy his investment interest either because control cannot be given effectively, or, in some cases also sould not be given, then, as a last remedy, he must be able to get out of the corporation and, what is even more important, he must get a fair price for his shares.

To realize that second possibility of protection, possibilities for a substitute for the not existing ready market for his shares must be found. So here again, a special characteristic of the close corporation (no ready market for its shares) is looked at, and from there, an approach is taken to improve the position of the minority shareholder.

In order to effect those two theoretical approaches, I shall examine three principle devices:

(1) Statutory provisions;

(2) Charter and bylaw provisions, shareholders' agreements; and

(3) "Equity" applied by the courts.

(1) Statutory provisions

To include mandatory provisions in the state corporation acts which relate to the special situation of close corporations, could be imagined. For certain areas those mandatory

provisions protecting the minority exist, e.g. high vote or even unanimity requirements for shareholders' decisions about fundamental changes exist in most states.[39]

In the context of fundamental changes, another important remedy is given in all states except West Virginia: the appraisal right, which means that a shareholder, who unsuccessfully dissented against a decision about fundamental changes, has the right to separate from the corporation and to obtain— if necessary by determination of the court— a "fair" price for his shares.

Thus, for the specific shareholder decision about fundamental changes (but only there) the statutes take the above proposed logical approach: if control cannot be realized, the minority has to be able to acquire a substitute for the lack of a ready market.

Another important, only partially mandatory statute prescribes cummulative voting for the election of the Board of Directors[40] (see later in detail.)

Thus, it can be seen that statutory provisions can be used as one device to protect the minority. But the difficulties to meet all the various situations of a close corporation in <u>general</u> <u>applicable</u> statutes will be a main problem

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39 Cal Corp Code §§4107, 4600, 3632, 3901
Del Code Ann Tit 8 §§251(c), 275(b), 242(c), 271(a).

40 For example: Ind Stats Ann 25-207(c)
La Rev Stats §12:75(B).

later in the study.

(2) Charter and bylaw provisions, shareholders' agreements

Because of the difficulty in meeting various situations by generally applicable statutes, more differenciated regulations can be included into individual optional charter or bylaw provisions or shareholder agreements in a close corporation. Because of the importance of those instruments, their main characteristics and function will be generally described.

The charter, which is identical to the expressions "article of incorporation," "certificate of incorporation," or "basic incorporation document," is filed by the incorporators with a state agency and contains the essentials of the stipulated law of a specific corporation especially concerning those aspects which are important to third parties, (external matters). In the mandatory charters, the charter must state e.g., the name, the purpose of a specific business, the county of principle office, the number and names of its directors and the capital structure.[41] Optional charters would include more general structural provisions such as provisions for the power of assessment upon shares, provisions for preemptive rights and lawful provisions regulating

[41] Cal Corp Code §§301-304.

the power of shareholders and directors.

For the minority, the inclusion of specific matters into the charter may be especially important, because a later amendment or change of the charter is regarded as a "fundamental" decision in which the minority already has certain protection by statute (see above.)

Bylaws are rules for the internal management of a corporation. They provide the pattern to which the directors and officers of the corporation must adhere in the conduct of its affairs. Bylaws are ordinarily subordinate to the charter, as well as to constitutional and statutory provisions, and therefore as a general proposition, bylaws inconsistent with the charter are invalid. Unlike the charter, bylaws are not public documents and are not filed in a public office. Though the corporation, its shareholders, directors and officers are bound by the provisions of the bylaws, outsiders (for instance persons contracting with agents of the corporation) are generally not charged with notice to those provivions.[42] Thus typically, bylaw provisions specify the duties and the authority of each corporate officer, the formalities of meetings of shareholders and directors, and the voting provisions governing issuance and transfer of shares.

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[42] see O'Neal, Close Corporations, Law and Practice, Vol I, ch. 3.71 (1971).

Shareholders' agreements are contracts between all or some of the shareholders and are especially useful for minority shareholders in pooling their interest or in binding the majority. From a legal point of view they are subordinate to charter and bylaw provisions. For the minority, agreements upon the following matters could be helpful: how the shares of parties to the agreement are to be voted in elections of directors ("voting agreements"); who are to be the officers of the corporation; long term employment arrangements for some or all of the participants; the salaries to be paid to shareholder-employees; the power one or more of the participants is to have to veto corporation decisions; the circumstances in which dividends are to be declared; and a method of resolving corporate disputes.

To put which clause in which specific instrument often is a problem because some jurisdictions state that a specific type may be inserted in one sort of clause but do not make clear whether it is disallowed in another clause. Those more formalistic problems will not be discussed in this study, rather, I will focus on the principle legal problems of the validity of some of those especially important instruments.

(3) "Equity" applied by the courts

When statutes or optional clauses have to be interpreted or none exist, the courts' position as a third device to protect the minority is important. Vested with broad judicial power in the choice of any appropriate remedy, the court of equity can react to any special situation and any interest of a shareholder. Therefore, equity as applied by the courts and the grounds on which they decide (in this context the fiduciary duties play their important role), are of significant value in the protection of the minority shareholder.

I. SHARING CONTROL WITH THE MINORITY BY ALLOWING AN INFLUENCE ON STOCKHOLDERS' AND DIRECTORS' DECISIONS.

A. General Legal Principles Regarding the Influence of Shareholders in the Close Corporation.

There are two principles which govern the corporation law and which have great impact on the influence of shareholders, especially of minority shareholders in a close corporation— the principle of majority rule, which means that shareholders' decisions can be made against the will of the minority, and the principle of the separation of ownership and management. That means that the Board of Directors is regarded as an independent body, that has its own rights and jurisdictions which it has to exercise. The Board of Directors is the body which directs the business and governs

the policy and plans of the corporation, in short, the Board of Directors actually runs the business. In addition, the Board also decides about the rights of the corporation against the shareholders, i.e., about the important issues of capital structure and the declaration of dividends.

The day to day management of the corporation is mostly executed by officers, who are elected by the Board of Directors.

But also the "owners," i.e., the shareholders, have some special rights concerning the management of the corporation. Thus the right of the Board of Directors to manage the corporation is limited as far as "fundamental changes" are concerned. These are important questions for the existence of the corporation, such as amendments of the charter, mergers, consolidations, dissolutions and the sale of all assets.

Another shareholders' right as an "owner" is the yearly right to elect the Board of Directors. Thereby the shareholders have an indirect influence on the management of the business.

Thus, regarding the influence of a shareholder in a corporation, influence on the decisions in the shareholders' meetings concerning direct shareholders' rights and influence on decisions which lie in the function of the Board of Directors must be clearly distinguished. Eventhough the

shareholders and directors are often identical, this fundamental distinction must be made although it is often not given enough consideration, because the realization of the influence in both areas underlies different corporate principles and limitations.

The principles of the majority rule and of the separation of functions in a corporation were established and fit for the publicly held corporation with many shareholders. But, because of the different situation of the close corporation (as described in Part One), the participants in a close corporation often want to depart from this traditional framework of corporate management.

Thus, in what follows, some main instruments which would realize such a deviation from the principle norms and the legal problems involved will be shown. A distinction between the decisions of the shareholders in the shareholders' meetings concerning their shareholders' rights, and how the minority can insure its interest (see below in 1, 2, 3, 4) and the decision of the directors in the Board meetings, and whether and how the shareholders can influence those decisions, will be made (see below in 5).

B. Devices with which to Deviate from the Principle Corporate Organization.

The main objective for the minority shareholder seeking influence and control within the corporation is directed against the power vested in the majority by the principle of majority rule. Thus a minority shareholder seeks to protect his substantial shareholders' right: influence on the election of the Board of Directors.

1. Cumulative voting

A limited protection for the minority shareholder concerning the election of the Board members is already given by the right of cumulative voting, which is mandatory by either constitution[43] or statute,[44] but is in most states permissive.[45] The purpose of cumulative voting for the election of the directors is to enable minority shareholders to place a representative on the Board of Directors.

Under a system of cumulative voting, each share is given one vote for each director to be elected, which means that the number of shares held by a shareholder is multiplied by the number of directors to be elected; then the shareholder may cast the total number of votes derived from this process

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43 Ariz Const Art 14 §10; Idaho Const Art XI §e.

44 Cal Corp Code §2235
Kan Stats Ann §17-3303.

45 Ind Stats Ann 25-207(e)
La Reo Stats §12:75(B).

of multiplication for a single candidate, or he may distribute the total among several candidates as he sees fit.[46] Thus, if there are five directors to be elected and a shareholder owns ten voting shares, he has ten votes for each director, or a total of fifty votes— meaning that he could cast them all for one director.

The effect of this voting system is that when there are five directors to be elected, a 20% shareholder can insure the election (and prevent the removal) of one director on the Board by casting all of his votes for a single director.

The limited protection of that system follows from the fact that the majority shareholders may attempt to curtail the minority's right by the introduction of staggered[47] voting, or by the reduction of the size of the board.[48]

Because of those limitations, to effect minority protection by the device of cumulative voting, a need for contractual arrangements between shareholders still exists.

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[46] O'Neal, Close Corporations, Law and Practice, Vol I, ch 3.58 (1971).

[47] The fewer directors being elected at any one time, the greater the number of shares needed to assure representation. Thus the majority may seek to amend articles or by-laws to stagger the terms of directors in order to cut down the impact of the minority shareholders' cumulative voting rights.

[48] e.g., if there are five directors, a shareholder holding 20% of the outstanding shares (plus one) is entitled to representation. However, if the number of directors is reduced to three, he has no assurance of representation— it would take 33 1/3% plus one share.

2. Veto or high vote requirements in the charter or bylaws.

By changing the vote requirements for shareholders' actions (for example, the election of Board members) the participation of a minority stockholder having a comparably smaller number of shares in the corporation can be assured. If, for example, unanimity for shareholders' decisions is required, a minority shareholder can obtain his election into the Board by making, dependent on his election, his agreement to the proposals of majority shareholders for the rest of the Board members.

Whether a charter or bylaw provision requiring unanimity or high vote for shareholders' action is valid, i.e. enforceable, depends on its being explicitly authorized in the respective statute. Explicitly in this context means the verbal permittance of contractual arrangements with unanimity or high vote requirements. The authorization in broad terms of the inclusion in the charter of special or optional provisions regulating the "conduct of corporate affairs," as most of the state laws do, have not been clearly interpreted by the courts with respect to the validity of unanimity arrangements.

The general arguments against such arrangements is that they violate other provisions of the statute, that they are

inconsistent with the statutory scheme of corporate management, or "that they contravene an essential part of the state policy as reflected in its statutes."[49]

The Virginia Court of Appeals[50] has very strongly pointed out that high vote and unanimity requirements for shareholders' actions violate the statute. In particular, the court recognized a "right of majority rule in corporate affairs,"[51] and after discussing business considerations against giving a single individual power to render the corporation helpless, it asserted unequivocally that charter provisions giving such power "violate both common and statute law and are suicidal of [sic] corporate existence."[52]

The leading New York case unfavorable to high vote requirements is Benintendi v. Kenton Hotel.[53] In this case, in which two shareholders had agreed upon a unanimity requirement for shareholders' actions, this bylaw was held "obnoxious to the statutory scheme of stock corporation management," because "this state has decreed that every stock corporation chartered by it must have a representative government, with voting conducted conformably to the statutes."[54] The bylaw

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[49] In re William Faihndrick, Inc. 141 NE 2d 597, 161 NYS 2d 99.

[50] Kaplan v. Block, 183 Va 327, 31 SE 2d 893 (1944).

[51] Ibid at 335.

[52] Ibid at 336.

[53] 60 NE 2d 829 (1945).

requiring a unanimous stock vote for the election of the directors was held to violate a statutory norm, namely a section of the Stock Corporation Law providing that directors shall be chosen by a plurality of the votes cast.[55]

The importance of that case lies in the fact that although bylaw provisions were invalidated in the case, the reasoning of the decision was broad enough to invalidate those provisions even had they been included in the charter. That can be concluded when the court says: "That whole concept, [representative corporate government conformable to statute] is destroyed when the stockholders, by agreement, by-law or certificate of incorporation provision as to unanimous action, give the minority interest an absolute, permanent, all-inclusive power of veto."[56] The reasoning in the two cases in the Virginia and the New York courts is given much importance here although both, in the meantime, have been superseded by the Virginia Code[57] and the New York Business Corporate Law,[58] both of which explicitly authorize charter clauses requiring unanimity of high vote requirements

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54 Ibid at 831.

55 NY Stock Corp Law §55.

56 Op Cit 60 NE 2d 831.

57 Va Code Ann § 13.1-33.

58 Initially NY Stock Corp Law §9, now NY Bus Corp Law §616a (2), 709a(2).

for shareholder action; because the reasoning of those courts unfavorable to those provisions could still be of a certain significance for states in which the state law does not explicitly authorize such clauses in the charter and/or bylaws.

Besides the New York and Virginia statutes, some more recent statutes also sanctioned setting up high vote requirements for the actions of shareholders in the charter or bylaws.[59] In addition, also in absence of those specific statutes,a trend that the courts are showing an increasing tendency to sustain unanimity and high vote requirements can be observed.[60] Especially with respect to the different circumstances in a close corporation (which was also the reasoning for the New Jersey Supreme Court[61]) it might be argued in favor of high vote or unanimous requirements: "Refusal to allow deviation from the statutory scheme of majority control may be desirable for public issue corporations where the ability to reach effective corporation decision would be blocked by giving to large numbers of shareholders an

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[59] Del Code Ann Tit 8 §102(b)
NC Gen Stats §55-66(b)
Md Ann Cod Art 23 §42(b).

[60] Bator v United Sausage Co., 138 Conn 18,81A 2d 442 (1951)
Roland Park Shopping Center, Inc. v Hendler 206 MD 10, 109A 2d 753 (1954).
Application of Burkin, 1 NE 2d 862 (1956).

[61] Katcher v Oshman, 26 NJ Supr 28 97A 2d 180 (Ch 1953).

individual power of veto. But no public policy requires that the owner-manager-shareholders of a close corporation be prevented from unanimously limiting majority power."[62]

3. Voting agreements

Because of the only negative, which means preventing effect of the discussed veto which a minority shareholder has against a decision, the more effective possibility of agreements which establish that the vote has to be used in a specific way in order to insure the election of certain persons in the Board of Directors, will be discussed.

Voting agreements in connection with the election of the directors —so-called "pooling agreements"— provide that the contracting shareholders will vote their shares as a unit in elections of directors. Under such an arrangement, each shareholder retains the title to his shares and the right to vote them; he merely binds himself contractually to vote in accordance to the agreement. Typically, this instrument is also used by the controlling group for insuring its "majority" power. For the purpose of this study, this instrument will be regarded from the point of view of the minority's use to protect itself.

A pooling agreement is of special value for the minority

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[62] 62 Harv L Rev 526, 527 (1949).

in cases where, because of cumulative voting or special high vote requirements, much power is given to a certain minority so that if two very minor shareholders vote together, they together can be influential.

The validity of those agreements was not approved by the courts for a long time. Some of the decisions indicated that there could be no agreement, or any device whatsoever, by which the voting power of stock was irrevocably separated from the ownership of the stock.[63]

Since 1910, this thinking sharply reversed. Shareholders' voting agreements were not held void per se solely because the voting power was separated from the ownership of the shares.[64] In the influential decision[65] in favor of agreements about how to exercise the voting power, the relevant legal aspects are pointed out clearly. In this case, two shareholders had agreed to vote jointly after consultation. The court held that the shareholder has broad discretion in exercising his voting power irrespective what his motivations are. The limit is reached when other sharehold-

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63 Morel v Hoge, 130 GA 625, 61 SE 487 (1908. The voting agreement was held against public policy, although the court acknowledged that the motives of the contracting parties might have been to promote the prosperity of the corporation.

64 Hall v Merril Trust Co., 106 Me 465, 76A 925 (1910).

65 Ringling Brothers B & B Combined Shows Inc. v Ringling,

ers would suffer disadvantage. The courts of Massachusetts even hold that a voting agreement is not valid unless all the holders of stock in the corporation assent.

In recent years a trend toward sustaining voting agreements seems to have gained added momentum.[66] In Manson v Curtis,[67] the reasons and limits for the validity of those agreements are pointed out very clearly. The court held: "An ordinary agreement, among a minority in number, but a majority in shares, for the purpose of obtaining control of the corporation by the election of particular persons as directors is not illegal. Shareholders have the right to combine their interests and voting powers to secure such control of the corporation and the adoption of and adhesion by it to a specific policy and course of business. Agreements of such intendment and effect, are valid and binding if they do not contravene any express charter or statutory provision or contemplate fraud, oppression, or wrong against other stockholders or other illegal [sic]." In some

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29 Del Ch 610, 53A 2d 441 (1947).

[66] Katcher v Ohsmann, 26 NJ Supr 28, 97A 2d 180 (Ch 1953)
Galler v Galler, 32 Ill 2d 16, 203 NE 2d 577 (1964)
Weil v Beresth, 154 Conn 12, 220A 2d 456 (1966).

[67] Manson v Curtis, 223 NY 313, 119 NE 559 (1948).

corporation laws, agreements which provide how to exercise the vote are now expressively admitted.[68]

4. Protection in the case of decisions about fundamental changes.

Besides the in 1. discussed protection of the minority shareholder in exercising his shareholder's right in the election of the members of the Board, the minority needs protection in the second category of the shareholders' jurisdiction, that is, the decision about fundamental changes within the corporation. Fundamental changes, such as mergers, transfer of assets or dissolution, have a considerable influence on the position of the shareholders. For a minority shareholder, those changes may disadvantageously influence the ratio and the value of his interest in the corporation.

In many states a big enough minority is protected to some degree by statutory provisions requiring, for fundamental corporate acts, the vote of two-thirds or three-fourths of the shares held.[69] But for smaller minorities, in

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[68] NY Bus Corp Law Sec 620(a)
NC Bus Corp Act §55-73
Me Bus Corp Act Me Rev Stats Ann Tit 13-A, §617(1) (1973)
Tex Bus Corp Act Tit 2.30-2 (1974 Supp).

[69] Cal Corp Code §§500, 3632, 3901, 4107
Mass Gen Laws Ann c 155, §50, c 156, §§42, 46b(5)
Minn Stats Ann §§301.36, 301.37(3), 301.39(2), 301.42(2).

those states and for minorities in states without those high vote requirements, additional protection is needed.

As mentioned in 2. charter or bylaw provisions or shareholders' agreements also serve as a device for those decisions. But more effective protection in this area can be given by the courts.

Thus the main issue in the study is on which grounds the courts can provide that protection for the minority. The underlying legal principle applicable for those cases is the court's adjudication of fiduciary duties which shareholders owe each other.

Because of the importance of the application of this principle, not only for the special case of decisions about fundamental changes but for any decision where the minority needs protection, the nature and extent of this duty in general, and how the courts developed it, will be discussed.

In the past, some courts have permitted majority shareholders to exercise, without any restriction other than good faith, whatever powers they had as controlling shareholders under the statutes and the corporation's charter and bylaws.[70] The underlying principle was that each shareholder could

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[70] McNulty v W & J Sloane, 184 Misc. 835, 54 NYS 2d 253 (Sup Ct 1945).

exercise his property right over his share even against the interest of other shareholders as long as that was not a tort.

At that stage, a fiduciary duty existed only for the administration of the corporation. This duty was derived from the Common Law principle of the trust, which says that the management, comparable to the trustee, has to observe duties towards the beneficiary concerning the corpus. That means that at that time, fiduciary duties only existed for the management towards the corporation and its shareholders as a whole.

A first step in the development of fiduciary duty was its extension to stockholders in cases in which they effectively controlled the management of a corporation. A New York Court of Appeals[71] in 1919 held: "Whenever a number of stockholders constitute themselves, or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude towards the other or minority shareholders that the directors sustain generally towards all the stockholders, and the law requires of them the utmost good faith, and a court of equity will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of

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[71] Kavanaugh v Kavanaugh Knitting Co., 226 NY 185, 123 NE 148 (1919).

the corporation, which violate the fiduciary relation and are directly injurious to the stockholders." (emphasis added)

Today, this "indirect" fiduciary duty of the stockholder who directly influences management decisions is generally accepted.[72]

From these two cases of "direct" (director's) and "indirect" (shareholder's) fiduciary duties concerning the administration and management of the business, cases where the shareholder in his capacity as shareholder participates in the management of the corporation must be strictly distinguished. There are, besides the election of the Board, decisions about fundamental changes such as mergers, liquidation, etc., which are more important in this context of fiduciary duty.

The above mentioned acceptance of an unlimited power of the shareholder to exercise his property right by unrestrained voting is no longer followed. The courts[73] established the existence of a fiduciary duty owed by shareholders which is not derived from the director's duty but which originates directly from the shareholder's capacity as shareholder and exists towards the corporation and the minority shareholders.

A still further, very recent and significant development

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72 Zahn v Transamerica Corp. 162F 2d 36, 46 (3rd Cir 1947).

73 Gaines v Long Mfg. Co., 234 NC 340, 67 SE 2d 350 (1951).

was reached by the Supreme Court of Massachusetts. That court adjudicated[74] the existence of fiduciary duties of the shareholders in their capacity as shareholders not only towards the corporation and the minority, but stated that those fiduciary duties exist between all shareholders in a close corporation. The court also extended the standard of that fiduciary duty. The court holds, "that shareholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another."

This is a development in two respects:

First, the question of the relation of fiduciary duties between which members of the corporation; the development of that question was described above: duty exists only for directors towards the corporation and the shareholders as a whole, then, the extension of this duty for shareholders who are directors or control the directors, and then the further extension of this, duty exists for shareholders in the capacity of shareholders, but only towards the corporation and the minority. In the Massachusetts case cited here, the development lies in the fact that the fiduciary duty exists directly between all single share-

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[74] Donahue v Rodd Electrotype Co of N.E., Inc., Mass. 328 NE 2d 505, 515.

holders in their capacity as shareholders.

The development of the decision in the second respect lies in the fact that the standard of that fiduciary duty was extended. The differenciations made for the standard which different participants until that decision owe, was as follows: the less stringent standard was adjudicated for the shareholders of any corporation; that duty is described in Winchell v Playwood Corporation.[75] For close corporations that standard was already strengthened in Silversmith v Sydemann,[76] in which the court held "stockholders participating in management [do so] to a standard of fiduciary duty more exacting than the traditional good faith and inherent fairness standard because of the trust and confidence reposed in them by the other stockholders."

In the Massachusetts Supreme Court case, the fiduciary duty is still further strengthened when all individual shareholders owe it to each other. There it is held[77] that in addition to the fiduciary duty owed by an officer to the corporation, a more rigorous standard of fiduciary duty applies to the shareholder by virtue of the relationship between the stockholders.

Accepting the same duties owed by partners in a partner-

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[75] 324 Mass 171, 174, 85 NE 2d 313 (1949).

[76] 305 Mass 65, 25 NE 2d 215 (1940).

ship as the standard for the stockholders in a close corporation, the Massachusetts court[77] cites the then Chief Judge Cardozo of the New York Court of Appeals[78] in describing the duty which exists between partners and applying it to the stockholders of a close corporation: "Joint adventures like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties...Not honesty alone, but the punctilo of an honor the most sensitive is then the standard of behavior."[79]

The acceptance of a fiduciary duty directly between shareholders is expecially important for the minority in cases of fundamental changes, because in those decisions the majority acts out of its own capacity so that a directly existing duty between shareholders as shareholders can best protect the minority.

5. Arrangements concerning the minority shareholders' influence on the Board of Directors.

Until this point in Part Two, section I, the decisions

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77 Donahue v Rodd Electrotype Co. of N.E., Inc. Mass. 328 NE 2d 516.

of shareholders in their capacity as shareholders with respect to deviation from the traditional corporate pattern with the goal to give the minority shareholders in a close corporation better protection, has been discussed. The problems involved in setting up arrangements which provide effective shareholders' influence on decisions which lie in the jurisdiction of the Board of Directors will be shown here; i.e. that means the question that is involved is whether and what deviations from the corporate principle of the separation of ownership and management are possible.

Traditional American law does not allow shareholders to participate in the management. This function is exclusively performed by the Board of Directors. The law is ruled by the assumption that there is a traditional division of corporate functions. In an older decision[80] concerning this principle, it is pointed out that the directors are not representatives of the shareholders and are therefore free of any direct control; that, performing their function, they are obliged to exercise their best judgment for the benefit of the corporation and that this best judgment is not subject

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[78] Meinhard v Salomon, 249 NY 458, 164 NE 545 (1928).

[79] Donahue v Rodd Electrotype Co. of N.E., Inc. Mass. 328 NE 2d 505, 516. (1975).

[80] Continental Securities Co v Belmont, 206 NY 7, 99, NE 138 (1912).

to supervision— which is called "business judgment rule"— and that the corporation is owner of the property but that the directors can exercise their duties and obligations as if they themselves were the owners, but that they have certain fiduciary duties towards the corporation.

a. Unanimity requirement for directors' decisions

As seen with decisions on the shareholder level, the easiest (but not sufficient) way to insure minority participation is to agree upon high vote or unanimity requirements for the directors' decisions, so that each member participates in the decisions on the Board. (If there is an agreement requiring unanimity for the shareholders' decision, in addition to that, a shareholder can insure his influence on the Board's decisions, because he then surely has influence on <u>who</u> is in the Board and this person (probably he himself) has an assured influence of the Board's decision).

The courts were even more reluctant to hold those arrangements about unanimity requirements for directors' decisions valid than in the cases of unanimity requirements for shareholders' decisions. In Benintendi v. Kenton Hotel, Inc.,[81] the bylaw requiring unanimity for directors' action was referred to as "almost as a matter of law, unworkable and

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[81] 294 NY 112, 60 NE 2d 829 (1945); invalidating bylaws but on grounds apparently also applicable to shareholders'

unenforcable," and was held to violate the statutory scheme of corporate management established in the statute.

In another case, an agreement between one majority member and two other shareholders, who were also directors, was held invalid. They had agreed to decide (as directors!) unanimously about the election of the officers and their salaries and of general management policy.[82]

b. Agreements binding directors actions

More effective than such a right to veto decisions,which only has a negative effect on the other directors' proposals, is an arrangement in which not only the voting modus is agreed upon, but in which what the directors have to decide is also formulated. Those arrangements contain, for example, the obligation to elect a certain shareholder as officer and to pay him a certain salary (important for the minority); another important arrangement for the minority is to prescribe the payment of dividends. Such agreements have met with highly variable and inconsistent treatment by the courts.

Many mostly older, but also some recent decisions laid down the principle that shareholders cannot by agreement bind

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agreements.

[82] Burnett v Ward Inc., 412 SW 2d 792 (Tex App. 1967!).

themselves to elect a Board which will consent to be "dummies."[83] In Jackson v Hooper[84] an agreement by two shareholders jointly to choose three directors who were to vote as directed by the two shareholders was held unenforcable because it was an improper restriction on the discretion of the directors.

Decisions invalidating agreements binding directors to a predetermined course of action or otherwise restricting the director's exercise of judgment are predominantly based on the grounds that the agreement conflicts with the section of the Corporation Act which provides that the directors shall manage the affairs of the corporation[85] or that the agreement may result in the directors' disregard of their fiduciary duties to exercise their best judgment for the benefit of the corporation and the shareholders.[86]

And even aside from the violation of specific statutory norms, shareholders' agreements were held invalid if they establish a pattern of corporation management and operation different from that contemplated by the corporation statute.

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[83] Ford v Magee, 160F 2d 457, 460 (2nd Cir); Cert den 332 US 759.

[84] 76 NJ Eq 592, 75A 568, 27 LRA (NS) (Ct App 1910).

[85] Long Park, Inc. v. Trenton-New Brunswick Theaters 297 NY 174, 77 NE 2d 633 (1948).

[86] Odman v Oleson, 319 Mass 24, NE 2d 439 (1946).

Such holdings, all on the grounds that the agreements are inconsistent with statutory norms or with a scheme of corporation management supposedly fixed by statute, must be considered as formalistic; obviously still following the old concession theory of corporate existence, the courts regard this formalistic reasoning as sufficient, because they regard the incorporation and limited liability as special privileges granted by the state, out of which follows that the enjoyment of those privileges is conditioned on strict conformity to the traditional pattern of corporate management and operation.

As far as the agreements are held invalid on the grounds that the public interest is violated, it must be questioned what the public interest in the existence of an independent Board of Directors is. Since the action of the Board of Directors underlies fiduciary duties towards shareholders and creditors, a violation of those duties would at the same time be a violation of the public interest. Thus one could say that the free judgment of the directors can be unobjectively restricted unless binding the judgment is a violation of the fiduciary duty owed by the directors at the same time.

A treatment of the courts in favor of certain agreements of that nature on the grounds that they are neither against

the public interest (because they deviate from the norm too much) nor that they violate an interest of shareholders or creditors, started with the case Clarc v Dodge in 1936.[87] The development of that different treatment is described in an Illinois Supreme Court Case[88] in 1964: "There has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as sui generis. Several shareholder-director agreements that have technically 'violated' the letter of the Business Corporation Act have nevertheless been upheld in the light of existing practical circumstances, i.e. no apparent public injury, the absence of a complaining minority interest, and no apparent prejudice to creditors...Courts have long ago, quite realistically, we feel, relaxed their attitudes concerning statutory compliance when dealing with close corporation behavior, permitting 'slight deviations' from corporate 'norms' in order to give legal efficacy to common business practice."

In this cited case, an agreement between the two principle shareholders of a corporation required, among other things, an annual declaration of dividends, provided the

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[87] 269 NY 410, 199 NE 641 (1936).

[88] Galler v Galler 32 Ill 2d 16, 203 NE 2d 577, 584 (1964).

corporation maintained an earned surplus in excess of $500,000, and, on the death of one of the participants, the purchase by the corporation of enough of its shares from the deceased's estate to pay estate and inheritance taxes and meet the estate's administrative expenses.

As is also cursorily mentioned in this decision, there appears to be no justification for an existence of a rigid compliance with the norms in a close corporation, unlike in a publicly held corporation where the investor may need protection because he does not participate in setting up the corporation structure and organization; the shareholders in a close corporation, who enter into an agreement after careful deliberation and bargaining, need not or even do not want such a protection which makes it impossible for them to mold their corporate structure to the needs of their enterprise.

A number of legislatures, also recognizing that the close corporation should not be required to comply strictly with traditional schemes of corporation management, have granted participants in a close corporation greater freedom to tailor the corporation's control pattern to meet the needs of the business and their own desires. Thus Florida's[89] and

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[89] Fla Stats Ann §§608.75(2).

Delaware's[90] jurisdictions provide that no written agreement among stockholders nor any provision of the charter or bylaws relating to any phase of the corporation's affairs (including but not limited to management of its business, declaration and payments of dividends or other profits, the election of directors or officers or the employment of shareholders) shall be invalid on the ground that it is an attempt by the parties to treat the corporation as if it were a partnership or to arrange relations among the shareholders in a manner that would be characteristic of a partnership. Some modern statutes[91] allow a more flexible featuring of the internal organization as well; all or some shareholders, depending on the statutes, are allowed to agree upon matters normally within the province of the Board and by that they are able to divide the functions between themselves and the directors in a way which deviate from the "norm."

The statutes of Florida, Delaware and Maryland[92] go the farthest, declaring that a close corporation's charter may

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[90] Del Code Ann Tit 8 §354.

[91] Fla Stats Ann §508.75(3)
Del Code Ann Tit 8 §350
Md Ann Code Art 23 §105a(c)
NC Gen Stats 55-73c
NY Bus Corp Law §620b
SC Code Ann §12-16.22
Pa Stats Ann Tit 15 §§1381, 1382.

[92] Fla Stats Ann 608.72
Del Code Ann Tit 8 §351

provide that it will have no Board of Directors, in which case the corporation's business and affairs shall be managed by direct action of the shareholders, exercising all of the powers given to the directors by the State's Stock Corporation Law. Such an arrangement has the logical effect of subjecting the shareholders to liabilities imposed upon directors by the Stock Corporation Law and also of imposing upon them responsibility to take any action formerly required to be taken by the Board of Directors.[93]

Such a provision naturally solves all the above discussed problems about the validity of an agreement concerning the influence of the shareholders on the Board of Directors. But for all the states in which the legislatures are reluctant to react to the special needs of the close corporation, all of the above discussed reasons for an eventual invalidity of agreements concerning the influence on the Board of Directors, are of significant importance.

C. In Search of an Improved Position of the Minority Shareholder.

In the first section of Part Two, some important devices

Md Ann Code Art 23 §105(a)(1).

[93] See for example, Md Ann Code Art 23, §§105(a)(1), (c)(1), 105(a)(2).

to strengthen the control of the minority shareholder within the corporation were discussed. The problems about the validity of those possible arrangements arose out of the fact that they all force deviation from traditional corporate principles.

Thus, to present a general conclusion concerning the share of control of minority shareholders, I will refer to those corporate principles described previously, and I will show whether and to what extent these principles governing the general corporate law should be given up or should be deviated from.

1. Limits of minority protection.

First, there was the principle of majority rule, and second, the principle of separation of stock ownership and management in the corporation.

To give up the majority rule and to introduce by statute unanimity for shareholders' actions in a close corporation would be one very effective method of protecting the minority against being overruled by the majority. That would provide an absolute veto power for any minority shareholder, because his vote would be needed for any decision. This principle of unanimity for the decisions of the "owners"

governs the Partnership Law.

Whether the principle of unanimity for shareholders' decisions should replace the principle of majority rule shall not be looked at as a principle legal question, rather it is thought of as a question of policy.

Thus, it must be considered whether such a powerful position of a minority shareholder guaranteed by statute is justified and desirable for the corporation as a whole and for all its shareholders.

Even considering the personal character of the relation among shareholders in a close corporation compared to the exclusively capital-oriented engagement of a shareholder in a public-issue corporation, the close corporation still remains a corporation where the capital investment, besides the strong personal relation, is still a determinative characteristic.

Thus, from this theoretical legal point of view it is justified to give a participant in a close corporation who has more capital involved relatively more influence and power than to somebody who participates with a small capital interest. That is what the majority rule does.

But also from a practical point of view there exists an argument against a blanket power for a minority to veto any decisions in the conduct of the corporation. A corporation is a business and decisions must be made to keep the busi-

ness running. Thus, decisions must also be made if there are controversial opinions between two parties within the corporation. In those situations, the existence of a veto power, held by a minority, would increase the chance of deadlock and corporate paralysis. Therefore, in such situations the opinion of one of the parties must succeed in order to reach a decision and continue the business. And it does seem justified that that party succeeds which has the bigger capital interest involved in the corporation. That is especially true in cases where the minority seeks a decision which is only advantageous to itself but not to the corporation as a whole, and consequently not to the majority of the shareholders.

Summarizing, it can be stated that, "Veto provisions, therefore involve the problem of balancing the safeguards necessary to protect the interests of minority shareholders against the freedom of action that is beneficial to the corporation and the shareholders as a group."[94]

Thus, for theoretical and practical reasons it does not seem opportune to replace the corporate principle of majority rule with the principle of unanimity for shareholder' decisions by statute. An effective protection of a minority

[94] O'Neal, Close Corporations, Law and Practice, Vol I, ch

within those demonstrated limits, because of the complexity and variety of problems, cannot be reached by a strict and inflexible, mandatory statutory regulation which does not and cannot differentiate between all the possible factual possibilities of how a close corporation is organized and reflect all the various existing interests and special needs.

2. Expanding the concept of fiduciary duty and allowing a broader contractual freedom.

With respect to those special needs, especially in relation to the minority and its protection which cannot be covered by fixed statutes, the courts have to create the law. They do that in this context by improving the control for a minority shareholder, not only because there is no statute, and that shall be pointed out, but they have to use their judical power because there cannot be an applicable and effective statute.

Thus, the development of the existence of the fiduciary duties which shareholders in a close coporation owe each other, and the tendency of the courts to expand the implementation of those duties, is considered to be a most important device for protecting the minority in close corporations.

4.30 (1971).

If the extreme solution of principally giving up the majority rule and of introducing unanimity requirements for shareholder action by statute was denied above, that does not mean that there should not be an expressive allowance within the statutes that shareholders, in the charter or by-laws or by agreement, may give up that rule or deviate from it. Such provisions, which give a wider freedom to mold the pattern of business, should be urgently included in the statutes. Only by expressively including those provisions in the statutes will the uncertainty that has until now existed in many states with respect to the validity of deviations from the traditional pattern be abolished, which means protection for the minority at the same time. The arguments above, against the introduction of the principle of unanimity by mandatory statutes do not count for allowing the shareholders to agree upon it contractually by expressive statute.

The shareholders can or at least must be expected to be able to decide whether it is opportune in their specific situation for one shareholder to acquire so much power. Surely, there exist factual situations where this will be true and useful for the company as a whole.

Thus, the approach in this study is that the shareholders themselves bear a large amount of responsibility to set up appropriate instruments. And therefore, the allow-

ance by statute of large contractual freedom for their special situations is regarded as a strong source of protection for the minority shareholder. It will be possible, even for a minority, to largely succeed with these protective arrangements: at the time of the formation and organization of the corporation the majority has not yet any overwhelming power position. At that time the majority needs the capital of the minority and so it is only a question of "fair bargaining" for those special charter and bylaw provisions or agreements among the parties.

No theoretical arguments will be made against the complete abolition of the second main corporate principle— separation of ownership and management. But here too, I do not propose to introduce statutes which generally change the jurisdiction of the shareholders and the Board of Directors. Rather, the statute should only (but expressively and clearly) allow complete freedom in the division of powers or make the provision to even allow no Board of Directors at all.

Summarizing and concluding, it shall be said that special statutes for the close corporation are necessary in order to make deviations from the traditional pattern of the corporate structure and organization possible. It seems to be sufficient to give that freedom in special statutes within the

general corporation laws.

Because it is impossible to lay down a general guide for the solution of what are essentially unforeseeable cases, the courts in addition, should have the power to impose upon the parties whatever settlements they consider just and equitable.

If special statutes shall be established for the "close corporation" in the laws, that makes it necessary to formulate a definition which covers most of the business situations which were regarded to require such special provisions. A clear distinction for corporations which may have such freedom to structure and organize their business is of importance, because publicly held corporations should not be allowed to deviate from the rules which had been created for their business situation, and which meet their needs and the needs and interests of their shareholders. The separation of ownership and management has great importance for the publicly held corporation; it concerns the protection of all the shareholders and therefore, the publicly held corporation should not be allowed to deviate from it.

So, even if it seems difficult to find a precise definition for the close corporation, it is necessary to give one definition to make it possible to give the freedom for close

corporations to set up a fitting organization. The recent, first explicit definition of a close corporation by the Massachusetts Supreme Court[95] will be adopted. That court defines the close corporation as a "corporation to be typified by:

(1) a small number of stockholders

(2) no ready market

(3) substantial majority stockholder participation in the management, direction and operations of the corporation."

II. SUBSTITUTING A READY MARKET FOR THE SHARES OF MINORITY SHAREHOLDERS.

A. A Ready and Fair Market for Minority Shares as a Remedy of Last Resort.

In the first section of Part Two, I discussed the protection of the minority shareholder by giving him active control devices so that he can effectively influence the action of the corporation. Where this protection, by sharing the control, cannot be given effectively, or does not help in a special situation (remember especially the "squeeze-outs" by not paying dividends or by absorbing profits by paying high salaries), the separation from the corporation is in fact the only and the last viable possibility for the continuously ex-

95 Donahue v Rodd Electrotype Co of N.E., Inc., Mass 328 NE 2d 505, 511 (1975).

ploited minority; for to enforce control in those cases, continuous support by the court would be needed.

Also, it must be taken into consideration that the personal relationship in the close corporation is substantial; if this basis of trust and mutual respect is disrupted, a continuation of that relationship by continued affiliation will not increase the profitability of the corporation.

Thus, if the investment interest of the minority shareholder cannot be satisfied by giving him effective control (and there may even be justifiable cases in which he should not have control, e.g. in cases where it is not to the best interest of the whole corporation to pay dividends), the logical alternative is, that he then must be given the right to go out, but also, that he gets a fair price for his shares.

Without special provisions, the minority shareholder cannot realize that solution, because for a participant in a close corporation, the "way out" which is open for the shareholder of a publicly held corporation is not available. There are often restrictions on the transferability of the shares and, more important, there is no ready market for the shares of a close corporation.

Thus, if control does not protect the minority shareholder while he remains in the corporation, he must be given a substitute for the not existing ready market, which means he must be provided with the possibility to obtain a fair

price for his shares. This logical connection between the two alternatives (active influence or way out to a fair price) is generally not pointed out.

It shall also be pointed out that this second way should be available only as a last remedy. That means that it shall not be used if another less rigid device can protect the minority.

In this second section of Part Two, the possibilities which exist for this last remedy by statute will be discussed, as well as what the equity right provides if no statutes exist and the way I think that protection should be improved.

B. Traditional Legal Devices for the Separation of Shareholders from the Corporation.

Since no statutes nor firm and standing jurisdictions exist which expressively establish, under certain circumstances, the right for a minority shareholder to sell its shares for a fair price to the corporation, the institutions which do exist and which make a separation from the corporation possible for a shareholder will be discussed first.

1. Dissolution

a. Statutory dissolution provisions

All jurisdictions now have statutes setting forth procedures for dissolving a corporation and stating the grounds on

which a corporation will be dissolved.

The law differentiates between voluntary dissolution (mostly requiring a favorable vote of two-thirds or three-fourths and thus giving no relief to the minority shareholder,) and on the other hand involuntary dissolution authorizing the courts to dissolve the corporation under specific circumstances, e.g. the Connecticut Statute[96] provides dissolution in very broad terms whenever "any good and sufficient reason" exists for the dissolution. The Pennsylvania Corporation Act and other states[97] provide such dissolution if actions of directors or those in charge of the corporation are illegal, oppressive or fraudulent, and if it is beneficial to the interest of the shareholders that the corporation be wound up and dissolved. The South Carolina Statute,[98] remarkably, provides dissolution if, for the time period of three years, no dividends have been payed.

A few states try to avoid the disadvantages which lie in the face of corporate dissolution by empowering a majority,[99] or even any shareholder,[100] to avoid dissolution by purchas-

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96 Conn Gen Stats Ann §33-382.

97 Pa Stats Ann Tit 15 §2107
Minn Stats Ann §301.49
Nev Rev Stats §78.650
Model Bus Corp Act §97 (Rev ed 1969).

98 Code of Laws of SC §12-651.

99 Cal Code §§4658-4659
W VA Code Ann 3093.

ing the shares of the dissolution-seeking shareholder. The enterprise can thus be preserved as a going business.

The major problem of providing a dissolution right by statute for the protection of the minority shareholder is that it is difficult to formulate all the possible situations for which the remedy could be necessary. An even more relevant argument against a statutory dissolution right is the impact on the existence of the corporation. The minority must not be allowed to selfishly exercise this right against the corporate interest of staying in business.

Thus, a mere dissolution right for minority protection without a possibility for the corporation or the shareholders to redeem the shares and preserve the continuation of the enterprise is not regarded as an acceptable device.

b. Reluctant application of dissolution rights by the courts

Until the end of the nineteenth century, it has been the general rule that aside from statutes, the courts do not have the power to dissolve a solvent corporation,[101] the main argument being that it is in the power of the majority to decide the important question of the existence or nonexist-

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100 Conn Gen Stats Ann 33.384
Md Ann Code Art 23 §109(c).

ence of the company.

A breakthrough was established by the equity ruled decision in Miner v Belle Isle Co.[102] In this case, a majority shareholder let the corporation discontinue the payment of dividends, let himself as director pay inappropriate, high salaries and let the corporation enter into contracts with himself as a third party, which obliged the corporation to purchase commodities from him at unjustified high prices. Here the dissolution was regarded to be the only effective remedy for the minority shareholder. The removal of the majority shareholder from the directorship as a less strong remedy was not thought to give relief because the majority shareholder would be able to influence the future director's, elected by him.

Since that time, dissolution by the courts as a device is generally accepted. Especially in the case of continuing damage to the minority because of fraudulent, selfish action by the majority, dissolution by the courts is granted.

In Leibert v Clapp[103] the New York Court of Appeals held that a cause of action for dissolution on nonstatutory grounds was made with a complaint which alleged that the

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101 Wallace v Pierce-Wallace Pub. Co., 101 Iowa 313, 70 NW 216 (1897).

102 93 Mich, 97, 53 NW 218 (1892).

103 13 NY 2d 313, 247 NYS 2d, 196 NE 2d 540 (1963).

directors were looting corporate assets, thereby enriching themselves at the expense of minority shareholders, and that they were continuing existence of the corporation solely to benefit those in control and to coerce minority shareholders to sell their holdings at a depreciated price to the majority shareholders.

But in all cases of granting dissolution, it was made clear that dissolution shall be available to solve dissension between shareholders only as a last remedy, which means that it will be used if no easier way for granting relief exists.

Thus, a buy-out arrangement was ordered, with the court[104] in the absence of local authority relying on its equity powers. Although the judge enumerated some 27 acts of waste and breaches of fiduciary duty by the managing officer-shareholders, and found that the confidence of the minority in the controlling group no longer existed, he hesitated to order dissolution because of the impact on the corporation employees and the tax consequences which the minority, but not the majority, were prepared to accept. Instead, a master was appointed to value the assets as a whole and separately, so that the minority could give up their stock for property of the corporation. This decision

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[104] Belder v Birmingham Trust Nat. Bank, 348F Supp 61 (ND Ala 1968).

points out the real weakness of a mere dissolution right (already discussed for the statutory dissolution provisions above.)

Thus, it can be concluded that for the purpose of protecting the minority, the dissolution of the corporation as a device is generally accepted, but that the courts are reluctant to grant this remedy; and that it is also not regarded as an appropriate remedy, mainly because of its heavy consequences on the corporation and because it does not guaranty that the minority gets a fair price for its shares.

2. Appraisal right

A provision for an appraisal right is given in almost all jurisdictions.[105] The opportunity to obtain an appraisal gives any shareholder, who voted without success against a decision about fundamental changes in the structure of the corporation which affect his rights (such as mergers, consolidation, sale of all assets, or charter amendments), the right to separate from the corporation and to demand the payment of the fair cash value of his shares.

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105 For example, Cal Corp Code §§4300-4318
Del Code Ann Tit 8 §262
NY Bus Corp Law §623
NC Gen Stats §55-113

Thus, in contrast to the above explained dissolution right, the statutes provide a substitute for the non-existing ready market for the minority shareholder without suffering financial loss, so that the minority shareholder has the right to sell his shares for a fair price to the corporation.

C. In Search of an Improved Position of the Minority Shareholder.

The appraisal right (described above) is a device that provides the minority shareholder with a substitute for the not existing ready market. But as this statutory appraisal right only exists for the shareholders' decisions about fundamental changes, the minority shareholder has no substitute for the lacking ready market in all other areas in which he needs protection, (for instance, in the case of unfair dividend policy, or paying the majority high salaries or of entering into an inadequate contract with the corporation.)

Thus, it will be discussed how this remedy of providing a "ready market" should be extended by statute, possible agreements and by the courts, and also, where the limits for providing such a "ready market" lie.

Only West Virginia does not have that remedy.

1. <u>Limits of minority protection.</u>

An extreme solution which would protect the minority very effectively, would be to give the minority shareholder the right at any time and for any reason to require the corporation or the other shareholders to buy his shares at a fair price. Thus, Professor Hetherington suggested that a minority shareholder in a close corporation, eventhough he has not bargained for the privilege of withdrawing from the business, should nevertheless, if he decides he wants to dispose of his interest, be able to liquidate his investment on terms that will insure him of receiving a fair share of the enterprise's accumulated earnings. This could be achieved, he points out, by giving any shareholder the right to require the corporation or the other stockholders to buy his shares at a "fair" price.[106]

Such a broad, generally existing appraisal right cannot be accepted: a corporation must not be steadily obliged to such an uncertain and evenually high financial commitment. That would be against the nature of an equity investment, where the equity is needed to run that business.

Business partners (such as banks, etc.) trust in the

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[106] Hetherington,"Special Characteristics, Problems and Needs of the Close Corporation," 1969 Ill L Forum 1,22.

steady existence of the equity of a corporation; and also, the liquidity might become jeopardized by a sudden exercise of such an appraisal right by a minority shareholder.

Thus, such a general appraisal right, which is opposed to those principles of a corporation, which are also valid for a close corporation, goes too far in protecting the minority, and it creates a danger for the corporation as a whole.

2. Statutory allowance of broader contractual freedom and the expansion of fiduciary duty.

In the statutes the device of an appraisal right should be available in other cases which have impact on the minority shareholders' position. The right should be given not only in the case of fraud, bad faith or clear unreasonableness on the part of directors, but also in cases in which, without such a motivation by the majority, a "squeeze-out" in effect takes place.

Because of the diversity of possible situations in which the remedy should be applicable, and the difficulty to meet those in a statute, probably a "catch all" clause would be sufficient. Equity principles (see later) would fill out such a clause.

As in the existing "appraisal statutes" for cases of fundamental changes, the court should be authorized to make a

decision about a "fair" price if an agreement cannot be reached. The often used argument, that the courts do not have the skills and that it also is not their role to make business decisions— here the difficult decision of setting a fair price for the shares of a close corporation— can be invalidated by proposing that the courts should not themselves make those decisions but that they should have the power to make the decision about a fair price by making use of an objective professional third party (e.g. an accounting firm) which is able to set such a price.

Because of the different real life situations for which an appraisal right for a minority could be useful, an even better protection for the minority could be provided if an appraisal right under certain circumstances would be determined in the charter or bylaws or in written agreements.

There is no reason why those agreements will not be held valid eventhough it might not have been provided for in a statute or, might not exist sanctioning by judicial decision. The arrangements about appraisal rights are analagous to restrictions on the transferability of shares, and those are now uniformly held to be valid. Those arrangements about an appraisal right do not affect decisions concerning the jurisdiction or management <u>within</u> the corporation (see problems for those arrangements in Part One) but instead, a non-

corporate decision (selling of shares) is involved, where any agreement must be valid.

Also, the doubt in the New York jurisdiction about the validity of a buy-out agreement because of not legally available funds, are over-ruled by the New York Business Corporation Law;[107] it provides that the possibility that a corporation might not be able to purchase its shares because of a failure to have funds legally available at the time for that purpose shall not be grounds for denying to either party specific performance of an agreement for the purchase by a corporation of its own shares, if at the time for performance the corporation does have funds legally available to purchase all or part of such shares.

Contractual arrangements (the best seems to be a shareholders' agreement) in addition to the specific circumstances under which the appraisal right should be given, should also lay down a method for determining a fair price. (A reasonable valuation method should take into account the earning power and net worth, considering the fact of a higher going concern value.)

Agreements, naturally, cannot completely foresee and be subject to all possible future developments, But, as said for

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[107] NY Bus Corp Law §514(b).

statutory provision, equity will fill this gap here as well.

Even if there is no statute and no arrangement which provide an appraisal right for the protection of minority shareholders, the courts should use their power to provide a substitute for the lack of a ready market under certain circumstances. There is no reason why the minority should not be protected in the case where a state fails to provide a regulation and equally when minority shareholders did not foresee upcoming differences between themselves and a majority, and therefore failed to set up such a provision.

On the whole, American courts have been singularly unresourceful in developing remedies to assist minority shareholders in this context. The main argument being that it is not their role to interfere in business decisions (see above). But no interference in the business of a corporation (as already said above) can be seen when the courts decide about the price of shares having made use of an independent and qualified appraiser, who is able to set such a "fair" price.

Thus, as a conclusion also relating to Section I which discussed the protection of the minority shareholder by giving him control devices, the following shall be said:

The fiduciary duty between shareholders should not only serve as a legal principle to support the minority in

improving their share of control (this is the area in which fiduciary duty is mostly discussed), but should equally, or even more importantly, serve as a ruling principle in protecting the minority if the only remaining possibility for it is to go out of the corporation.

Thus, because of an existing fiduciary duty among shareholders of a close corporation, the majority shareholder, in cases where the minority shareholder would be squeezed out deliberately or even only factually, must purchase or let the corporation purchase the shares of the minority shareholder at a "fair" price.

Recently, along these lines, the Massachusetts Supreme Court,[108] on the grounds of an existing fiduciary duty between shareholders also in their capacity as shareholders, (see Part Two, section I) determined a price for the

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[108] Donahue v Rodd Electrotype Co. of N.E. Inc., Mass 328 NE 2d 521: The fiduciary duty of the majority shareholder is held to be breached because the majority shareholder had made the corporation buy his shares; but the corporation had not extended the same offer to a minority shareholder. "Although the purchase price for the controlling stockholders' shares may seem fair to the corporation and other stockholders, the controlling stockholder who's stock has been purchased has still received a relative advantage over his 'corporate fellow' by utilizing his control of the corporation to establish an exclusive market in previously unmarketable shares from which the minority stockholders are excluded." (Ibid at 521,518).

minority shareholders' shares which the corporation should be required to purchase from the minority shareholder by the judge below.