



Case Western Reserve Law Review

Volume 19 | Issue 4

1968

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Wallace J. Mayer Jr.

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Recommended Citation

Wallace J. Mayer Jr., *Corporations--Dissolution and Forfeiture of Franchise--Evidence* [*Browning v. C & C Plywood Corporation*, 434 P.2d 339 (Ore. 1967)], 19 Case W. Res. L. Rev. 1130 (1968)

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**CORPORATIONS — DISSOLUTION AND FORFEITURE
OF FRANCHISE — EVIDENCE**

Browning v. C & C Plywood Corp., 434 P.2d 339
(Ore. 1967).

Dilution of a minority shareholder's interest by the issuance of new stock is a common problem in close corporations. Probably the best source of protection for the minority shareholder in the dilution or "squeeze out"¹ situation is the doctrine of preemptive rights.² However, when the shareholder is financially unable to exercise his preemptive rights to purchase newly issued stock, the courts have been somewhat hesitant to grant relief,³ although a minority view does exist.⁴

In accord with this minority view, it has been held that the parties who control the corporation stand in the position of fiduciaries both to the corporation and to the minority shareholders, and that such controlling parties may not act in such a way as to diminish the minority's proportionate interest⁵ unless such conduct is prompted by a material and substantial need of the corporation,⁶

¹ The following example illustrates the typical dilution or "squeeze out" situation: Assume that X owns 100 shares in B Corporation, which has 1,000 shares of capital stock outstanding, and Y and Z each have 450 shares. If Y and Z cause the corporation to issue an additional 1,000 shares of stock, which they in some way acquire for themselves, obviously they cut in half the percentage of the business owned by X. Repeated issues of stock can of course result in further dilution of X's interest. F. O'NEAL & J. DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* 91 (1961).

² "The shareholder's preemptive right is his right to preempt or to purchase before others a new issue of shares in proportion to his present interests in the corporation." H. HENN, *CORPORATIONS* § 177 (1961). By exercising his preemptive rights, the minority shareholder obviously may preserve his proportionate interest in the business.

³ In this respect the courts apparently have been influenced in part by the "general judicial policy of refusing to interfere in the internal affairs of a corporation." 2 F. O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* 120 (1958).

⁴ See *Schwab v. Schwab-Wilson Mach. Co.*, 13 Cal. App. 2d 1, 55 P.2d 1268 (1936); *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953); *Canada S. Oils, Ltd. v. Manabi Exploration Co.*, 33 Del. Ch. 537, 96 A.2d 810 (Ch. 1953); *Gamble v. Queens Water Co.*, 123 N.Y. 91, 25 N.E. 201 (1890).

⁵ More fully explicated, the minority position holds that the shareholders have the right to expect that the officers and directors will not use their positions for their own personal advantage, and that they will not issue stock or conduct themselves generally in such a way as to obtain or retain control of the corporation. *Schwab v. Schwab-Wilson Mach. Co.*, 13 Cal. App. 2d 1, 3, 55 P.2d 1268, 1269 (1936). See also H. HENN, *supra* note 2, §§ 176, 241.

⁶ In accordance with the entrenched majority view, "most courts will probably sustain a new issue of shares if a plausible case can be made that the corporation needs additional capital." F. O'NEAL & J. DERWIN, *supra* note 1, at 96; see *Thom v. Baltimore Trust Co.*, 158 Md. 352, 148 A. 234 (1930); *Meredith v. New Jersey Zinc &*

i.e., a legitimate business purpose.⁷

*Browning v. C & C Plywood Corp.*⁸ is a recent case which poses some of the major problems attendant upon the determination of whether such a legitimate business purpose exists. Browning, a minority shareholder, brought an action for liquidation against the directors of the corporation on the grounds that the directors had caused new stock to be issued to themselves at a time when they knew that Browning was financially unable to exercise his preemptive rights and that this recapitalization scheme reduced Browning's interest in the corporation from 32 percent to 1 percent. In reversing the trial court's denial of relief, the Supreme Court of Oregon held that the ostensible purpose of the recapitalization was to squeeze out the plaintiff,⁹ and implied that the recapitalization was neither necessary nor of any material benefit to the corporation.¹⁰ Accordingly, the court concluded that such conduct was wrongful and oppressive as proscribed by the statute pleaded by Browning.¹¹

In reaching its somewhat questionable holding, the majority of the court found the following facts. When first organized, the corporation had authorized 1,000 shares of no par value stock, of which Browning was the recognized owner of 320 shares.¹² The corporation operated at a loss¹³ until some time after its second fiscal year, which ended on July 31, 1962. The corporation was in debt to two trusts in an amount approaching \$500,000. By the end of the third fiscal year, July 31, 1963, it became clear that the corpora-

Iron Co., 55 N.J. Eq. 211, 37 A. 539 (Ch. 1897); H. BALLANTINE, CORPORATIONS § 209 (rev. ed. 1946).

⁷ Ballantine has concluded that "[t]he reason [for the exception] is based upon practical convenience and the exercise of discretion of the directors in making new issues of shares to accomplish corporate purposes." H. BALLANTINE, *supra* note 6, at 490.

⁸ 434 P.2d 339 (Ore. 1967).

⁹ "[T]he only demonstrable purpose served by the increase of stock was to provide the tools with which to drastically reduce the interest of Browning in the corporation." *Id.* at 343.

¹⁰ *Id.*

¹¹ ORE. REV. STAT. § 57.595 (Supp. 1961) provides in part: "(1) The Circuit courts shall have full power to liquidate the assets and business of a corporation . . . [where] the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent." Apparently no case prior to the instant one had arisen under this statute.

¹² Of the remaining shares, Campbell, the financier and leader of the majority shareholders, owned 20 shares. Defendant Thomason had 160 shares, while defendants Winn and Riddlesbarger, the trustees of two trusts set up by Campbell for the benefit of his daughters, each owned 250 shares. 434 P.2d at 340.

¹³ The annual report for fiscal 1962 showed an operating deficit of more than \$200,000. *Id.* at 341.

tion was making a profit for the first time in its history.¹⁴ Nine months previously, however, the shareholders had adopted a resolution¹⁵ to increase the number of authorized shares from 1,000 to 500,000.¹⁶ On December 14, 1962, a preemptive stock allotment was given to Browning. The court concluded that "[t]he defendant-directors knew that it was financially impossible for Browning to exercise this pre-emptive right, either in full or for any substantial part of it. It was, and it was intended to be, an eviction notice."¹⁷ Browning in fact could not exercise his preemptive rights. Sometime after the expiration of the preemptive right period, the directors, at a special meeting, authorized all of the defendant-shareholders to subscribe for any amount of the new stock.¹⁸ Browning had no notice of the meeting and thus was not afforded the same opportunity. Approximately 31,000 shares were purchased,¹⁹ the squeeze out was completed. Although "[i]t was stated

¹⁴ *Id.*

¹⁵ This was only 3 months after the second annual report showing the considerable losses. Browning had notice of the meeting but did not attend.

¹⁶ The court apparently placed great emphasis on the inference that the directors could have known that the corporation was emerging into a successful enterprise:

At what time in the [third] fiscal year it could have been foreseen that the corporation was emerging into a profitable operation is not found in the record. It is possible to infer that sometime during that fiscal year the defendant-directors could have known that the organizational and operational problems of the corporation's business had been resolved and that future profitable operation could have been anticipated. 434 P.2d at 341.

This language indicates that the court was proceeding on the weak implication that if a profitable operation could reasonably have been foreseen by the directors, this would tend to negate the need for recapitalization. See text accompanying notes 21-22 *infra*.

¹⁷ 434 P.2d at 341. Browning would have been allowed to subscribe for up to 151,696 shares of new stock at \$1 per share. While admitting that the certificate did not compel him to subscribe and pay for the entire amount, the court emphasized that "Browning considered that this was the effect of the certificate." Moreover, Browning would have had to expend a considerable sum to retain any "meaningful proportionate interest in the corporation." *Id.* For a contrary and equally persuasive opinion as to the effect of the certificate received by Browning, see *id.* at 345 (dissenting opinion).

¹⁸ The court used language clearly unfavorable to the directors, e.g., "immediately following the expiration of the pre-emptive right period." *Id.* at 341 (emphasis added). Actually, the period expired on January 17, 1963, and the directors' authorization was given on February 11, 1963 — almost 1 month later.

¹⁹ Each of the two trusts was issued 10,454 shares; payment was in the form of cancellation of part of the debt owing to the trusts. Thomason was issued 10,240 shares; payment was by exchange of an unpaid salary claim. Campbell was issued 32 shares. (In the aggregate, 31,180 shares were issued. This represented a cancellation of corporate debt in the same amount, since each share had a value of \$1. See note 23 *infra*. However, the court apparently did not see fit to observe this fact as legitimate business purpose). "Browning's interest in the corporation was reduced from 32 percent to one percent. He was not . . . given any opportunity to subscribe for the drastically reduced amount of stock that would have retained his proportionate shares." 434 P.2d at 342. Browning also had an unpaid salary claim and he should have been given the same opportunity, or so the court felt. See *id.* at 343. However, there was considerable evi-

that it was necessary to permit the trustees to have a greater participation in the profits and to permit cancellation of *overdue* corporation notes due them as trustees,"²⁰ and although there was testimony "that the need for the additional paper capitalization was to enable them [the directors] to permit public sale of the stock [and] to provide a better ratio between capitalization and debt . . . ,"²¹ the court nevertheless concluded that no legitimate business purpose existed.²²

On the other hand, by drawing inferences which perhaps were more realistic under the circumstances, the dissent found the same facts to be considerably more favorable to the directors with respect to the question of a legitimate business purpose. In October 1962, when the additional stock was authorized, the corporation's financial picture was far from encouraging.²³ Since attempts to secure conventional loans probably would not have been feasible and since federal loans were not available,²⁴ additional capital could be obtained only by further shareholder loans, or by the issuance of more stock.²⁵ Whereas the majority of the court merely inferred that the directors could have known that the corporation was emerging into a success-

dence that he had failed to perform the job for which he was originally awarded his shares. *Id.* at 340. While his unpaid salary claim was clearly disputed (it was already the source of another litigation), the court felt that it must have had some value.

²⁰ 434 P.2d at 342 (emphasis added). Query if the cancellation of overdue notes is not a legitimate business purpose.

²¹ *Id.*; see note 28-29 *infra* & accompanying text.

²² The difficulty with accepting [the defendant's] explanations [of a legitimate business purpose] . . . is that none of them were accomplished, or even attempted.

. . . The large debt of the corporation was not materially reduced. The ratio of the debt to the paid-in capital stock was only nominally changed. . . . [D]efendants did not attempt to explain how the increase of stock . . . accomplished any of the business purposes they claimed for the entire transaction. The only tangible result of the increase of the stock and the amount issued was the elimination of Browning's 32 percent interest in the corporation. 434 P.2d at 342.

Query if the payment of legitimate corporation debts by means of cancellation and the issuance of shares is not a legitimate business purpose even if the consequent change of debt ratio is only nominal, when the fact that the corporation was making a profit had become known.

²³ Current liabilities were \$227,000, while current assets were \$117,000. Capital stock was a mere \$1,000, and long term loans were in the amount of \$440,000 (of which \$320,000 was owing to the trustees). The continuing existence of the trustees' only source of income, which upon receipt was immediately handed over to the corporation, was always questionable. *Id.* at 344. The dissent concluded that the directors could have reasonably decided that the corporation needed more capital. *Id.*

²⁴ *Id.*

²⁵ The inadvisability of the majority shareholders making further loans was apparent. There would be "no opportunity for a greater share of the profits with the plaintiffs continuing to hold 32 percent of the stock." *Id.* at 345.

ful operation,²⁶ the dissent's more realistic conclusion was that the corporation needed additional capital, that conventional loans were not feasible, and that a new stock issue was the only practical alternative.²⁷ While the majority found it difficult to accept the directors' explanation that the new stock was issued for business purposes, because none of the purposes was accomplished or attempted,²⁸ the dissent responded that this failure was due to changed business and economic conditions.²⁹ The dissent unfortunately did not take advantage of several bolstering arguments which are examined in depth in the footnote.³⁰

²⁶ See note 16 *supra*.

²⁷ 434 P.2d at 346-47.

²⁸ See note 22 *supra* & accompanying text.

²⁹ 434 P.2d at 346-47.

³⁰ At the end of fiscal 1962, the financial picture showed a huge deficit. Accordingly, the new stock was authorized. When the purchases were completed in February 1963, the need for long term additional capital had decreased. The corporation's financial position was clearly improving because the huge deficit of the prior year had been erased and had been changed to retained earnings by the end of fiscal 1963, and in addition a considerable part of the debt owed to the trustees had been reduced beginning in March 1963. In other words there was little need for going public at this time — the stock was too valuable to be sold at \$1 per share to the public and at the same time it was a valuable investment for the defendants.

Secondly, the debt-capital ratio was reduced from 320:1 to 10:1 by the issuance of approximately 31,000 new shares of stock. This smaller ratio was advantageous — a legitimate business purpose — to the corporation because it not only cancelled or paid off substantial corporate debts, but also because it was favorable for income tax purposes. *Id.* at 347. The dissenting judge probably could have bolstered his argument by expounding upon the tax aspect as a legitimate business purpose. In brief, the significant issue would be whether the original financial arrangement between the corporation and the trustee-shareholders gave rise to a valid debtor-creditor relationship, or whether it merely gave rise to a contribution to capital on their part. With respect to the repayment by the corporation of the amount advanced by these shareholders, if it were found that a true debtor-creditor relationship existed, then a deduction properly taken for the interest paid on the indebtedness under section 163(a) of the *Internal Revenue Code of 1954* would benefit the corporation. On the other hand, if it were found that the financial arrangement did not create a valid debt, then the payments would be considered to be distributions of property by the corporation under section 301(a), and would be accorded dividend treatment under sections 301(c) and 316. In all probability, substantial tax benefits would accrue to the corporation in the former situation, whereas substantial taxes would likely be assessed in the latter. For these reasons it would obviously behoove corporate management to take the necessary safeguards to insure that the status of the shareholder advances are properly regarded as loans.

Many tests are utilized in the determination of whether or not a particular financial arrangement really amounts to a loan. One such test involves the debt-capital ratio. While this test is not exclusively relied upon, it nonetheless continues to be of influence. Essentially, the theory is that the greater the ratio, the more likely it is that the Internal Revenue Service will conclude that the shareholder advances are in reality contributions to capital, and not loans, *i.e.*, an attempt at tax avoidance. See Gerver, *De-Emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics*, 23 J. TAXATION 28, 31 (1965). That the Internal Revenue Service would not fail to scrutinize, and perhaps see through, such an arrangement is a foregone conclu-

The court appears to have placed the burden of proof on the directors to show that the new issue of stock was prompted by a legitimate business purpose. Ordinarily this stiff burden has remained with the complaining shareholder.³¹ Apparently the only direct evidence in this case was that Browning had not done the job for which he had received his 320 shares and that the defend-

sion. Viewed in a different light, however, it has been held that the avoidance of tax is not an improper purpose of corporate management; or, conversely put, that it is a legitimate business purpose. See *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 128 (2d Cir. 1956).

The inescapable conclusion of the dissent in *Browning*, of course, is that the directors' conduct, leading to a substantial decrease in the debt-capital ratio, amounted to a legitimate business purpose. For an excellent discussion of this and many relevant, complex issues, see Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1 (1960). On a similar vein, the dissent possibly could have used the lowered debt-capital ratio to show perhaps an even more substantial legitimate business purpose. The financial plight of the corporation at this time was obvious; conceivably, the directors may have feared that they and the other shareholders were running the risk of losing their limited corporate liability — that is, of becoming liable as partners to their creditors. Although the courts have generally been hesitant to disregard the corporate entity in order to grant relief to creditors where there has been a showing of inadequate capitalization, at least several California courts have been so inclined. *Automotriz Del Golfo De California v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957); *Temple v. Bodega Bay Fisheries, Inc.*, 180 Cal. App. 2d 279, 4 Cal. Rptr. 300 (1960). Both courts quoted with approval the following language:

If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege. H. BALLANTINE, *supra* note 6, at 302-03.

A final argument could have been made regarding the reduced debt-capital ratio. The corporation had been operating in the red, and the facts fairly warranted the inference that further capital was needed. Ordinarily, such capital could have been obtained by any of three sources: shareholder loans, conventional loans, or by the issuance of more stock. Unfortunately, as explained in notes 25 and 26 *supra* and accompanying text, the former two sources were not in fact available. However, by issuing the new shares in exchange for claims against the corporation, the directors considerably enhanced the corporation's credit picture. Although this change was only nominal (no new capital actually flowed into the corporation), there now existed an opportunity to secure further capital: with a debt-capital ratio of but 10:1, financial institutions conceivably would have been much more willing to extend credit to the corporation. In brief, the reduced debt-capital ratio and the inferences arising therefrom possibly could have been better exploited by the dissent.

³¹ "[I]n jurisdictions where the courts have shown a disposition to protect minority shareholders against freeze outs by the issuance of additional stock, the burden of proof that a complaining shareholder must bear to get relief is a heavy one." 2 F. O'NEAL, *supra* note 3, at 123-24. See generally C. MCCORMICK, EVIDENCE §§ 306-07 (1954).

ants intended to squeeze him out of the corporation.³² It is contended here that, in arriving at its decision that no legitimate business purpose existed, the court was influenced primarily by the directors' professed intent to squeeze out Browning. By so holding, the Oregon Supreme Court has considerably relaxed the degree of proof usually required of a minority shareholder seeking judicial relief.³³ In effect, this line of reasoning will tend to minimize the significance of the legitimate business purpose test. The dissent in *Browning* ably demonstrated that the facts of the case could certainly give rise to reasonable inferences that such a purpose existed. Yet four justices saw fit, where the facts did not *clearly* show a legitimate business purpose, to impliedly conclude that the test for relief should be whether the intent or primary purpose of the majority shareholders was to squeeze out the minority, notwithstanding a possible or incidental benefit to the corporation.³⁴

Browning was a case of first impression in the State of Oregon. Although, as a general rule, the courts have been somewhat hesitant to interfere in intracorporate matters,³⁵ there appears to be an emerging view that one of the hallmarks of the close corporation

³² 434 P.2d at 340, 342. In view of the language throughout the entire opinion, it apparently was no secret that the defendants were not happy with Browning's performance, and, to say the least, would have been delighted to be rid of him.

There are only a few cases in which the courts apparently have been equally influenced by the majority shareholders' intent or "primary purpose" of freezing out the minority. This minority view is expressed in *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953) and *Canada S. Oils, Ltd. v. Manabi Exploration Co.*, 33 Del. Ch. 537, 96 A.2d 810 (Ch. 1953). *Contra*, *Hyman v. Velsicol Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1951). However, one authority on close corporations feels that the minority view may be emerging as the majority view. *See* 2 F. O'NEAL, *supra* note 3, at 122-24.

³³ This is a clear departure from the strict tests announced in other jurisdictions. In *Bellows v. Porter*, 201 F.2d 429 (8th Cir. 1953), the court stated that

"To warrant the interposition of the court in favor of the minority shareholders . . . a case must be plainly made out which shows that such action is so far opposed to the true interests of the corporation itself as to lead to the *clear* inference that no one thus acting could have been influenced by any honest desire to secure such interests, but that he must have acted with an intent to subserve some outside purpose, regardless of the consequences to the company, and in a manner inconsistent with its interests." *Id.* at 433-34 (emphasis added), *quoting from* *Gamble v. Queens County Water Co.*, 123 N.Y. 91, 25 N.E. 201 (1890).

³⁴ The court observed that other "courts have given relief when the purpose of the increased stock issue is only for the benefit of the majority and serves no corporate purpose," and then went on to say that "the only demonstrable purpose served by the increase of stock was to . . . reduce the interest of Browning in the corporation." 434 P.2d at 343. It seems difficult to believe that the court could honestly say that no legitimate business purpose was served by the stock issue. Hence the necessity for asserting the court's implied conclusion.

³⁵ *See* note 3 *supra* & accompanying text.

is its fiduciary characteristics, and that perhaps the courts should be more willing to grant relief to the minority shareholder in the squeeze out situation.³⁶ The impact of the decision is of course not shattering. Proof of the legitimate business purpose remains a significant factor; however, the burden of proof does seem to have been shifted from the minority to the majority shareholders. This is not to say that bare proof of intent on the part of the majority to squeeze out the minority is enough to obtain relief. Nor is this court's result without support, for the burden has been shifted in this manner in other areas of corporate law.³⁷ In addition, it has already been pointed out that other courts are becoming more willing to grant relief in such cases.³⁸ Whether the *Browning* decision will have any influence in other jurisdictions is difficult to conjecture. Although the more conservative courts will naturally tend to follow the entrenched majority view,³⁹ the decision really does not represent a radical departure from traditional theories, and accordingly it will probably find acceptance in many jurisdictions.⁴⁰

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³⁶ Mr. Justice Brandeis has said: "The majority has the right to control; but when it does so, it occupies a fiduciary position toward the minority . . ." *Southern Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919). See generally F. O'NEAL & J. DERWIN, *supra* note 1, § 5.15; 2 F. O'NEAL, *supra* note 3, § 8.07; H. HENN, *supra* note 2, §§ 231, 236, 241.

³⁷ In *Mardel Sec., Inc. v. Alexandria Gazette Corp.*, 183 F. Supp. 7 (E.D. Va. 1960), it was presumed that a contract between the corporation and its officers was invalid; the evidence was insufficient to sustain the officers' burden of proving good faith in transactions involving commingled business interests. In *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960), the Illinois Supreme Court reversed an appellate decision denying relief to the minority shareholder, holding that transactions between corporations having common directors are presumptively unfair and that the directors had the burden of overcoming the presumption. The essence of these and related cases is their conflict of interest issue. Where the fiduciary problem is the fundamental issue, it appears that the courts have decided that a shifting of the burden of proof will more readily effectuate justice. While these cases are not directly on point, it would certainly seem that they would lead support, in principle, for the court's decision in the instant case.

Similarly, there is legislative support for this type of result. The purpose of section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1964), whereby defendants find themselves effectually saddled with the burden of proof, was the avoidance of the considerable common law difficulties generally encountered by plaintiff-purchasers of securities. For an excellent summary of these difficulties, see Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

³⁸ For discussions pertaining to the fiduciary theory in close corporations, see note 37 *supra* & accompanying text. There is additional support for this theory in the analogous area of partnerships, particularly limited partnerships. While perhaps the analogy is rough, it nonetheless appears to have some influence in corporate law. See H. OLECK, *MODERN CORPORATION LAW* § 189 (student ed. 1960).

³⁹ See note 6 *supra* & accompanying text.

⁴⁰ It is interesting to note that the decision is no windfall for the minority share-