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CORPORATE GOVERNANCE FOR THE ENTREPRENEUR

“The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.”

—John Maynard Keynes—

General Theory of Employment, Interest and Money

INTRODUCTION

Over the years, divergent schools of corporate scholarship have produced a litany of commentary on the topic of corporate governance, specifically in the context of public corporations.¹ On the right are those who advocate the shareholder² model. This model, a long-standing doctrine in corporate law, asserts that the responsibility of corporate directors is to foster the profit motive of the residual owners, or shareholders.³ On the left are

¹ See generally Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671 (1995); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As A Multi-Player Game*, 78 GEO. L.J. 1495 (1990).

² The term “shareholder” has been defined by the Revised Model Business and Corporations Act to mean “the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.” REVISED MODEL BUS. CORP. ACT § 1.40 (1985). The terms “shareholder and stockholder are ... synonymous and may be used as interchangeable terms” 11 TIMOTHY P. BJUR & JAMES SOCHEIM, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5805 (1995).

³ See John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1462 (1994) (“The viability of the shareholder primacy theory derives from economic theory; it says that shareholders’ unfettered pursuit of maximum profits promotes economic efficiency ...”); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 491-97 (1980) (defending wealth maximization); Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103 (1979) (rejecting utilitarianism in favor of wealth maximization); Richard A. Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 291 (1979) (recognizing that maximization of wealth is not among problems associated with economic theory of common law).

those who advocate the stakeholder model.⁴ Stakeholder model proponents argue that directors and officers owe a fiduciary duty to all corporate constituents, or stakeholders. The term "stakeholders" is defined to include not only shareholders, but also "suppliers, customers, employees, stockholders, and local community, as well as management in its role as agent for these groups."⁵ In the middle is an amalgamation of the shareholder and stakeholder models which considers the best interests of the corporation.⁶ Proponents of this view insist that directors should

These theorists posit the notion that by focusing on the best interests of the shareholders, directors will enhance corporate wealth and in the process, will best serve the interests of the non-shareholder constituencies. See Matheson & Olson, *supra*, at 1462 (stating that wealth maximization will collaterally promote social welfare); Marleen A. O'Connor, *Introduction to the Symposium on Corporate Malaise Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3, 5-6 (1991) (asserting that wealth maximization will benefit employees, customers, and surrounding community); see also Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, (Magazine), at 32-33 (stating that social responsibility of business is to increase its profits rather than pursue beneficial social goals).

⁴ See Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 954 (1993). Stakeholder proponents advocate a fiduciary duty owed by directors to nonshareholder constituents, or stakeholders, such as employees, suppliers, and local communities. See *id.* at 954-55 (arguing that fiduciary duties should be owed to employees); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 915-23 (discussing fiduciary issues in corporate law); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1235-44 (1991) (proposing introduction of fiduciary duty to protect worker's reliance on implicit contract).

Professor Marleen O'Connor, one of the leading proponents of directorial fiduciary duties to employees, argues that directors should owe fiduciary duties to workers dislocated by restructurings, layoffs, and plant closings. See O'Connor, *Restructuring the Corporation's Nexus of Contracts*, *supra*, at 1235-60. See generally Joseph W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988) (arguing that employees should have property rights in closing plant).

Certain legal scholars have taken this concept one step further and proffered the notion that courts should allow stakeholders to sue for breach of fiduciary duties. See Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1372 (1991); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 236-38 (1990); see also Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 635-36 (1992) (applying close corporation law by analogy to balance conflicting interests of shareholders and stakeholders).

⁵ Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 21 (1992) (quoting JAMES W. KUHN & DONALD W. SHRIVER, JR., *BEYOND SUCCESS: CORPORATIONS AND THEIR CRITICS IN THE 1990S* 67-68 (1991)).

⁶ See Steven M. H. Wallman, *The Proper Interpretation of Corporate Constitu-*

not afford primacy to any particular stakeholder, but rather to the corporation as a whole.⁷

In the wake of the takeover boom of the 1980s, many states enacted statutes specifically granting corporate directors the power to consider nonshareholder interests when making decisions involving the corporation.⁸ These nonshareholder constituency statutes codified the directors' right to consider the best interests of the corporation as a whole.⁹ In many states, this standard arguably has become the accepted model of corporate governance for public corporations.¹⁰

It is unclear whether this broad authorization to consider the interests of the corporation as a whole was extended to directors of closely-held corporations. Unlike their publicly-held counterparts, in many states directors of close corporations are subject to remedial legislation intended to protect noncontrolling shareholders.¹¹ Legislatures have provided a statutory remedy granting the relief of dissolution for illegal, oppressive or

ency Statutes and Formulation of Director Duties, 21 STETSON L. REV. 163, 167 (1991) (suggesting that "best interests" model is beneficial for all stakeholders, including shareholders).

Under this standard, a corporation is most efficient in satisfying all constituents' interests over the long term if directors are clothed with the authority to develop the corporation's core competence unfettered. See ARTHUR A. THOMPSON, JR. & A. J. STRICKLAND, III, *STRATEGIC MANAGEMENT: CONCEPTS AND CASES* 37-38 (6th ed. 1992).

⁷ See Wallman, *supra* note 6, at 165 ("The overriding mandate is that the directors' duty is owed solely to the corporation, not to shareholders or any other group."); *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241, 244 (1990) (statement of Business Roundtable) ("The thrust of history and law strongly supports the broader view of the directors' responsibility to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation").

⁸ See Carol B. Swanson, *The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism*, 30 GA. L. REV. 943, 974 (1996); see also Robert A. Raggio, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 1023 (1993) (describing general corporate law and legitimacy of considering interests of nonshareholder constituencies).

⁹ See Matheson & Olson, *supra* note 3, at 1466; see also Timothy L. Fort, *Corporate Constituency Statutes: A Dialectical Interpretation*, 15 J.L. & COM. 257, 261-62 (1995) (describing corporate constituency statutes).

¹⁰ See, e.g., Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1024 (1992) (noting that over half of states have constituency statutes).

¹¹ See generally Edwin J. Bradley, *An Analysis of the Model Close Corporation Act and a Proposed Legislative Strategy*, 10 J. CORP. L. 817 (1985); F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1986).

fraudulent conduct by the controlling shareholders because non-controlling shareholders are particularly at risk when disagreements develop in a close corporation.¹²

Application of the remedy of dissolution in accordance with the remedial legislation has proved somewhat difficult.¹³ In attempting to determine whether specific conduct is sufficiently oppressive to merit involuntary dissolution, a number of jurisdictions adopted the reasonable expectations test¹⁴ which requires that the controlling shareholders of a close corporation act so as not to defeat objectively reasonable expectations of the non-controlling shareholders.¹⁵

In the majority of circumstances involving close corporations, application of the reasonable expectations test is compatible with the best interests of the corporation model of corporate governance. Decisions by the controlling shareholders that are made in good faith to benefit the corporation as a whole will generally meet the reasonable expectations of the noncontrolling shareholders. Illegal or fraudulent conduct by the controlling

¹² See ALA. CODE § 10-2B-14.30 (1994); ARK. CODE ANN. § 4-27-1430 (Michie 1996); CAL. CORP. CODE § 1800(b)(4) (West 1990) (banning "persistent unfairness" toward shareholders); COLO. REV. STAT. ANN. § 7-114-301 (West Supp. 1996); GA. CODE ANN. § 14-2-940 (1994); IDAHO CODE § 30-1-97 (1996); IOWA CODE ANN. § 490.1430 (1991); MD. CODE ANN., CORPS. & ASS'NS § 3-413 (1993) (limiting action to shareholders with at least 25% of votes entitled to be cast); MICH. COMP. LAWS ANN. § 450.1489 (West 1990); MISS. CODE ANN. § 79-4-14.30 (1996); MO. ANN. STAT. § 351.494 (West 1991); MONT. CODE ANN. § 35-1-938 (1995); NEB. REV. STAT. § 21-20, 162 (Supp. 1995); N.H. REV. STAT. ANN. § 293-A:14.30 (Supp. 1996); N.J. STAT. ANN. § 14A:12-7 (West Supp. 1996) (limiting remedy to corporations having 25 or fewer shareholders); N.M. STAT. ANN. § 53-16-16 (Michie 1983); N.Y. BUS. CORP. LAW § 1104-a(a)(1) (McKinney 1986) (applying only to plaintiffs who own at least 20% of shares); OR. REV. STAT. § 60.661 (1993); PA. STAT. ANN. tit. 15, § 1981 (West 1995); R.I. GEN. LAWS § 7-1.1-90 (1992); S.C. CODE ANN. § 33-14-300 (Law Co-op. 1990); S.D. CODIFIED LAWS § 47-7-34 (Michie 1983); TENN. CODE ANN. § 48-24-301 (1995); UTAH CODE ANN. § 16-10a-1430(2) (1995); VT. STAT. ANN. tit. 11A § 14.30 (1995); VA. CODE ANN. § 13.1-747 (Michie 1997); WASH. REV. CODE ANN. § 23B.14.300 (West Supp. 1997); W. VA. CODE § 31-1-41 (1996); WIS. STAT. ANN. § 180.1430 (West 1992); WYO. STAT. ANN. § 17-16-1430 (Michie 1989).

¹³ See Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 709-11 (1993); see also Joshua M. Henderson, Note, *Buyout Remedy for Oppressed Minority Shareholders*, 47 S.C. L. REV. 195, 199-200 (1995).

¹⁴ See, e.g., Franklin A. Gevurtz, *Squeeze-Outs and Freeze-Outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497, 500 (1995).

¹⁵ See Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1467-68 (1989) (discussing reasonable expectation standard and oppressive conduct standard in case law); Thompson, *supra* note 13, at 712 (explaining oppressive conduct standard).

shareholders, however, would neither meet the reasonable expectations of the minority shareholders nor be in the best interest of the corporation.

Difficulty arises when the conduct ascribed to the controlling shareholders under the reasonable expectations test is described as "oppressive." Unlike fraudulent or illegal conduct, "oppressive conduct" is not easily defined.¹⁶ Since the term "oppressive conduct" is somewhat vague, controlling shareholders of a close corporation must effectively make their "best guess" as to whether a good faith decision in the corporation's best interest defeats the reasonable expectations of the noncontrolling shareholders.¹⁷ If the majority guesses wrong, the decision could result in corporate dissolution.¹⁸

This Note asserts that the application of the reasonable expectations test to good faith decisions made in the best interest of a close corporation by controlling shareholders is untenable. The reasonable expectations test is particularly inappropriate when applied to start-up entrepreneurial firms. For purposes of this Note, the term "entrepreneurial firm" describes a close corporation in a rapid growth phase while under the control of an individual interest.¹⁹ Unlike a mature close corporation, one ultimate goal of the entrepreneurial firm, as defined in this Note, is to become a public corporation.²⁰ After achieving public corpo-

¹⁶ See *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984) (analyzing standard appropriate for oppressive conduct which triggers involuntary dissolution in close corporation).

¹⁷ See Sandra K. Miller, *Should the Definition of Oppressive Conduct by Majority Shareholders Exclude a Consideration of Ethical Conduct and Business Purpose?*, 97 DICK. L. REV. 227, 229-30 (1993) (asserting that assigning definition of "oppressive conduct" to judicial interpretation defeats attempts of business corporation statutes "to provide certainty and clarity in the law to enhance the attractiveness of doing business").

¹⁸ See *infra* notes 98-116 and accompanying text (discussing remedial legislation affording remedy of involuntary dissolution to noncontrolling shareholders).

¹⁹ Generally, an entrepreneur is "one who organizes, manages, and assumes the risks of a business or enterprise." MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 387 (10th ed. 1994). On Wall Street, however, an "entrepreneur" or "entrepreneurial firm" has a special meaning. Financial analysts treat corporations as fitting within one of three distinct stages: (1) the nascent "entrepreneurial" or "rapid growth" phase during which the firm is often controlled by an individual interest, as a close corporation; (2) the expansion phase of "maturing growth;" and (3) the mature phase. See JEROME B. COHEN, ET AL., INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 341-68 (5th ed. 1987).

²⁰ See COHEN, *supra* note 19, at 370-73 (describing growth of firm through initial start-up phase into mature phase).

ration status, the entrepreneurial firm will no longer be subject to the reasonable expectations test.²¹ It is unreasonable, therefore, to limit the growth of entrepreneurial firms by restricting their decision-making ability while in the early, close corporation stage. In order to effectively build and invigorate a long term competitive position in the marketplace, an entrepreneurial firm should be afforded the right to weigh the best interests of all its constituents.

When a good faith decision by the controlling shareholders of an entrepreneurial firm is deemed to be oppressive, this Note proposes that the standard set by the nonshareholder constituency statutes should trump the application of the reasonable expectations test. Part I of this Note discusses nonshareholder constituency statutes and asserts that these statutes should be applied to entrepreneurial firms. Part II discusses the remedial legislation allowing involuntary dissolution in close corporations and the reasonable expectations test. Part III concludes that entrepreneurial firms, in particular, deserve the right to consider the best interests of the corporation as a whole in making corporate decisions. In essence, this Note proposes that good faith decisions by controlling shareholders of an entrepreneurial firm made in the best interests of the corporation should not subject the company to the risk of involuntary dissolution.

I. NONSHAREHOLDER CONSTITUENCY STATUTES

A. *Background*

Nonshareholder constituency statutes trace their roots back to the notion that corporations are chartered under the laws of the states to promote economic growth for their shareholders, the community, and society as a whole.²² States authorized the

²¹ See, e.g., N.Y. BUS. CORP. LAW § 1104-a(a) (McKinney 1986) (allowing remedy of involuntary dissolution to "[t]he holders of twenty percent or more of all outstanding shares of a corporation, other than a corporation registered as an investment company under an act of congress entitled 'Investment Company Act of 1940' ...").

²² See RALPH ESTES, TYRANNY OF THE BOTTOM LINE 30-32 (1996); see also John C. Carter, *The Rights of Other Corporate Constituencies*, 22 MEM. ST. U. L. REV. 491, 491 (1992) (arguing that "[c]orporations, which are entities created by law, should rightfully have some obligations to the society from which the law arose"); Frank J. Garcia, Note, *Protecting Nonshareholder Interests in the Market for Corporate Control: A Role for State Takeover Statutes*, 23 U. MICH. J. L. REFORM 507, 513 (1990) (arguing that "the state, as representative of the community, is in a position

formation of corporations with the intentions of stimulating the economy and providing employment for citizens.²³ Early corporations received special benefits, such as limited liability of shareholders and continuity of life, in exchange for the obligation to perform a public service.²⁴ The aforesaid theories of corporate responsibility did not go uncontroverted. Professor Adolf Berle championed the argument that the board of directors of a corporation should operate in the best interests of the shareholders.²⁵ To mandate otherwise would engender a "social-economic absolutism of corporate administrators."²⁶ Berle often debated with Professor Merrick Dodd over the question: "For Whom Are Corporate Managers Trustees?"²⁷ Of grave concern to both debaters was whether corporations owe a duty of "trusteeship" or "responsibility" to the interests of corporate stakeholders other

to demand that the enterprise be conducted in a manner that best serves the interests of the community as a whole").

²³ See ESTES, *supra* note 22, at 30.

²⁴ See J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES: 1780-1970* 15 (1970) ("Almost all of the business enterprises incorporated ... in the formative generation starting in the 1780's were chartered for activities of some community interest—supplying transport, water, insurance, or banking facilities."); PAUL A. SAMUELSON, *ECONOMICS* 86-86 (8th ed. 1973).

Without limited liability and the corporation, society could simply not reap the benefit that comes when large supplies of capital can be attracted to competing corporations that produce a variety of complementary products, that pool risks, and that best utilize the economies of sizable research units and managerial know-how. This is the economic rationale of the legal fiction called the corporation.

SAMUELSON, *supra*, at 86; Trevor S. Norwitz, "The Metaphysics of Time": A Radical Corporate Vision, 46 *BUS. LAW.* 377, 387 (1991) (asserting that "the corporation is a legal fiction—a creature of the law—and the benefits of participation in [an] enterprise with limited liability are provided for the benefit of society"); Wallman, *supra* note 6, at 167 (explaining that states granted certain benefits to corporations because "society benefits by encouraging corporate growth and vitality").

²⁵ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 310 (Rev. ed. 1968) (arguing that "a corporation 'belongs' to its shareholders").

²⁶ Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 *HARV. L. REV.* 1365, 1372 (1932); see Walter M. Cabot, *The Free Market Promotes Long-Term Efficiency That Benefits All Stakeholders*, 21 *STETSON L. REV.* 245, 251 (1991) ("While we should have safety nets and compassion for those who fail, socialism is not the answer to America's economic woes").

²⁷ E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 *HARV. L. REV.* 1145, 1148 (1932) (retorting that corporation is "an economic institution which has a social service as well as a profit-making function"); see also A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 *HARV. L. REV.* 1049, 1049 (1931) (asserting that corporate powers should be "at all times exercisable only for the ratable benefit of all the shareholders").

than shareholders.²⁸

Nevertheless, scholars continued to debate the appropriate model of corporate governance until "corporate responsibility" was codified in the form of antitakeover statutes passed by the states in the 1980s.²⁹ It is uncertain as to whether such legislation was passed in response to the concerns of the companies or of the stakeholders themselves. Some argue that the companies themselves initiated such reform to create a bulwark in combating impending threats of hostile takeovers.³⁰ Others have taken the position that antitakeover legislation was passed in response to the stakeholders, many of whom suffered from the effects of hostile takeovers. While shareholders often benefited from takeovers by a surge in stock prices, creditors, employees and local communities were often hurt by the resulting closings or downsizing.³¹

Pennsylvania was the first state to enact a constituency statute.³² Its legislative history suggests that the interests of both corporations and corporate stakeholders were equally con-

²⁸ See N. CRAIG SMITH, *MORALITY AND THE MARKET: CONSUMER PRESSURE FOR CORPORATE ACCOUNTABILITY* 64-65 (1990) (discussing social responsibility and trusteeship in management).

²⁹ See generally Alan E. Garfield, *State Competence to Regulate Corporate Takeovers: Lessons from State Takeover Statutes*, 17 HOFSTRA L. REV. 535 (1989).

³⁰ See John C. Anjier, *Anti-Takeover Statutes, Shareholders, Stakeholders, and Risk*, 51 LA. L. REV. 561, 578-79 (1990) ("Almost universally, states initially adopted anti-takeover statutes in response to a single local corporation that was the target of a hostile bid or was apprehensive that it could become a target."); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 137 (1987) (stating that "the concern of a local firm that it might be acquired was quite often the impetus for the legislation."); cf. Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCI. 745, 748 (1990) (stating that "these laws reflect the desire of target firms' managers to keep their jobs and their ability to influence state legislators").

The Scott Paper Company supported the legislation because, at the time, the company was the target of a hostile takeover attempt from a Canadian firm. See Virginia Inman, *Pennsylvania Senate Is Seen Near Vote on Bill that May Deter Dissident Investors*, WALL ST. J., Dec. 6, 1983, at 12.

³¹ See John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435, 440 (1988) (stating that takeovers often adversely affect stakeholders); see also Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 171 (stating that modern constituency statutes "make explicit concerns that may motivate legislators when enacting any takeover regulation, that a takeover will adversely affect the local labor market").

³² Ronn S. Davids, *Constituency Statutes: An Appropriate Vehicle for Addressing Transition Costs?*, 28 COLUM. J.L. & SOC. PROBS. 145, 154 (1995); Richard B. Tyler, *Other Constituency Statutes*, 59 MO. L. REV. 373, 390 n.90 (1994).

sidered in drafting the legislation.³³ Nevertheless, regardless of whose interests were of paramount importance it remains uncontroverted that constituency statutes were enacted specifically in response to the hostile takeover movement.³⁴

³³ SENATOR FUMO: ... When [the statute] was originally proposed [by the Chamber of Commerce] to me I sat back, quite frankly, as a Democrat and was very surprised. I said this is the kind of legislation I would normally see come out of the Democratic caucus and not from big business. After closer scrutiny I ... had some philosophical problems with it.... It was one of my professors at Wharton [who] put it in a nutshell for me and made me understand it and made me be at peace with my vote today.... This bill would basically protect the corporations that are in Pennsylvania.

....

This bill would prevent foreign interests from coming in and taking over Pennsylvania corporations and obliterating those corporations, putting them out of business, milking their assets, milking their cash and, in the end, increasing unemployment because of the people who they would lay off after the mergers were consummated.

....

I say to my colleagues on this side of the aisle that although this appears to be big business legislation, and it may very well be, our constituents work in the factories owned by big businesses. We are crazy if we want to drive those businesses out of our state along with those jobs.

SENATOR FISHER: ... [T]he only thing I know is that it was felt that ... the bill ... had the complete support of the corporate community in Pennsylvania and others such as the labor community

SENATOR FUMO: I submit to this Senate that, yes, this bill does help corporate interests in Pennsylvania, but it helps Pennsylvania in improving the corporate business climate here so we can keep our jobs here and hopefully even attract new ones I urge all the Members of the Senate to vote in favor of this bill this time so we can give a very clear message to the business community, the labor community and to the entire nation that businesses do, in fact, have a friend in Pennsylvania, and that friend is its Legislature who [sic] can respond to corporate needs when they are in the best interests of all the citizens of Pennsylvania.

Orts, *supra* note 5, at 25-26 n.47 (alteration in original) (citing COMMONWEALTH OF PENNSYLVANIA, LEGISLATIVE JOURNAL, Dec. 6, 1983, at 1431, 1436; Dec. 14, 1983, at 1524).

³⁴ "I am not naive I also know this bill will probably have a chilling effect on adverse corporate takeovers." Orts, *supra* note 5, at 26 (citing COMMONWEALTH OF PENNSYLVANIA, LEGISLATIVE JOURNAL, Dec. 6, 1983, at 1431, 1436; Dec. 14, 1983, at 1524) (quoting Sen. Fumo). *But cf. id.* at 26 n.48 (citing COMMONWEALTH OF PENNSYLVANIA, LEGISLATIVE JOURNAL, Dec. 6, 1983, at 1430; Dec. 14, 1983, at 1524) (statement of Sen. Zemprelli) ("[Q]uite frankly, we are not quite sure what the bill does."); *but see also Committee on Corporate Laws, American Bar Association, Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2257 (1990) (noting that legislation was enacted to allow directors to consider other factors in decision making, and such legislation "ha[s] been generally inspired by concern over unwanted takeovers").

B. Cryptic Statutory Language

1. Public, Close, or Both?

Generally speaking, constituency statutes allow the directors of corporations to consider the interests of corporate stakeholders when making decisions on behalf of the corporation.³⁵ These stakeholders include shareholders, employees, suppliers, customers, and local communities.³⁶ A number of states have adopted some form of constituency statutes.³⁷ The New York constituency statute,³⁸ for example, allows directors to consider both long-term and short-term interests of the corporation, its shareholders,³⁹ and other stakeholders.⁴⁰ This statute has been

³⁵ See Orts, *supra* note 5, at 26.

³⁶ See *supra* note 4 and accompanying text (discussing stakeholder model of corporate governance).

³⁷ ARIZ. REV. STAT. ANN. § 10-1202.A (West 1996); CONN. GEN. STAT. § 33-313(e) (1995); FLA. STAT. ANN. § 607.0830 (3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (Harrison 1994); HAW. REV. STAT. § 415-35(b) (1990); IDAHO CODE § 30-1602 (1996); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 1993); IND. CODE § 23-1-35-1(d) (1995); IOWA CODE ANN. § 491.101(B) (West 1991); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie Supp. 1996); LA. REV. STAT. ANN. § 12:92(G) (West 1994); ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1991 & Supp. 1996); MASS. GEN. LAWS ch. 156B, § 65 (1996); MINN. STAT. § 302A.251 (1985 & Supp. 1997); MISS. CODE ANN. § 79-4-8.30(d) (1996); MO. ANN. STAT. § 351.347 (West 1991); NEB. REV. STAT. § 21-2045(1)(c) (1991); N.J. STAT. ANN. § 14A:6-1 (West 1990 & Supp. 1996); N.M. STAT. ANN. § 53-11-35(D) (Michie 1990 & Supp. 1996); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1997); OHIO REV. CODE ANN. § 1701.59(E) (Banks-Baldwin 1992); OR. REV. STAT. § 60.357(5) (1988 & Supp. 1996); 15 PA. CONS. STAT. § 515-16 (1995); R.I. GEN. LAWS § 7-5.2-8(a) (1992); S.D. CODIFIED LAWS § 47-33-4 (Michie 1991); TENN. CODE ANN. § 48-103-204 (1995); VA. CODE ANN. § 13.1-727.1 (Michie 1993); WIS. STAT. ANN. § 180.0827 (West 1992); WYO. STAT. ANN. § 17-16-830 (Michie 1989).

³⁸ N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1997).

³⁹ See *id.* Section 717(b) provides, in pertinent part:

In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-term and the short-term interests of the corporation and its shareholders....

Id.

⁴⁰ See *id.* Section 717(b) provides:

[A] director shall be entitled to consider ...

(2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

- (i) the prospects for potential growth, development, productivity and profitability of the corporation;
- (ii) the corporation's current employees;
- (iii) the corporation's retired employees and other beneficiaries

considered "the basic framework for corporate governance in one of the major industrial and commercial states in the nation."⁴¹ The language of the statute, however, does not specifically designate the type of corporation to which it applies.⁴² The New York statute merely refers to the entity at issue as the "corporation."⁴³ The question remains open as to whether the legislature was referring only to public corporations, or intended to include close corporations as well.⁴⁴ The Maine nonshareholder constituency statute⁴⁵ contains language similar to that of the New York statute. The Maine statute provides that, "[t]he directors and officers of a corporation"⁴⁶ may consider other corporate stakeholders. Again, it merely refers to the corporation, leaving the question of what type of corporation is so empowered unanswered.

Other statutes are expressly limited to *public* corporations. The Connecticut statute,⁴⁷ for instance, specifically provides that

receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
 (iv) the corporation's customers and creditors; and
 (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

N.Y. BUS. CORP. LAW § 717(b). The statute expressly states, however, that its tenor should not be construed to create fiduciary duties nor afford primacy to any one particular group. *See id.*; *see also* Paramount Comm., Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("[A]bsent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover.").

⁴¹ N.Y. BUS. CORP. LAW. § 717(b); N.Y. BUS. CORP. LAW. § 717 commentary at 27 (Richard A. Givens).

⁴² *See* N.Y. BUS. CORP. LAW § 717(b) ("In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation ...") (emphasis added).

⁴³ *See id.*

⁴⁴ *See* Ronn S. Davids, *Constituency Statutes: An Appropriate Vehicle for Addressing Transition Costs?*, 28 COLUM. J.L. & SOC. PROBS. 145, 193 ("New York's constituency statute permits the directors of public corporations to consider an expanded group of interests when making decisions on behalf of the corporation.").

⁴⁵ ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1981 & Supp. 1996).

⁴⁶ *Id.* Indiana's nonshareholder constituency statute is similarly broad: "A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent." IND. CODE § 23-1-35-1(d) (1989).

⁴⁷ CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1996).

the director of a public corporation may consider the best interests of all corporate stakeholders as well as the long-term and short-term interests of the corporation.⁴⁸ The South Dakota statute may be similarly construed.⁴⁹

2. Hostile Takeover Context

Several nonshareholder constituency statutes are expressly limited to decisions affecting corporate control.⁵⁰ The South Dakota statute, for example, is applicable when directors are considering "action which may involve or relate to a change or potential change in the control of a domestic public corporation."⁵¹ The Iowa statute is applicable when directors are "considering a tender offer or proposal of acquisition, merger, consolidation, or similar proposal."⁵² Finally, in Louisiana, the statute applies when directors are "evaluating a tender offer or an offer to make a tender or exchange offer or to effect a merger or consolidation."⁵³

Conversely, nonshareholder constituency statutes in most other states are more open-ended.⁵⁴ The Illinois statute,⁵⁵ for ex-

⁴⁸ The statute provides, in relevant part:

For purposes of sections 33-364, 33-365 and 33-371, section 33-372 insofar as it relates to the sale of all or substantially all of the assets of a corporation whether or not in the usual and regular course of business of the corporation, ... a director of a corporation which has a class of voting stock registered pursuant to Section 12 of the Securities Exchange Act of 1934, ... shall consider, in determining what he reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations....

Id.

⁴⁹ S.D. CODIFIED LAWS § 47-33-4 (Michie 1996).

⁵⁰ IOWA CODE ANN. § 490.1108(1) (West 1991); LA. REV. STAT. ANN. § 12:92 (G) (West 1994); MO. ANN. STAT. § 351.347 (West 1991); NEV. REV. STAT. ANN. § 78.138(4) (Michie 1994); N.J. STAT. ANN. § 14A:6-1(3) (West Supp. 1996); OHIO REV. CODE ANN. § 1701.59(E) (Banks-Baldwin 1994); OR. REV. STAT. § 60.357(5) (1) (1988 & Supp. 1996); R.I. GEN. LAWS § 7-5.2-8(a) (1992); S.D. CODIFIED LAWS § 47-33-4; TENN. CODE ANN. § 48-103-204 (1995).

⁵¹ S.D. CODIFIED LAWS § 47-33-4.

⁵² IOWA CODE ANN. § 491.101B (West 1991).

⁵³ LA. REV. STAT. ANN. § 12:92(G) (West 1994).

⁵⁴ ARIZ. REV. STAT. ANN. § 10-1202.A (West 1996); CONN. GEN. STAT. ANN. § 33-313(e) (West 1987 & Supp. 1996); FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 22-2202(b)(5) (Harrison 1989); HAW. REV. STAT. ANN. § 415-35(b)

ample, states that directors and officers may consider the long-term and short-term interests of the corporation and the effects of any action upon all corporate stakeholders.⁵⁶ The legislature defined "any action" to "includ[e], *without limitation*, action which may involve or relate to a change or potential change in control of the corporation."⁵⁷ Thus, it appears that although the statute was enacted in response to the takeover boom, the legislature found additional merits in an expanded application of the statute.

C. Limited Judicial Applicability

The language of the constituency statutes does not, in most states, preclude application to close corporations. The next step,

(Michie 1993); IDAHO CODE § 30-1602 (1996); 805 ILL. COMP. STAT. ANN. 5/8.85 (1993); IND. CODE ANN. § 23-1-35-1 (West 1989 & Supp. 1996); KY. REV. STAT. ANN. tit. 13-A, § 271B.12-210(4) (Banks-Baldwin 1996); ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1981 & Supp. 1996); MASS. ANN. LAWS ch. 156B, § 65 (Law. Co-op. 1996); MINN. STAT. ANN. § 302A-251 (West 1985 & Supp. 1997); MISS. CODE ANN. § 79-4-8.30(d) (1996); N.M. STAT. ANN. § 53-11-35(D) (Michie Supp. 1993); N.Y. BUS. CORP. LAW § 717(b) (McKinney 1986 & Supp. 1996); 15 PA. CONS. STAT. ANN. § 1715-16 (West 1995); WIS. STAT. ANN. § 180.0827 (West 1992); WYO. STAT. § 17-16-830 (1989).

⁵⁵ 805 ILL. COMP. STAT. ANN. 5/8.85 (West 1993).

⁵⁶ *Id.*

⁵⁷ *Id.* Other states do not go so far as to provide a definition of "any action." They do, however, contain language alluding to the same idea. For example, consider Kentucky's nonshareholder constituency statute. That statute provides:

(4) In discharging its duties under this section, or otherwise, the board of directors, in considering the best interests of the corporation, may consider in addition to the interests of the corporation's shareholders, any of the following:

- (a) The interests of the corporation's employes [sic], suppliers, creditors and customers;
- (b) The economy of the state and nation;
- (c) Community and societal considerations; and
- (d) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

KY. REV. STAT. ANN. § 271B.12-210(4). Minnesota's nonshareholder constituency statute provides:

Subd. 5. Considerations. In discharging the duties of the position of director, a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation.

MINN. STAT. ANN. § 302A.251.

therefore, requires reconciliation with court opinions. Unfortunately, only four cases considering constituency statutes have been reported to date.⁵⁸ All four cases have addressed the limited issue of hostile takeover contests in public corporations.

1. The Cases

In *Baron v. Strawbridge & Clothier*,⁵⁹ the court applied Pennsylvania's constituency statute in denying plaintiff's motion for preliminary injunctive relief against the defendant corporation and its board of directors.⁶⁰ The plaintiff challenged the board of directors' decision to reclassify the stock in response to a tender offer.⁶¹ In adopting the defensive measure, the court determined that "[i]t was proper for the company to consider the effects the ... tender offer would have, if successful, on the Company's employees, customers and community."⁶²

Moreover, in *Amanda Acquisition Corp. v. Universal Foods Corp.*,⁶³ the court faced the issue of whether the board's refusal to redeem poison pill rights⁶⁴ in response to a tender offer was valid under the statute.⁶⁵ Relying on Wisconsin's constituency statute, the court concluded that, "[it could] find no basis to conclude other than that the board has acted in accord with its fiduciary responsibilities in a manner reasonably related to the perceived threat to the corporation, its shareholders, and other constituencies."⁶⁶

⁵⁸ See Orts, *supra* note 5, at 32.

⁵⁹ 646 F. Supp. 690 (E.D. Pa. 1986).

⁶⁰ *Id.* at 696-97.

⁶¹ *Id.* at 692.

⁶² *Id.* at 697.

⁶³ 708 F. Supp. 984 (E.D. Wis.), *aff'd on other grounds*, 877 F.2d 496 (7th Cir. 1989).

⁶⁴ Poison pill rights have been defined as: "[A] plan by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event." *Revlon v. Mac Andrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986). For an example of other defensive measures, see *Paramount Comm., Inc. v. Time Inc.*, 571 A.2d 1140, 1144 n.5 (Del. 1989) ("Time had in place a panoply of defensive devices, including a staggered board, a 'poison pill' preferred stock rights plan triggered by an acquisition of 15% of the company, a fifty-day notice period for shareholder motions, and restrictions on shareholders' ability to call a meeting or act by consent.")

⁶⁵ *Amanda Acquisition Corp.*, 708 F. Supp. at 1008.

⁶⁶ *Id.* at 1016. It is important to note that, while the District Court relied on Wisconsin's constituency statute, WIS. STAT. ANN. § 180.305 (current version at WIS. STAT. ANN. § 180.0827 (West 1992)), the Court of Appeals relied on Wisconsin's business combination statute, WIS. STAT. ANN. § 180.726 (West 1992) (current ver-

In another relevant case, *Georgia-Pacific Corp. v. Great Northern Nekoosa Corp.*,⁶⁷ the court relied on Maine's constituency statute in upholding a poison pill defense.⁶⁸ Georgia-Pacific brought suit to annul an aspect of Great Northern's poison pill scheme which afforded directors the ability to schedule a shareholders' vote on whether to redeem the pill within ninety to one hundred twenty days of the tender offer.⁶⁹ Great Northern's directors waited until the one hundred twenty-day period elapsed,⁷⁰ and Georgia-Pacific argued that this caused impermissible delay.⁷¹ The court upheld the directors' decision, citing Maine's constituency statute. Because of the myriad of interests directors may consider under the statute, one hundred twenty days was not deemed patently unreasonable.⁷²

A fourth case, *Keyser v. Commonwealth National Financial Corp.*,⁷³ interpreted the Pennsylvania constituency statute. There, the court applied the statute to a hostile takeover defense which employed a "white knight defense."⁷⁴ The plaintiff-shareholders brought the action, claiming that Commonwealth's board breached its fiduciary duty by approving a merger agreement and lock-up option with Mellon Bank as a defense against a potential hostile tender offer from Meridian Bancorp.⁷⁵ Although it rejected defendant board's motion for summary judgment, the court noted that under Pennsylvania's constituency statute, "the Board could consider so-called social issues in

sion at WIS. STAT. ANN. §180.1140-1144 (West 1992 & Supp. 1996)), in sustaining the trial court's holding. See *Amanda Acquisition Corp.*, 877 F.2d at 498.

⁶⁷ 727 F. Supp. 31 (D. Me. 1989).

⁶⁸ *Id.* at 33-34.

⁶⁹ *Id.* at 33.

⁷⁰ *Id.* at 32.

⁷¹ *Id.* at 32-33.

⁷² *Georgia Pacific*, 727 F. Supp. at 32-33. The court concluded:

Certainly, 120 days is not a patently unreasonable amount of time for the directors to marshal and present to the shareholders the information on their position regarding the offer. This is particularly so when Maine law suggests that the Directors of a corporation, in considering the best interests of the shareholders and corporation, should also consider the interests of the company's employees, its customers and suppliers, and communities in which offices of the corporation are located.

Id. at 33 (citing ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1989)).

⁷³ 675 F. Supp. 238 (M.D. Pa. 1987).

⁷⁴ In corporate law, a potential acquirer usually sought out by the target of an unfriendly takeover to rescue it from the unwanted bidder's takeover. BLACK'S LAW DICTIONARY 1596 (6th ed. 1990).

⁷⁵ *Keyser*, 675 F. Supp. at 241.

evaluating merger proposals."⁷⁶ Particularly, the court insinuated that evidence that board members "express[ed] their concern for the employees of Commonwealth and the community ..., believing that employee opportunity would be much greater with Mellon than it would be with Meridian" was relevant to the issue of compliance with the fiduciary duty of care.⁷⁷

2. The End of the Line?

The limited case law interpreting nonshareholder constituency statutes might very well remain limited. In recent years, hostile takeovers have been on the decline.⁷⁸ In 1991, total acquisitions in the United States fell thirty-four percent to a total of \$142.3 billion, which was seventy-three percent below the peak level of activity in 1988.⁷⁹ The decline of hostile acquisitions was even steeper, dropping from almost \$127 billion in 1988 to approximately \$45.5 billion in 1989, to approximately \$11 billion in 1990.⁸⁰ As a result, courts may not have the opportunities to interpret these statutes. Nevertheless, nonshareholder constituency statutes will undoubtedly continue to be applied in the limited context of hostile takeover contests.

D. Summary

By virtue of the foregoing authority, albeit limited, nonshareholder constituency statutes were unequivocally enacted in response to hostile takeovers. Most nonshareholder constituency statutes are not limited by their language to hostile takeover situations.⁸¹ In addition, most nonshareholder constituency statutes by their language are not strictly limited to public cor-

⁷⁶ *Id.* at 265.

⁷⁷ *Id.*

⁷⁸ See Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1931-32 (1991) (citing savings and loan crisis and excessively optimistic financial projections as contributing factors); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. REG. 119, 178 (1992) ("The collapse of the junk bond market and the corresponding credit crunch, caused by banking and financial services sector weakness and new government policies restricting financial institutions' holding of high yield debt, surely contributed to the decline in takeovers.").

⁷⁹ Randall Smith, *Merger Activity Fell for Third Year in a Row*, WALL ST. J., Jan. 2, 1992, at R4.

⁸⁰ SECURITIES DATA COMPANY, THE 1991 DOMESTIC MERGER YEARBOOK 9 (1991).

⁸¹ See *supra* notes 54-57 and accompanying text.

porations.⁸² To date, courts have not applied these statutes more broadly to other corporate law issues.⁸³ This limited judicial construction must not foreclose the application of these statutes to new concepts. Both the language and the policies underlying these statutes support an application of these statutes to a broader array of corporate issues in the future.⁸⁴ As one commentator has stated, “[t]hey have ... certainly not yet brought ‘revolution’ or ‘radical’ change to corporate law. The full legal implications of constituency statutes remain to be seen.”⁸⁵

This Note proposes that the wane of hostile takeovers should not render constituency statutes moot. Rather, the courts should apply the statutes to entrepreneurial firms, enabling them to consider the interests of all stakeholders in making corporate decisions. It is asserted that entrepreneurial firms, unlike mature close corporations, are particularly suited to the best interests of the corporation model of corporate governance. Because entrepreneurial firms are essentially the initial start-up phase of corporations which may become public upon maturity, it is reasonable to apply the best interests standard from the outset. Utilizing these statutes as standards of behavior for entrepreneurial firms will result in more profitable, efficient, and socially responsible corporations.

II. THE CURRENT STANDARD FOR CLOSELY HELD BUSINESSES

A. *Intracorporate Disputes*

A close corporation is a corporation whose shares are held by a relatively small number of persons, whose shareholders are the managers of the corporation, and whose shares are devoid of a ready market.⁸⁶ Unlike their counterparts in public corporations,

⁸² See *supra* notes 42-46 and accompanying text.

⁸³ See Orts, *supra* note 5, at 34.

⁸⁴ *Id.*

⁸⁵ *Id.* at 34-35.

⁸⁶ The Model Statutory Close Corporation Supplement defines the close corporation as follows:

§ 3. Definition and Election of Statutory Close Corporation Status

(a) A statutory close corporation is a corporation whose articles of incorporation contain a statement that the corporation is a statutory close corporation.

(b) A corporation having 50 or fewer shareholders may become a statutory close corporation by amending its articles of incorporation to include the statement required by subsection (a). The amendment must

noncontrolling shareholders in close corporations are particularly vulnerable when disagreements develop with the controlling shareholders.⁸⁷ Controversy may arise for a number of reasons, including divergent opinions relating to corporate policy⁸⁸ or personality clashes between shareholders.⁸⁹ In some respects, shareholders act as "partners" in the corporation, suggesting the need for fiduciary duties similar to those in the partnership context.⁹⁰ Shareholders, however, are fundamentally different from

be approved by the holders of at least two-thirds of the votes of each class or series of shares of the corporation, voting as separate voting groups, whether or not otherwise entitled to vote on amendments. If the amendment is adopted, a shareholder who voted against the amendment is entitled to assert dissenters' rights under [MBCA ch. 13].

MODEL STAT. CLOSE CORP. SUPP. § 3, reprinted in CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES, MATERIALS AND FORMS (Melvin Aron Eisenberg, ed., 1995); see DEL. CODE ANN. tit. 8, § 342 (1991); *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 511 (Mass. 1975) (characterizing close corporation as being defined 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").

One popular definition states that a "close corporation is a corporation whose shares are not generally traded in the securities market." F. HODGE O'NEAL & ROBERT B. THOMPSON, *CLOSE CORPORATIONS: LAW AND PRACTICE* 1.02 (3d ed. 1992).

⁸⁷ See Kathleen L. Kuhlman, *Beyond Crosby v. Beam: Ohio Courts Extend Protection of Minority Stockholders of Close Corporations*, 27 AKRON L. REV. 477, 478 (1994) (noting that vulnerability of minority stockholder is distinguishing characteristic of close corporations); Adam Chernichaw, Note, *Oppressed Shareholders in Close Corporations: A Market-Oriented Statutory Remedy*, 16 CARDOZO L. REV. 501, 508 (1994) (describing various vulnerabilities of minority stockholder in close corporations).

⁸⁸ See Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 3 (1982).

⁸⁹ See *id.*

⁹⁰ In partnership law, the standard of conduct is more than good faith. Chief Judge Cardozo articulated the higher standard as "[n]ot honesty alone, but the punctilio of an honor the most sensitive..." *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928); see *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969). Justice Traynor described the fiduciary duty owed by majority shareholders to minority shareholders as follows:

[M]ajority shareholders, either singly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's

partners. Partners face unlimited liability,⁹¹ thereby requiring the additional protection provided by the fiduciary duties of partnership law.⁹² Shareholders, on the other hand, enjoy limited liability,⁹³ and therefore need less protection.⁹⁴ The fiduciary duties found in partnership law are tempered in their application to corporate law. In order to comply with their fiduciary duties, shareholders must show good faith⁹⁵ and exhibit a legitimate business purpose.⁹⁶ If the controlling shareholders meet this threshold, the burden shifts to the noncontrolling shareholders to "demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest."⁹⁷

In recognition of the risks borne by noncontrolling shareholders, a number of states adopted remedial legislation providing them with the remedy of dissolution for specific conduct.⁹⁸

business.

Jones, 460 P.2d at 471; see *Donahue*, 328 N.E.2d at 515 (holding that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another").

⁹¹ UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 456 (1995); REV. UNIF. PARTNERSHIP ACT § 306, 6 U.L.A. 45 (1995).

⁹² See Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 424-66 (1987) (discussing fiduciary duty in partnership as one of its main shields against unfair dealings).

⁹³ See WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS* 117 (7th ed. 1995). "General partners are personally liable for obligations that arise out of the conduct of their business. In contrast, shareholders of a corporation are not personally liable for corporate obligations. This legal rule is conventionally expressed by the statement that shareholders have limited liability." *Id.*

⁹⁴ See, e.g., Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 390 (1992).

⁹⁵ See *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976) (stating that such "selfish ownership, in the corporation ... should be balanced against the ... [majority's] fiduciary obligation to the minority.>").

⁹⁶ *Id.*

In asking this question, we acknowledge the fact that the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation. It must have a large measure of discretion, for example, in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.

Id.

⁹⁷ See *Wilkes*, 353 N.E.2d at 663; see also *Hallahan v. Haltom Corp.*, 385 N.E.2d 1033, 1034 (Mass. App. Ct. 1979); *Daniels v. Thomas, Dean & Hoskins, Inc.*, 804 P.2d 359, 366 (Mont. 1990).

⁹⁸ See *supra* note 12 and accompanying text (listing states which have passed statutes granting remedy of involuntary dissolution).

New York, for example, enacted section 1104-a of the Business Corporation Law.⁹⁹ This statute provides for the dissolution of a close corporation when "... those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders"¹⁰⁰ The term "oppressive conduct," as used in the statute, has proved difficult to define. The issues of what may be deemed oppressive conduct and what justifies the dissolution of a close corporation were left to the courts to determine.¹⁰¹

B. *Oppressive Conduct and the Reasonable Expectations Analysis*

In *In re Kemp & Beatley, Inc.*,¹⁰² the court addressed the appropriate standard for oppressive conduct triggering involuntary dissolution in a close corporation.¹⁰³ The plaintiffs seeking dissolution were two long-term, key employees of the defendant, a

⁹⁹ N.Y. BUS. CORP. LAW § 1104-a provides:

(a) The Holders of twenty percent or more of all outstanding shares of a corporation, other than a corporation registered as an investment company under an act of congress entitled "Investment Company Act of 1940", no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or an affiliated securities association, who are entitled to vote in an election of directors may present a petition of dissolution on one or more of the following grounds:

- (1) The directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders;
- (2) The property or assets of the corporation are being looted, wasted, or diverted for non-corporate purposes by its directors, officers or those in control of the corporation.

(b) The court, in determining whether to proceed with involuntary dissolution pursuant to this section, shall take into account:

- (1) Whether liquidation of the corporation is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment; and
- (2) Whether liquidation of the corporation is reasonable necessary for the protection of the rights and interests of any substantial number of shareholders or of the petitioners....

N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986).

¹⁰⁰ *Id.* § 1104-a(a)(1).

¹⁰¹ See *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1178 (1984); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1467 (1989) (discussing reasonable expectation standard and oppressive conduct standard in case law).

¹⁰² *Kemp & Beatley*, 473 N.E.2d at 1173.

¹⁰³ *Id.* at 1179.

close corporation.¹⁰⁴ The plaintiffs were two of eight shareholders and held 20.33% of the corporation's total outstanding stock.¹⁰⁵ It was a long-standing practice within the corporation to make year-end distributions to shareholders and, in the event a shareholder retired, for the corporation to buy out the retiree.¹⁰⁶ When the plaintiffs were no longer employees of the corporation (although they retained their equity in the corporation), the corporation changed its policy so that earnings were no longer based upon shareholder status, but upon service rendered.¹⁰⁷ This policy thus eliminated any chance for plaintiffs to receive a return on their investments.¹⁰⁸ As a result, plaintiffs sought dissolution pursuant to New York Business Corporation Law section 1104-a.¹⁰⁹ They argued that the directors' "fraudulent and oppressive" conduct rendered their stock "a virtually worthless asset."¹¹⁰

In its finding of oppressive conduct, the Court of Appeals affirmed the trial court's holding in favor of the plaintiffs.¹¹¹ Because the majority did not proffer an alternative course of action more favorable to the minority, the court determined that the fairest result required a buyout option, even though the minority did not request it.¹¹² In so holding, the court adopted a "reasonable expectations" analysis.¹¹³ When considering the mi-

¹⁰⁴ *Id.* at 1176.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Kemp & Beatley*, 473 N.E.2d at 1180.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 1176.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 1180.

¹¹² *Kemp & Beatley*, 473 N.E.2d at 1181.

¹¹³ *Id.*; see *Meiselman v. Meiselman*, 307 S.E.2d 551, 558 (N.C. 1983). In *Meiselman*, Judge Frye stated that:

Professor O'Neal, perhaps the foremost authority on close corporations, points out that many close corporations are companies based on personal relationships that give rise to certain 'reasonable expectations' on the part of those acquiring an interest in the close corporation. Those 'reasonable expectations' include, for example, the parties' expectation that they will participate in the management of the business or be employed by the company.

Meiselman, supra, at 558. This doctrine has become more and more accepted. See Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy For Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25 (1987).

The reasonable expectations doctrine has been gaining wide acceptance in the past few years. Decisions in at least eight states have explicitly adopted this concept, and decisions in at least nine additional states have implicitly recognized it. The approval of the reasonable expectations doctrine by the New York Court of Ap-

nority's petition for dissolution, a court must look to what the majority shareholders knew, or should have known, the minority's expectations were in entering the business endeavor.¹¹⁴ Those expectations, viewed objectively, must be "both reasonable under the circumstances and ... central to the petitioner's decision to join the venture."¹¹⁵ These expectations may not take into account hope and desire for success because disappointment in and of itself is not a ground for dissolution.¹¹⁶

C. *Controlling Shareholders and Their Right to Consider the Interests of All Stakeholders*

In essence, the reasonable expectations test, a doctrine accepted in several states,¹¹⁷ bestows upon controlling shareholders an obligation to ensure that corporate decisions conform to the reasonable expectations of the noncontrolling shareholders.¹¹⁸ They may not deprive the latter of the ability to receive a return on their investment.¹¹⁹ In the case of entrepreneurial firms, this

peals in the 1984 case of *In re Kemp & Beatley, Inc.* is quite significant and will undoubtedly influence other courts. *Id.* at 37-38 (footnotes omitted). *But see* Hillman, *supra* note 88, at 77 (submitting need for limitations under reasonable expectations test, including showing by dissatisfied participant that "(1) he or she became a participant because of a substantial expectation or set of expectations known or assumed by the other participants; (2) that the prospect that the expectation will be achieved is unlikely; and (3) that the failure to achieve the expectation was in large part beyond the control of the participant").

¹¹⁴ See *Kemp & Beatley*, 473 N.E.2d at 1179.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ See *Stefano v. Coppock*, 705 P.2d 443, 446 n.3 (Alaska 1985); *Smith v. Leonard*, 876 S.W.2d 266, 272 (Ark. 1994); *Bauer v. Bauer*, 54 Cal. Rptr. 2d 377, 381 (Cal. Ct. App. 1996); *Retzer v. Retzer*, 578 So. 2d 580, 594 (Miss. 1990); *Balvik v. Sylvester*, 411 N.W.2d 383, 387-88 (N.D. 1987); *Gee v. Blue Stone Heights Hunting Club, Inc.*, 604 A.2d 1141, 1145 (Pa. Commw. Ct. 1992).

¹¹⁸ See, e.g., *Balvik*, 411 N.W.2d at 388 (finding that in light of "fiduciary duty" and "reasonable expectation" concepts, minority shareholder who had been "frozen-out" was entitled to relief); *Meiselman v. Meiselman*, 307 S.E.2d 551, 563 (N.C. 1983) (finding that shareholder's rights in corporation include shareholder's reasonable expectations and these rights are to be protected by courts in shareholder suits); *Kemp & Beatley*, 473 N.E.2d at 1179-80 (upholding order of dissolution where majority shareholder's conduct "substantially defeat[ed] expectations that, objectively viewed, were both reasonable under circumstances and were central to petitioner's decision to join the venture."). See generally O'NEAL & THOMPSON, *supra* note 86 (positing that minority shareholders are entitled to enforce certain reasonable expectations, including voice in management).

¹¹⁹ See J.C. Bruno, "Reasonable Expectations" - A Primer on an Oppressive Standard, 71 MICH B. J. 434, 434-35 (1992) (citing O'NEAL & THOMPSON, *supra* note 86, suggesting that minority shareholders are entitled to enforce rights to return on

Note asserts that compliance with nonshareholder constituency statutes should preclude the application of the reasonable expectations test. Although noncontrolling shareholders must be afforded protection from freeze-outs by controlling shareholders, good faith corporate decisions which may be deemed oppressive should not subject entrepreneurial firms to involuntary dissolution.

III. APPLICATION OF THE BEST INTEREST OF THE CORPORATION MODEL TO ENTREPRENEURIAL FIRMS

It is asserted that, in most circumstances, corporate decisions made by the controlling shareholders of entrepreneurial firms will meet both the reasonable expectations test and conform to the best interests of the corporation model. In the unusual situation, however, in which a decision by an entrepreneurial firm made in the best interests of the corporation fails to meet the reasonable expectations of the noncontrolling shareholders, the standard provided by the nonshareholder constituency statutes should trump the reasonable expectations test.

Entrepreneurial firms are in a unique position with regard to the majority of closely-held corporations. Many would argue that most people go into business for one reason and one reason only: to make money.¹²⁰ This author loathes to embrace that assertion as the eleventh commandment. Entrepreneurs, on the other hand, are motivated by *freedom*.¹²¹ They value the freedom to be independent and autonomous—to start a business and work toward creating an empire. Entrepreneurs need to be free

investment); see also *Balvik*, 411 N.W.2d at 387-88 (finding that where minority shareholder has been frozen-out by termination of employment and thereby denied primary means for obtaining return on investment, minority shareholder was entitled to relief).

¹²⁰ George B. Hall, *Keep the "Advertising" in "Advertising Injury," Part Two*, 23 MEALEY'S LITIG. REP. 17 (Intell. Prop. 1996) ("In a business venture, virtually every activity is designed to make money and therefore to promote the business enterprise."); cf. Joseph A. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 FORDHAM L. REV. 227, 233 (1990) (noting that while subsidiary corporation is not in business to make money for itself, it exists "to generate profits for its parent or its parent's shareholders").

¹²¹ See WILSON HARRELL, FOR ENTREPRENEURS ONLY 150 (1994).

It is the quest for *freedom* that fuels the entrepreneurial spirit. Free to be your own person; free to get your head above the crowd; free to have an idea, and turn that idea into a company, and that company into an empire, if you can.

Id. (emphasis in original).

to take an idea and implement it according to their own business plan, without noncontrolling shareholders impeding the growth process. Most importantly, entrepreneurs should be free to consider their employees, customers, and fellow owners. Finally, the entrepreneurial mind behind the venture should be able to reward employees for commendable work.¹²²

Pursuing this dream of freedom involves risk-taking. Risk is highly influential on corporate strategy. Risk-averters prize conservative strategies that return a guaranteed profit.¹²³ Risk-takers, on the other hand, thrive on opportunities where boldness may generate great wealth.¹²⁴ Moderate risk-taking is a characteristic of entrepreneurial behavior.¹²⁵ Entrepreneurs crave innovation and strategic offense while eschewing imitation and defensive conservatism.¹²⁶

Entrepreneurs who control a majority interest in close corporations must retain an unbridled prerogative to put short-term earnings on the backburner for the sake of the corporation and its future.¹²⁷ In order to see the dream to fruition, an entrepre-

¹²² Charlie Baum, an early Wal-Mart partner, was quoted as saying:

I've known Sam since his first store in Newport, Arkansas, and I believe that money is, in some respects, almost immaterial to him. What motivates the man is the desire to absolutely be on top of the heap. It is not money. Money drives him crazy now. His question to me at 6 A.M. not long ago was 'How do you inspire a grandchild to go to work if they know they'll never have a poor day in their life?'

SAM WALTON WITH JOHN HUEY, SAM WALTON: MADE IN AMERICA. MY STORY 8-9 (1992).

¹²³ See Walter Adams & James W. Brock, *Predation, "Rationality" and Judicial Somnambulance*, 64 U. CIN. L. REV. 811, 866 (1996) (describing risk-averters as those who "systematically prefer smaller, but more certain gains over larger but less likely gains").

¹²⁴ See THOMPSON & STRICKLAND, *supra* note 6, at 46; see also Ronald Henkoff, *Inside America's Biggest Private Company*, FORTUNE, July 13, 1992, at 83 ("The essence of Cargill's philosophy is patience. Take calculated risks, reinvest gains, and hang on for the long haul.").

¹²⁵ Yvon Gasse, *Elaborations on the Psychology of the Entrepreneur*, in ENCYCLOPEDIA OF ENTREPRENEURSHIP 57-58 (Calvin A. Kent et al. eds., 1982) ("There is a good deal of agreement about the attitudes and motives that characterize the entrepreneur: independence, desire for prestige, desire for power, internal locus-of-control belief, control, high involvement, strong self-actualization and moderate risk-taking.").

¹²⁶ "I'm a pretty conservative guy. But for some reason in business, I have always been driven to buck the system, to innovate, to take things beyond where they've been ... [I]n the marketplace, I have always been a maverick who enjoys shaking things up and creating a little anarchy." WALTON, *supra* note 122, at 47-48.

¹²⁷ "[I]f minority shareholders create pressure for short-term profitability at the expense of long-term prosperity of the enterprise, prudent management dictates the

neur must spend money. If the entrepreneur feels that a new computer system or a better phone system is crucial to the company's success, then money should be allocated as such, even if it means less payout for shareholders. An entrepreneur must aim at seizing its best growth opportunities and finding its niche rather than divesting the company of capital necessary for growth.¹²⁸ The controlling shareholders must remain steadfast in pursuit of their goals rather than resigning themselves to the pressures of the noncontrolling shareholders and/or outsiders who feel the corporation should be performing in a certain way.¹²⁹

The controlling shareholders of entrepreneurial firms must be free to pursue corporate objectives without the fear that it does not conform to current standards under the reasonable expectations test. It is true that noncontrolling shareholders have certain expectations when entering into a venture.¹³⁰ Nevertheless, the reasonable expectations test as a sole form of analysis for entrepreneurs must be rejected.¹³¹ The reasonable expecta-

elimination of the minority." Thomas W. Maddi, Note, *Nodak Bankcorporation v. Clark and Lewis v. Clark: Squeezing out "Squeeze-Out" Mergers Under the National Bank Act*, 51 WASH. & LEE L. REV. 763, 774-75 (1994).

¹²³ Anne Wells Branscomb, *Lessons From the Past: Legal and Medical Databases*, 35 JURIMETRICS J. 417, 448 (1995) ("A fundamental building block of public policy is to encourage information entrepreneurs to look for and serve niches in the mosaic of useful information and knowledge to build economic strength [and] create new jobs"); see Bruce Alan Mann & Marcus D. Wilkinson, *The Role of Counsel in Venture Capital Transactions If Disputes Arise*, 583 PLI/COMM. 393, 401 (1991) (noting that private companies rely primarily on earning reinvestment for growth).

¹²⁵ See WALTON, *supra* note 122, at 107-08.

As business leaders, we absolutely cannot afford to get all caught up in trying to meet the goals that some retail analyst or financial institution in New York sets for us on a ten-year plan spit out of a computer that somebody set to compound at such-and-such a rate. If we do that, we take our eye off the ball

.....

If we fail to live up to somebody's hypothetical projection for what we should be doing, I don't care. It may knock our stock back a little, but we're in it for the long run. We couldn't care less about what is forecast or what the market says we ought to do. If we listened very seriously to that sort of stuff, we never would have gone into small-town discounting in the first place.

Id.

¹³⁰ *Meiselman v. Meiselman*, 307 S.E.2d 551, 563 (N.C. 1983) (suggesting that courts should determine reasonable expectations on case by case basis); see also *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 662 (Mass. 1976) (noting that these expectations may include shareholders' expectations to participate in management of corporation).

¹³¹ Sandra K. Miller, *Should the Definition of Oppressive Conduct by Majority Shareholders Exclude a Consideration of Ethical Conduct and Business Purpose?*, 97

tions test is tenable in situations where the impetus of controlling shareholders' decision making is the looting or diverting corporate assets—truly oppressive conduct.¹³² But when both parties act in good faith, the corporate governing mode should focus on the well being of the *company* and its future. The current standard is problematic because entrepreneurs who consider the corporation as a whole may be subject to involuntary dissolution.¹³³ Employing the reasonable expectations test as the primary benchmark arguably creates a fiduciary duty owed by the controlling to the noncontrolling shareholders.¹³⁴ The reasonable expectations test affords primacy to shareholders, while ignoring the interests of other stakeholders such as employees, creditors and the community.¹³⁵ An approach which affords primacy to compliance with nonshareholder constituency statutes will allow entrepreneurial firms the freedom to make necessary corporate decisions without undue fear of repercussions.

CONCLUSION

Entrepreneurs should be allowed to balance the interests of all constituents, including shareholders, employees, and the surrounding community. Under the current standards of governance for close corporations the application of the reasonable expectations test may unduly restrict decisions by the controlling shareholders. The freedom provided by the best interests of the corporation model will allow entrepreneurial firms to grow and compete at the highest level of efficiency. The standard provided by the nonshareholder constituency statutes, therefore, should

DICK. L. REV. 227, 233 (1993).

¹³² See, e.g., *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1180 (N.Y. 1984).

¹³³ See *supra* notes 98-116 and accompanying text (discussing remedy of involuntary dissolution for conduct deemed oppressive).

¹³⁴ See Joseph W. Barlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 612-13 (1995) (discussing reasonable expectations approach as theory of liability for breach of fiduciary duty); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193 (1988) (arguing for enhanced fiduciary relationship between majority and minority shareholders using reasonable expectation standard).

¹³⁵ See Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 533 (1994) ("Exclusive use of the reasonable expectation standard may not always be appropriate ... [T]here may be many minority interests with equally legitimate but conflicting reasonable expectations ... [or] the majority's conduct may violate a minority member's reasonable expectations, but still further a legitimate business purpose.").

trump the application of the reasonable expectations test. Applying the best interests of the corporation model to close corporations and affording the ability to consider the interests of all corporate stakeholders, is ideal. The freedom to innovate, create and pursue long-term goals will result in a better, more profitable corporation for shareholders, stakeholders, and ultimately, society.

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