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TOWARD A DELAWARE COMMON LAW OF CLOSELY HELD CORPORATIONS

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INTRODUCTION

In the twentieth century, Delaware corporate law has swept the nation. Delaware's enabling philosophy of corporate law seeks to maximize managerial flexibility.¹ Because managers usually determine the state of incorporation, it comes as no surprise that Delaware is the domicile of choice for large, publicly held corporations.² Because states have an interest in generating the franchise fees that result from attracting incorporations,³ Delaware corporate law has been transformed into something akin to a national law of corporations as other states follow its lead.⁴ Although critics

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1. See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1481 (1989) (noting that "Delaware is usually taken as the apotheosis of enabling statutes"); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 123 n.192 (1991) (noting that "Delaware has fashioned what is predominantly an enabling statute that accommodates rather than restricts private ordering"). The other major philosophy of corporate law is the regulatory approach, which creates mandatory rules of corporate behavior and seeks to maximize shareholder protection. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1101 (1997) (contrasting the Delaware enabling model with a regulatory approach that, at its extreme, prohibits anything not expressly permitted by the corporation statute). As noted by its reporter, the Revised Model Business Corporation Act, promulgated in 1984, was designed to strike a balance between the enabling and regulatory approaches. See Robert W. Hamilton, *Reflections of a Reporter*, 63 TEX. L. REV. 1455, 1466-68 (1986).

2. Recent studies show that more than half the companies in the Fortune 500 and more than 40% of the companies traded on the New York Stock Exchange were incorporated in Delaware. See LEWIS D. SOLOMON ET AL., *CORPORATIONS: LAW AND POLICY* 6 (4th ed. 1998). Further, 82% of public firms that chose to reincorporate between 1960 and 1982 did so in Delaware. See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 244-45 (1985).

3. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 6-8 (1993) (noting that Delaware collected over \$200 million in franchise taxes in 1990, which accounted for 17.7% of the state's tax revenues). For an essay detailing New Jersey's early lead in the competition to attract franchise fees and the events that led to Delaware's ultimate victory, see Andrew G.T. Moore II, *A Brief History of the General Corporation Law of the State of Delaware and the Amendatory Process*, in 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* H-1 (3d ed. 1999).

4. One commentator has argued that other states have followed Delaware's statutory lead to the point that there is little significant difference in statutory approaches among the states. See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD.

may dispute whether the states are racing to the bottom⁵ or the top⁶ in copying Delaware corporate law, there can be no dispute that Delaware is winning the race.

There is, however, one area in which Delaware corporate law is starkly at odds with the rest of the nation. This area, now almost a quarter-century old, involves the special rights and obligations of shareholders in closely held corporations. In the landmark case of *Donahue v. Rodd Electrotype Co.*,⁷ the Massachusetts Supreme Judicial Court defined a closely held corporation as having: “(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.”⁸ *Donahue* recognized that shareholders in closely held corporations have a different set of expectations and vulnerabilities than do shareholders in publicly held corporations. Shareholders in small corporations often expect to run their businesses in the manner of a partnership rather than in the more formal

251, 255 (1977). Delaware’s common law has received similar respect among the several states. See, e.g., *Kamen v. Kemper Fin. Serv., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990) (describing Delaware as “the Mother Court of corporate law”), *rev’d on other grounds*, 500 U.S. 90 (1991); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) (noting that “Indiana takes its cues in matters of corporation law from the Delaware courts”), *rev’d on other grounds*, 481 U.S. 69 (1987); see also Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1969 (1991) (arguing that “the Delaware Supreme Court remains the national supreme court on corporate law”).

5. Proponents of the race-to-the-bottom theory argue that, in the absence of federal regulation, states have no choice but to compete with Delaware in relaxing corporate regulations to make their jurisdictions more attractive to managers who make incorporation decisions. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974); see also Lucien A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1509-10 (1992) (concluding that state competition is undesirable where the interests of managers and controlling shareholders diverge from the interests of public shareholders or the public at large). Although Professors Cary and Bebchuk argue for federal intervention to prevent the worst abuses of the state competition system, they do not propose the complete displacement of state corporate law by federal law. Other commentators, however, have gone further and argued for the federal chartering of corporations to protect the rights of shareholders and the public. See RALPH NADER ET AL., *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR FEDERAL CHARTERING OF GIANT CORPORATIONS* (1976); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

6. Law and economics scholars argue that market forces require managers to select the jurisdiction of incorporation that maximizes share value by offering the most efficient corporate rules. See Romano, *supra* note 2, at 265-73; Winter, *supra* note 4; see also FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 222 (1991) (arguing that, although the competition for incorporations may not make state law entirely efficient, “competition creates a powerful tendency for states to enact laws that operate to the benefit of investors”). Proponents of this race-to-the-top view argue that Delaware’s dominance in the corporate arena demonstrates that its enabling approach to corporate regulation is the most efficient approach.

7. 328 N.E.2d 505 (Mass. 1975). For a discussion of *Donahue*, see *infra* Part I.A.

8. *Id.* at 511. Much of this article refers to “majority” stockholders and “controlling” stockholders. These terms are used interchangeably to designate that person or group with sufficient power to make corporate decisions.

manner of a public corporation.⁹ Minority shareholders in a closely held corporation face constant danger that those in control will improperly deny minority shareholders their fair share of the corporation's income stream.¹⁰ In light of the practical realities of closely held corporations, the *Donahue* court held that stockholders in closely held corporations owe one another a fiduciary duty of fair treatment.¹¹ Although courts have differed in their conceptions of what this duty entails, the overwhelming national view has been to recognize the duty and define its contours on a case-by-case basis.¹²

The Delaware Supreme Court first considered the problem of closely held corporations only recently. Given Delaware's focus on large publicly held corporations, this fact is hardly surprising. In 1993, in *Nixon v. Blackwell*,¹³ the Delaware Supreme Court considered "[w]hether there should be any special, judicially-created rules to 'protect' minority shareholders of closely held Delaware corporations."¹⁴ The court emphatically declined to create any such special rules.¹⁵ If *Nixon* is to be read literally, much of what the rest of the country accepts as illegal conduct in the close corporation sphere has no remedy in Delaware. Further, given Delaware's status as a leader in the creation of national corporate law, *Nixon* may signify the beginning of the decline of special legal status for closely held corporations.

In light of the Delaware Supreme Court's decision in *Nixon*, does Delaware law provide a license for oppression of minority shareholders in closely held corporations? This article explores the extent to which Delaware common law may be expected to prevent such an outcome.

Part I of this article examines the national law on shareholder rights and obligations in closely held corporations. It will focus on the types of majority shareholder misconduct that have been thought sufficient to justify judicial intervention in the close corporation context. Part II examines the limited Delaware case law on closely held corporations. A close analysis of *Nixon* reveals that, although the court's refusal to create special rules for closely held corporations is broadly stated, *Nixon* did not involve egregious misconduct by a controlling shareholder. Indeed, the specific result in *Nixon* might well have been reached in jurisdictions that do impose special

9. *See id.* at 512.

10. *See id.* at 513 (describing a variety of freezeout techniques available to majority shareholders in closely held corporations).

11. *Id.* at 515 (quoting *Cardullo v. Landau*, 105 N.E. 2d 843 (1952)) (establishing standard of "utmost good faith [and] loyalty").

12. *See infra* Part I.

13. 626 A.2d 1366 (Del. 1993). The *Nixon* case is discussed in Part II.B, *infra*.

14. *Id.* at 1379.

15. *See id.* at 1379-81.

obligations on shareholders in closely held corporations. There is, therefore, some reason to doubt that the Delaware courts will allow oppression by a controlling party in a case where the problem is squarely presented.

Part III explores the extent to which the Delaware law applicable to corporations generally, including publicly held corporations, provides protection for minority shareholders in closely held corporations. In particular, controlling shareholders in all corporations have a duty of entire fairness when engaging in self-dealing transactions. Delaware, despite its general enabling philosophy, has applied the entire fairness test rigorously to protect the rights of minority shareholders. Part III argues that the Delaware entire fairness test provides a rubric that may be used to deal with most, if not all, of the special situations in which other states have provided remedies to minority shareholders in closely held corporations. In Part IV, the article concludes that, when confronted with appropriate cases, there is reason to believe that Delaware law in the close corporation context will turn out to be similar to that of the rest of the nation.

I. THE PREVAILING NATIONAL MODEL: PROTECTING THE RIGHTS OF MINORITY SHAREHOLDERS IN CLOSELY HELD CORPORATIONS

A. *The Creation of Fiduciary Duties*

In publicly held corporations, shareholders generally owe no duties to each other.¹⁶ An exception to this rule involves the duties of controlling shareholders engaged in self-dealing transactions, which are discussed in Part III. In contrast, courts have ascribed special duties to shareholders in closely held corporations in recognition of the special attributes of such corporations.¹⁷

The traditional model of the publicly held corporation treats shareholders as passive investors. It is the directors' job to supervise management of the corporation's affairs.¹⁸ Shareholders who are also employees have no special

16. See *infra* note 191.

17. The classic works on the special attributes of and the legal rules relating to closely held corporations are F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3d ed. 1998) [hereinafter O'NEAL & THOMPSON, CLOSE CORPORATIONS] and F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1997) [hereinafter O'NEAL & THOMPSON, OPPRESSION].

18. See DEL. CODE ANN. tit. 8, § 141(a) (1998). In exercising their statutory duties, directors have no obligation to conform to the wishes of shareholders. See, e.g., Alabama By-Prod. Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995) (noting that "directors, rather than shareholders, manage the business and affairs of the corporation"). Of course, "if the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn

rights as employees relative to nonshareholder employees.¹⁹ If the corporation is profitable, whether to declare dividends or reinvest the profits is a classic exercise of the board's business judgment.²⁰ Shareholders who are unhappy with the board of directors have two basic avenues of protest: they can engage in a proxy fight to replace the current board, or they can sell their stock.

An entirely different set of assumptions and practical realities applies to the closely held corporation. Shareholders in closely held corporations often expect to participate in the corporation's management, and closely held corporations usually distribute the bulk of their profits in the form of salaries rather than dividends.²¹ Indeed, shareholders may well invest in a closely held corporation for the purpose of providing themselves with jobs and salaries.²²

In closely held corporations, minority shareholders are particularly vulnerable. The minority is constantly at risk that the majority will divert to itself a disproportionate share of the corporation's income stream.²³ Moreover, in closely held corporations, the minority is at risk of a particular kind of self-dealing whereby the majority seeks to appropriate all or a portion of the minority's investment. The majority may "freeze out" minority shareholders by denying them employment and failing to pay dividends.²⁴

the board out." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985). For an argument that the traditional model of shareholder passivity is no longer entirely accurate even in publicly held corporations, and that shareholder activism provides a check on managerial discretion in the takeover defense context, see Robert A. Ragazzo, *The Legitimacy of Takeover Defense in the '90s*, 41 DEPAUL L. REV. 689, 731-35 (1992).

19. See *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 577 (7th Cir. 1996) (arguing that applying a "fiduciary" duty to every baggage handler at United Airlines just because the employee owns a share of stock would put employee-owned firms at such a competitive disadvantage that they would soon collapse").

20. See *infra* text accompanying notes 65-67.

21. See, e.g., 1 O'NEAL & THOMPSON, *CLOSE CORPORATIONS*, *supra* note 17, § 6.02, at 2 (noting that "[u]nderstandably, a person may be unwilling to embark his savings in a new enterprise unless he is assured of a continuing voice in the management of the business" and that "the usual practice in a close company is to distribute a high percentage of company earnings in the form of salaries rather than as dividends").

22. For example, in *Ueltzhoffer v. Fox Fire Dev. Co.*, 1991 Del. Ch. LEXIS 204 (Del. Ch. 1991), *aff'd*, 618 A.2d 90 (Del. 1992), discussed *infra* in Part II.A, the court noted that the timing of the formation of a closely held corporation was propitious because the subordinate shareholder was "out of work" and the father of the controlling shareholder "had some interest in finding a project that his daughter . . . could handle." *Id.* at *3.

23. See *infra* Part I.B.

24. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 664 (Mass. 1976) (finding that the discharge of a minority shareholder-employee by a close corporation that paid no dividends was "a designed 'freezeout' for which no legitimate business purpose has been suggested"); *In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1181 (N.Y. 1984) (holding that the discharge of minority shareholders by a corporation that paid no dividends amounted to an illegal

Because shares in closely held corporations lack a public market, the minority has great difficulty selling its stock to realize capital appreciation or even to receive a return-of-capital.²⁵ Often the majority employs a freezeout technique to coerce minority stockholders to sell their shares to the majority at bargain prices.²⁶

In *Donahue v. Rodd Electrotype Co.*,²⁷ the Massachusetts Supreme Judicial Court took note of the distinguishing characteristics of closely held corporations²⁸ and held 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.”²⁹ Although *Donahue* denominated this newly created shareholder duty as “fiduciary” in nature, this designation is a misnomer. A true fiduciary is required to act in a nonselfish manner for the benefit of some other party. Classic examples are trustees acting on behalf of beneficiaries and agents acting on behalf of principals.³⁰ However, controlling shareholders in closely held corporations, like all other shareholders, have legitimate selfish interests. Thus, the “fiduciary” duty recognized in *Donahue* is really a duty to act fairly toward

“squeeze-out”); see generally 1 O’NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, ch. 3 (describing a variety of freezeout techniques).

25. See generally 1 O’NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 2.15. Closely held corporations often have provisions restricting the transferability of shares. See DEL. CODE ANN. tit. 8, §§ 202(c) (1998) (permitting designated categories of transfer restrictions); § 342(a)(2) (making the existence of a stock transfer restriction a prerequisite to the election of statutory close corporation status). Although such provisions serve a legitimate purpose in allowing founding shareholders control over the introduction of new investors, they exacerbate the problem of illiquidity in closely held corporations.

Two commentators have argued that the best solution to the predicament of minority shareholders is to allow them a permanent right to sell their shares to the corporation at fair value. See John Hetherington & Michael Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977). But see EASTERBROOK & FISCHER, *supra* note 6, at 238-43 (arguing that an absolute buyout right would place too great a burden on most closely held corporations).

26. See *infra* Part I.B.5.

27. 328 N.E.2d 505 (Mass. 1975).

28. See *id.* at 511-15.

29. *Id.* at 515. For other cases holding that shareholders in a closely held corporation have the same duties as partners, see *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Comolli v. Comolli*, 246 S.E.2d 278 (Ga. 1978); *Cressy v. Shannon Continental Corp.*, 378 N.E.2d 941 (Ind. Ct. App. 1978). Although the typical context involves the application of fiduciary duties to majority shareholders, minority shareholders may also have such duties when they have the ability to exercise power over corporate action. See *Smith v. Atlantic Prop., Inc.*, 422 N.E.2d 798 (Mass. App. Ct. 1981).

30. See RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (defining “agency” as “the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and the consent by the other so to act”); RESTATEMENT (SECOND) OF TRUSTS § 2 (1959) (defining a “trust” as “a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person”).

other shareholders.

Courts have struggled with the parameters of this duty of fairness.³¹ The *Donahue* court took the position that whenever the majority receives a benefit in the corporate context, the minority must receive equal access to the same benefit.³² In *Donahue*, the court found a breach of fiduciary duty where a majority shareholder was permitted to sell his shares back to the corporation, albeit at a concededly fair price, because the minority did not receive the same opportunity.³³ The court placed special emphasis on the value of liquidity in the close corporation context.³⁴

Donahue's equal opportunity rule has proved controversial.³⁵ Indeed, the Massachusetts Supreme Judicial Court has abandoned the equal opportunity principle. Fearful that *Donahue* would unduly hinder the majority's ability to run the enterprise, the Supreme Judicial Court later held that the majority fulfills its fiduciary duty to the minority whenever it acts for a legitimate business purpose unless the minority can demonstrate that this purpose could be accomplished in an alternative manner less destructive of the minority's interests.³⁶

The Massachusetts rule measures fairness from the majority's perspective. It asks whether the majority has pursued legitimate goals rather than whether the majority's conduct has had an unfair impact upon the minority's investment.³⁷ Other states, led by New York, measure fairness from the minority's perspective. They hold that the majority breaches its fiduciary duty to the minority whenever it engages in conduct that frustrates

31. As noted by a leading commentator, however, "[d]ifferences as to the scope and meaning of the fiduciary duties under a *Donahue* standard do not detract from its widespread acceptance." Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 729 (1993).

32. See *Donahue*, 328 N.E.2d at 518-19.

33. See *id.* at 519-20.

34. See *id.* at 514-15, 518.

35. Delaware squarely rejected the equal opportunity rule in *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993); see *infra* Part II.B; see also *Toner v. Baltimore Envelope Co.*, 498 A.2d 642 (Md. 1985); *Sundberg v. Lampert Lumber Co.*, 390 N.W.2d 352 (Minn. Ct. App. 1986); *Delahoussaye v. Newhard*, 785 S.W.2d 609 (Mo. Ct. App. 1990); *EASTERBROOK & FISCHER*, *supra* note 6, at 247 (arguing that "courts have found the equal opportunity rule . . . impossible to administer"). The equal opportunity rule was adopted in the pre-*Donahue* case of *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (holding that majority shareholders breached their fiduciary duty by creating a market for their stock that was not made available to the minority) and has not been retracted by the California Supreme Court. See also James D. Cox, *Equal Treatment for Shareholders: An Essay*, 19 CARDOZO L. REV. 615 (1997) (defending the equal treatment regime).

36. See *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976).

37. For cases following the Massachusetts approach, see *Daniels v. Thomas, Dean & Hoskins, Inc.*, 804 P.2d 359 (Mont. 1990); *Crosby v. Beam*, 548 N.E.2d 217 (Ohio 1989); *Zidell v. Zidell, Inc.*, 560 P.2d 1086 (Or. 1977).

the reasonable investment expectations of the minority.³⁸ According to this view, the legitimacy of the majority's purposes is irrelevant if the minority is denied something for which it bargained, either explicitly or implicitly, at the time of investment.³⁹

In hard cases, the distinction between the Massachusetts and New York conceptions of the majority's fiduciary duty in the close corporation context might well be relevant. However, most litigated cases have been easy cases. Thus, there has been little cause to choose between the competing approaches.⁴⁰ The typical freezeout scheme is illegal, whatever the standard

38. See *In re* Judicial Dissolution of Kemp & Beatley, Inc., 473 N.E.2d 1173 (N.Y. 1984); see also *McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701 (8th Cir. 1998) (applying Minnesota law); *Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985); *Machmeier v. Southside Press, Ltd.*, 435 N.W.2d 377 (Iowa Ct. App. 1988); *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986); *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. Ct. App. 1988); *Masinter v. WEBCO Co.*, 262 S.E.2d 433 (W. Va. 1980). For a thoughtful analysis of the perspective from which fiduciary duties should be measured in closely held corporations, see Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. (forthcoming 2000).

39. Where no explicit contract exists, the concept of an implicit bargain is at the heart of the minority-centered view. The requirement that the minority's expectation at the time of investing must be "reasonable" requires a finding based on an objective standard that the majority was aware, or should have been aware, of the minority's special interests (e.g., in corporate employment). One court explained:

Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. . . . Rather, oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the [minority]'s decision to join the venture.

In re Judicial Dissolution of Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984); see also *Meiselman v. Meiselman*, 307 S.E.2d 551, 563 (N.C. 1983) (holding that "[i]n order for plaintiff's expectations to be reasonable, they must be known to or assumed by the other shareholders and concurred in by them").

Moreover, quasi-contractual language also appears in cases purportedly taking a majority-centered view. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 662-63 (Mass. 1976) (noting that "by terminating a minority shareholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture"). Although the reasonableness of a minority shareholder's expectations is usually measured as of the time of investment, one recent case holds that such expectations may evolve over time in a way that is entitled to judicial respect. See *A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997); see also *Mersilman v. Mersilman*, 307 S.E.2d 551 (N.C. 1983); 2 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 7.15, at 91 (arguing that "[t]he relevant expectations are those that exist at the inception of the enterprise, and as they develop thereafter through a course of dealing concurred in by all shareholders"). For an argument that courts should respect shareholder agreements to limit fiduciary duties in close corporations, see Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Businesses*, 66 U. COLO. L. REV. 881, 888-92 (1995).

40. See, e.g., *Steven C. Bahls, Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 322 (1990) (noting that "[a]lthough courts focusing on the majority's duty of utmost good faith and loyalty and courts focusing on the minority's reasonable

of judicial review, in any jurisdiction that accepts the basic principal that the majority owes a fiduciary duty to the minority in a closely held corporation. There is a well recognized core of minority interests that the majority may not transgress regardless of the standard of judicial review. These interests generally fall into five categories, which are discussed below.

B. The Scope of Fiduciary Duties

1. The Interest in Employment

Employees in publicly held corporations often own stock in their employers.⁴¹ It is increasingly common for public corporations to pay part of the employee's compensation in stock, stock options,⁴² or other forms that mirror the more traditional forms of equity ownership.⁴³ From the corporation's standpoint, forms of compensation that tie the employee's self-interest to that of the larger stockholder body are beneficial because they reduce the agency costs of running the enterprise.⁴⁴

From the standpoint of an employee in a publicly held corporation, however, the economic interest in stock ownership and the economic interest in employment are largely separate. As a stockholder, the employee's interest is the same as all other stockholders. The employee-stockholder seeks an expected return on his investment that adequately compensates for the risk of

expectations do take different approaches, in practice, there is little difference").

41. See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 42 (8th ed. 1998) (noting that pension funds own 17.4% of all equity securities); John Hoerr, "We're Not Going to Sit Around and Allow Management to Louse Things Up", *BUS. WK.*, May 18, 1987, at 107 (noting that "employees own at least 20% of nearly 30 publicly traded companies with more than 1,000 workers").

42. A stock option is an agreement by which the employee is granted an option to purchase a specified number of shares for a limited time, usually several years, at a fixed price. If the market price of the stock rises, the option may be profitably exercised.

43. Such forms include: stock appreciation rights (such rights allow the option holder to surrender the option to the corporation and receive, either in stock or cash, the difference between the current market value of the optioned stock and the option price); restricted stock plans (which involve the issuance of shares to an employee, typically as a bonus or at a bargain price, subject to substantial restrictions on transfer, such as the inability to sell for a specified period, that affect its value); and phantom stock plans (which credit the executive with "units" on the books of the corporation that are redeemable on death or retirement, with one "unit" being equal to the market value of one share of the corporation's stock when the "unit" is created, and with each unit being increased by the amount of dividends paid on a share of stock and by future increases in the market value of a share). See Subcommittee on Executive Compensation, ABA Section on Corporation, Banking and Business Law, *Executive Compensation: A 1987 Road Map for the Corporate Advisor*, 43 *BUS. LAW.* 185 (1987).

44. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976) (arguing that most conflicts between shareholders and managers can be minimized through incentive compensation schemes).

investing in the enterprise.⁴⁵ According to modern portfolio theory, company- and industry-specific risk can be eliminated by investing in a diverse portfolio of stocks.⁴⁶ Modern economic theory predicts, therefore, that the market provides no compensation for taking diversifiable risk.⁴⁷ As a consequence, a rational employee-shareholder should not invest too large a portion of his savings in his employer.

Such an employee's interest in his job, by contrast, is some function of the personal satisfaction that the job brings and the level of monetary compensation and other benefits that the job provides. If the employee is satisfied with his job, but comes to believe that the stock in his employer is a bad investment, the employee can simply sell the stock. If the employee desires to change jobs or is fired, but continues to believe that the stock is a good investment, the employee may continue to hold stock in his former employer. The act of changing jobs does nothing to alter the risk-return calculation that makes the stock in the employer either a good or a bad investment. Moreover, even if the employee believes that investment in the employer is worthwhile only as long as employment continues, the employee is at liberty to sell the employer's stock for noneconomic reasons at the time his job terminates.

Because these employee and stockholder interests are largely separate in a publicly held corporation, it is entirely proper that the general corporate rule provides the employee-stockholder with no special protection against discharge.⁴⁸ Indeed, an agreement between director-shareholders in a publicly held corporation permanently to maintain one of their number in an employment position is void as an illegal restraint on the board's authority to

45. The Capital Asset Pricing Model is the most accepted explanation of the relationship between risk and return. The model postulates that the expected return of an investment portfolio (ERp) is equal to the risk-free rate of return (Rf) plus the beta (which is a measure of the systematic or market-based risk of the portfolio and excludes company- and industry-specific risk) of the portfolio (Bp) multiplied by the difference between the expected rate of return on the market portfolio (ERm) and the risk-free rate of return. In symbols, $ERp = Rf + Bp(ERm - Rf)$. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 110 (2d ed. 1995).

The model makes two significant predictions: first, a portfolio's expected return will vary linearly with the beta of the portfolio, and second, since the other factors in the model represent observable constants, a portfolio's expected return will vary only in accordance with its beta. Studies have tended to verify the first but not the second of these predictions. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 782 (1985). For a significant challenge to the CAPM model, see Eugene Fama & Kenneth French, *The Cross Section of Expected Stock Returns*, 47 J. FIN. 427 (1992) (arguing that long-term returns correlate more closely with company size and price-to-book ratios than with the beta of the investment).

46. See, e.g., GILSON & BLACK, *supra* note 45, at 81-100.

47. This is the import of the Capital Asset Pricing Model. See note 45, *supra*.

48. See *Nagy v. Riblet Prod. Corp.*, 79 F.3d 572, 577 (7th Cir. 1996); see also *supra* note 19.

manage the corporation.⁴⁹ The directors owe a duty to the public shareholders who are not parties to the agreement to use their best judgment on a continuing basis in choosing the corporation's employees.

The rules and expectations change, however, in the close corporation context. Closely held corporations have a small enough number of shareholders so that all shareholders are normally parties to whatever explicit or implicit understandings are reached at the corporation's inception.⁵⁰ In a closely held corporation, a shareholder-employee has interests in his job and stock that are often economically intertwined.⁵¹ Holding stock in a closely held corporation, viewed purely as an investment decision, seems almost irrational from an economic perspective. Small businesses are exceedingly risky enterprises with high failure rates.⁵² To compensate fairly for this level of risk, the expected return would also have to be disproportionately large. Moreover, many investors in small businesses invest a significant portion of their life savings in the business.⁵³ This practice defeats their ability to diversify their investment portfolios and exposes them to company- and industry-specific risk. As a result, investors in closely held corporations would seem well advised to trust their capital to diversified mutual funds rather than a small corporation.

If investors in closely held corporations are economically rational, it can only be because such investments have compensating benefits not available to investors in publicly held corporations.⁵⁴ In many cases, a shareholder in a closely held corporation expects to receive such compensating benefits through employment. The shareholder may invest for the purpose of having a job that produces higher compensation than could be garnered through employment by third parties. Even if the employee-shareholder's compensation is no higher than his next best alternative, an investment in a

49. See, e.g., *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934).

50. Where all shareholders are a party to an explicit agreement and there is no injury to creditors, the cases generally uphold the ability of shareholders to contract to maintain one of their number in an employment position. See, e.g., *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964); *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936). In this context, there is no reason that courts should not enforce implicit agreements between shareholders as well as explicit ones.

51. See generally 1 O'NEAL & THOMPSON, *CLOSE CORPORATIONS*, *supra* note 17, § 6.02.

52. See U.S. SMALL BUSINESS ADMINISTRATION, *THE ANNUAL REPORT ON SMALL BUSINESS AND COMPETITION* 26 (1996) (noting that 60% of all small businesses fail within one year).

53. See 1 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 3.06, at 37 (noting that "[a] person acquiring a substantial interest in a close corporation often invests a large percentage of his personal resources to acquire that interest").

54. As Easterbrook and Fischel argue, closely held corporations experience lower agency costs than their public brethren because their is no separation of ownership from control. See EASTERBROOK & FISCHEL, *supra* note 6, at 229-30. It seems doubtful, however, that this reduction alone compensates for the enormous extra risk of investing in closely held corporations.

closely held corporation may still be justified because the ability to keep his job may be more stable and certain. Additionally, the employee may simply derive satisfaction from working in a business that he himself takes a substantial part in managing.⁵⁵

The close relationship between investment and employment in the closely held corporation is also demonstrated by a common method through which such corporations distribute their profits. Theoretically, employees should receive no more than a reasonable salary in return for their work. Any extra profit should be distributed to the shareholders by way of dividends. However, closely held corporations often distribute de facto dividends to their employee-shareholders in the form of enhanced salary and benefits.⁵⁶ As long as all shareholders receive their fair share of the corporation's income stream, the co-venturers are usually indifferent to the method by which profits are distributed.⁵⁷ Indeed, close corporations often prefer to distribute as much of their profits as they can in the form of salary because, unlike dividend payments, salary payments provide a tax deduction to the corporation.⁵⁸

Thus, a shareholder in a closely held corporation often has a significant investment interest in his job. He often invests for the purpose of having a job, and the salary and other benefits he receives are conceived to be part of the return on his investment. In these circumstances, the discharge of an employee in a closely held corporation usually involves appropriation of a portion of his investment by the remaining shareholders.⁵⁹ This action is

55. For an argument that employment in a closely held corporation has an investment value based on its superiority over alternative employment opportunities, see Douglas K. Moll, *Shareholder Oppression v. Employment At Will in the Closely Held Corporation: The Investment Model Solution*, 1999 U. ILL. L. REV. 517, 547-50.

56. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 660, 662 n.13 (Mass. 1976) (noting that the corporation never paid any dividends but increased salaries over time as it became more profitable); *In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1180 (N.Y. 1984) (finding that the corporation had "a long-standing policy of awarding 'de facto' dividends in the form of 'extra compensation bonuses'").

57. See, e.g., *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936) (upholding an agreement to maintain a 25% shareholder in an executive position and pay that shareholder 25% of the corporation's profits in either salary or dividends).

58. See 26 U.S.C.A. § 162(a)(1) (1994). The Internal Revenue Service may disallow corporate deductions for unreasonably large salary payments on the theory that some portion of the salary payments involves de facto dividends. Salary payments are reasonable if in "such amount as would ordinarily be paid for like services by like enterprises under like circumstances . . . existing at the date when the contract for services was made." 26 C.F.R. § 1.162-7(b)(3) (1999). For one among many cases applying this rule, see *Patton v. Commissioner*, 799 F.2d 166, 169-70 (5th Cir. 1986). Of course, given the self-assessment nature of the tax system, there is a large incentive to distribute corporate profits in the form of salaries and hope the matter never comes to the attention of the Internal Revenue Service.

59. See *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 577 (7th Cir. 1996) (noting that in a closely

especially injurious where the corporation pays de facto dividends in the form of enhanced salaries and benefits.⁶⁰ However, it is a problem even in situations where the majority pays itself no more than a reasonable salary after the minority's discharge. After discharge, the minority is relegated to the corporation's expected returns to justify the risk of its investment capital. As discussed above, these returns are unlikely to be satisfactory on their own.

Because their investment and employment expectations are interdependent, shareholders in closely held corporations receive protections against employment discharge that shareholders in publicly held corporations do not. The discharge of a minority shareholder is one of the common grounds relied upon by courts in finding a breach of the majority's fiduciary duty in the close corporation context.⁶¹

2. *The Interest in Dividends*

A shareholder in a profitable, publicly held corporation derives an

held corporation that distributes its profits in salaries, "firing an employee is little different from canceling his shares").

60. *See In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1180-81 (N.Y. 1984) (finding oppression of the minority based in part on the majority's decision to pay itself de facto dividends in the form of salary bonuses after minority shareholders were discharged).

61. *See, e.g., McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701 (8th Cir. 1998) (applying Minnesota law); *Notzke v. Art Gallery, Inc.*, 405 N.E.2d 839 (Ill. App. Ct. 1980); *W & W Equipment Co. v. Mink*, 568 N.E.2d 564 (Ind. Ct. App. 1991); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976); *In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984); *In re Application of Topper*, 433 N.Y.S.2d 359 (N.Y. Sup. Ct. 1980); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. Ct. App. 1984).

Courts have found, however, that lack of access to employment by the minority did not result in a breach of the majority's fiduciary duty where the expectation of employment had no reasonable basis, *see, e.g., Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (finding that a minority shareholder who received stock as a gift from her father and never worked for the company had no reasonable expectation that her son and daughter-in-law would receive employment), or a discharge was not part of any freezeout scheme, *see, e.g., Merola v. Exergen Corp.*, 668 N.E.2d 351 (Mass. 1996) (finding no relationship between the employee's stock and his job and noting that the employee was able to sell his stock back to the corporation at a fair price). Two New York cases hold that the majority may discharge the minority for the purpose of taking advantage of a contractual requirement that the employee offer the stock back to the corporation without breaching any fiduciary duty. *Gallagher v. Lambert*, 549 N.E.2d 136 (N.Y. 1989); *Ingle v. Glamore Motor Sales*, 535 N.E.2d 1311 (N.Y. 1989). *But see Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987). *Gallagher* and *Ingle* are difficult to square with other New York cases taking a strongly supportive view of the employment rights of minority shareholders in closely held corporations, such as *In re Judicial Dissolution of Kemp & Beatley, supra*. *Gallagher* is especially questionable because the contractual sale price for the employee's shares in that case was less than fair value. Perhaps *Gallagher* and *Ingle* are distinguishable because they involved employee-shareholders who started as employees and then became shareholders, rather than shareholders who invested on the understanding that they would be employees. As a consequence, the New York Court of Appeals may have been comfortable treating *Gallagher* and *Ingle* as employee termination cases rather than shareholder rights cases.

economic benefit whether profits are distributed through dividends or reinvested in the corporation. For example, if profits are \$2.00 per share, the shareholder will either receive \$2.00 in dividends or see the trading value of his stock increase by approximately \$2.00.⁶² To be sure, a public shareholder is not indifferent as to whether profits are paid out or reinvested. The board of directors should reinvest profits only when the new projects promise expected returns at a level equal to or in excess of the corporation's cost of capital.⁶³ Otherwise, shareholders are unfairly compensated for the risk of the investments and are better off receiving dividends and choosing their own investment vehicles.⁶⁴ The choice between paying dividends and reinvesting

62. Two leading economists have argued that dividend policy would be irrelevant in a world without transaction costs. See Merton Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961). In a world where dividend payments result in immediate taxation to the shareholder, this theory would suggest that shareholders prefer minimal or no dividends. Nevertheless, shareholders often react positively to the payment of dividends because such payments often signal positive management expectations regarding the future. See Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5-8 (1976). Moreover, managers may reinvest income to further their selfish goals rather than to make investments that are efficient from a corporate perspective. See *infra* note 64. As a consequence, a decision to withhold all dividends based on per share profits of \$2.00 may result in a market price increase of less than \$2.00.

63. The two most important capital budgeting methods are the net present value method and the internal rate of return method. See GILSON & BLACK, *supra* note 45, at 66-73, 76-78. To apply the net present value method, one determines the expected returns of a potential investment and discounts those returns to present value using a discount rate that appropriately measures the corporation's level of risk. As a result, expected returns in riskier corporations have lower present values than expected returns in less risky corporations. Investments are justified when the present value of the investment exceeds the present cost of the investment.

In contrast, the internal rate of return method asks at what discount rate the net present value of the expected returns of an investment is zero. Only if the internal rate of return generated by the project is higher than the rate of return normally required for corporate investments (which should equal or exceed the corporation's actual discount rate) should the project be undertaken. These capital budgeting methods are similar, and both reflect the concept that an investment that is likely to produce positive future returns can still be unwise unless those returns are sufficient to justify the risk of the investment.

64. According to Professor Jensen's free cash flow theory, managers often make investments for which returns are inadequate to compensate for the risks. See Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314, 319-21 (Coffee et al. eds., 1988) (arguing that cash-rich companies make excellent takeover targets). Such investments increase the size of the corporation and the power, prestige, and perquisites of its managers. They also diversify the corporation's business and help reduce the corporation's level of risk, which in turn reduces the risk of bankruptcy and helps to safeguard the positions and substantial salaries of the corporation's key executives. Diversification in publicly held investments, however, is better accomplished at the shareholder level than at the firm level. See GILSON & BLACK, *supra* note 45, at 336-62.

Shareholders would prefer to receive dividends rather than have the corporation make investments with a negative net present value or an internal rate of return that is less than the corporation's discount rate. From the perspective of diversified shareholders, the increased returns from profitable investments should more than compensate for potential losses from bankruptcy. Managers, however, are unable to diversify their employment capital in the same manner. Therefore, they have a selfish interest in increasing the size and safety of the corporation, even if this conflicts with the priorities of

profits has much more stark economic effects in the close corporation context.

Whether to pay dividends or reinvest profits in a publicly held corporation is a classic example of a directors' decision protected by the business judgment rule.⁶⁵ Because the business judgment rule requires scant justification to insulate director conduct from judicial scrutiny, it is tantamount to a rule of directors' *carte blanche*.⁶⁶ This freedom from judicial supervision is thought to be justified by: (a) the board's statutory duty to supervise management of the corporation's affairs; (b) the need to encourage risk-taking among directors without fear of second-guessing if business decisions turn out badly; and (c) the judiciary's relative lack of business expertise.⁶⁷

In closely held corporations, the payment of dividends is ordinarily of little consequence when all shareholders receive salaries. When the majority shareholder receives a salary, however, and the minority does not—either because a job for the minority was not part of the basic investment deal between the parties or because the majority has fired the minority—this situation changes drastically. A minority shareholder who receives neither salary nor dividends receives no present return on his investment.⁶⁸ Unlike a public shareholder, the minority shareholder has no public market in which he can sell his stock to realize capital appreciation.

The wrongful suppression of dividends is a common ground on which courts find that majority shareholders have breached their fiduciary duties in closely held corporations.⁶⁹ The Massachusetts Supreme Judicial Court's

diversified shareholders. For an argument that managers often pursue a less risky course than diversified shareholders would prefer, see John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

65. See, e.g., *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A.2d 276, 280 (Del. 1984).

66. In cases to which the business judgment rule applies, the board's decision is upheld whenever its conduct "can be attributed to any rational business purpose." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

67. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 822-23 (1981).

68. See 1 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 3.04, at 13 (noting that a nonemployed shareholder is "deprived of any return on his investment during the years that dividends are withheld").

69. See, e.g., *Crowley v. Communications for Hospitals, Inc.*, 573 N.E.2d 996 (Mass. App. Ct. 1991); *Miller v. Magline, Inc.*, 256 N.W.2d 761 (Mich. Ct. App. 1977); *Fox v. 7L Bar Ranch Co.*, 645 P.2d 929 (Mont. 1982); *In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984); *Hirschhorn v. Severson*, 319 N.W.2d 475 (N.D. 1982); *Patton v. Nicholas*, 279 S.W.2d 848 (Tex. 1955); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. App. 1984).

Conversely, when the majority pays substantial dividends, see *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (finding certain majority actions illegal but refusing to require dissolution where

decision in *Wilkes v. Springside Nursing Home, Inc.*⁷⁰ represents a classic example of a freezeout scheme that combined discharge with suppression of dividends. In *Wilkes*, four equal investors created a corporation for the purpose of running a nursing home. At the time of the corporation's creation, it was understood that each investor would be a director and an officer and would receive an equal distribution of the corporation's profits.⁷¹ Initially, the corporation made no payments to any of its shareholder-employees. After about one year of operation, the corporation began to pay each employee thirty-five dollars per week in salary. Eventually, this amount was increased to one hundred dollars per week.⁷² The corporation never paid any dividends.⁷³ Sixteen years after the corporation's formation, one of the shareholders, Wilkes, had a falling out with the other three. Wilkes was removed from the board of directors and discharged from his employment. The court noted that "by terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment."⁷⁴ Accordingly, the court held that the three controlling shareholders had violated their fiduciary duty to Wilkes.⁷⁵

3. *The Interest in Participation*

Shareholders in publicly held corporations have whatever participatory rights are allowed by the relevant state's corporation statute, plus whatever supplementary rights are granted by the corporate charter and bylaws. Typically, the public shareholder plays a passive role in corporate affairs. He has no right to be a director absent an enforceable shareholder agreement to this effect.⁷⁶ He can access the corporation's books and records if he has a

minority shareholder received dividends or de facto dividends ranging from \$17,500 to \$26,000 per year), or has persuasive business reasons for not paying dividends, see 1 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 3.05, at 21-22 (noting that "[w]henver the corporation needs large amounts of working or expansion capital and majority abuses are not present, retention of funds is sustained"), no breach of fiduciary duty will be found.

70. 353 N.E.2d 657 (Mass. 1976).

71. *See id.* at 659-60.

72. *See id.* at 660.

73. *See id.* at 662 n.13.

74. *Id.* at 662-63.

75. *See id.* at 664.

76. *See, e.g.,* *Ringling Brothers-Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. 1947); *see also* DEL. CODE ANN. tit. 8, § 218(c) (1998) (enforcing written shareholder voting agreements).

proper purpose.⁷⁷ Otherwise, the public shareholder has little or no say in the day-to-day management of the corporation.

By contrast, shareholders in closely held corporations often expect to be intimately involved in the corporation's affairs. Such shareholders often expect to be directors and senior executives and would not invest otherwise. Voting a minority shareholder off the board of directors⁷⁸ and denying the minority access to corporate information⁷⁹ have contributed to findings of breach of fiduciary duty in the close corporation context.

Although denying the minority participation rights alone may frustrate the minority's reasonable expectations, the majority often employs a participatory freezeout as a complement to a financial freezeout.⁸⁰ Removing minority shareholders from the board and denying or restricting their access to corporate records makes it more difficult for the minority to determine whether the corporation could pay reasonable dividends, the majority is receiving excessive compensation or other benefits, or the majority is otherwise engaged in illegal self-dealing. Denying access to financial records also makes it difficult for the minority to value its stock accurately in the event the majority makes a purchase offer.

4. *Protection Against Self-dealing*

In any corporation with a majority shareholder, the minority is at risk that the majority shareholder will engage in self-dealing and appropriate to itself a disproportionate share of the corporation's income stream.⁸¹ Although self-

77. See DEL. CODE ANN. tit. 8, § 220(b) (1998).

78. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976); *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987).

79. See, e.g., *McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701 (8th Cir. 1998) (applying Minnesota law and granting minority shareholder's petition for a buyout that alleged, inter alia, that the plaintiff had been excluded from decision-making and denied access to the corporation's books and records); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. App. 1984) (finding breach of the majority's fiduciary duty and noting that majority prevented discharged minority shareholders from returning to the corporation's premises).

80. See 1 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, § 3.06, at 38 (noting that "removal of a minority shareholder from the board reduces his access to information on what is going on in the corporation and thereby his ability to protect himself against squeeze plays"). For the various techniques that the majority may use in addition to removing the minority from the board, see *id.*, § 3.11.

81. Of course, this danger is present in publicly held as well as closely held corporations. See *Paramount Comm. Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-43 (Del. 1993) (noting the vulnerability of shareholders in a publicly held corporation when a controlling stake in a corporation is sold); see also *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1137 (D. Or. 1984) (noting that acquisition of a 51% interest would "subject remaining stockholders to a captive status"); Lucien A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1710-13 (1985) (arguing that the creation of a new majority shareholder in a public

dealing by a controlling shareholder is a problem that transcends the type of corporation involved, self-dealing has some special implications in the context of the closely held corporation. Initially, self-dealing is a more common problem in the closely held corporation. Most publicly held corporations do not have a majority or controlling shareholder.⁸² By contrast, closely held corporations often have a majority shareholder. Even when no majority shareholder exists, the number of shareholders is small enough that the formation of a controlling group is easy. As a consequence, oppression of minority shareholders is an omnipresent problem in closely held corporations.

In addition, the majority in a closely held corporation often employs self-dealing as a complement to a financial and participatory freezeout of the minority. Common self-dealing tactics in this context include: paying unreasonably high salaries to the majority; granting leases and loans to the majority on favorable terms; entering into other contracts between the corporation and the majority that are unfavorable to the corporation; having the corporation purchase shares from the majority at more than their fair value; allowing the majority to appropriate corporate assets for personal use; and allowing the majority to usurp corporate opportunities.⁸³

Moreover, self-dealing in closely held corporations is less constrained than in publicly held corporations. In publicly held corporations, the capital, product, and employment markets constrain opportunistic behavior.⁸⁴ These market mechanisms do not operate as effectively in closely held corporations because such corporations do not participate in the capital markets and the misbehavior of controlling shareholders is therefore less likely to become public. Self-dealing in a closely held corporation usually involves the majority's appropriation of a portion of the minority's investment with few countervailing costs to the majority.

For the foregoing reasons, courts often rely on illegal self-dealing by the majority to find breaches of fiduciary duty in the close corporation context.⁸⁵

corporation with the power to engage in self-dealing diminishes the value of minority shares).

82. See Robert J. Lerner, *Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963*, 56 AM. ECON. REV. 777, 780-85 (1966) (concluding that, in 169 of the 200 largest nonfinancial public corporations, no single shareholder owned as much as a 10% stake).

83. On the variety of self-dealing tactics employed by the majority, see 1 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, at §§ 3.07, 3.12-3.20.

84. See, e.g., Gilson, *supra* note 67, at 833-34. Another check on opportunistic behavior in public corporations is the market for corporate control. Of course, this market is inoperative in public corporations with a controlling shareholder.

85. See, e.g., *McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701 (8th Cir. 1998) (applying Minnesota law and granting minority shareholder's petition for a buyout that alleged, *inter alia*, that the majority had usurped corporate opportunities and commingled personal ventures with the

5. Protection Against Forced Sales

When the majority has engaged in some or all of the forms of misconduct described above, it often administers the coup de grace by offering to purchase the minority's stock at a fraction of its true worth. Such an offer has often been part of a freezeout scheme invalidated by the courts.⁸⁶ Were the courts to offer minorities no protection against forced sales, an oppressed minority might well have no choice but to accept the majority's low price because there is no other market for the stock and no other way for the minority to receive any value if it is subject to a freezeout.

C. Remedies

The traditional remedy for breach of fiduciary duty in closely held corporations was to provide compensation to the minority for past economic injuries combined with injunctive relief to help guarantee fairness in the future. For example, the remedy for an illegal discharge of a minority shareholder might be reinstatement or lost wages.⁸⁷ The remedy for suppressing dividends might be an injunction requiring the corporation to pay reasonable dividends in the future.⁸⁸ The remedy for violation of the shareholder's participatory rights might involve reinstatement as a director or the provision of expanded access to the corporation's financial information.⁸⁹

corporation's affairs); *In re* Judicial Dissolution of Kemp & Beatley, Inc., 473 N.E.2d 1173 (N.Y. 1984) (finding oppression of minority shareholders based in part on the fact that majority shareholders paid themselves de facto dividends in the form of extra compensation bonuses); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988) (affirming a jury finding of shareholder oppression that relied in part on the majority's contribution of corporate funds to a pension plan in which only the majority had an interest and on the majority's use of corporate funds to pay attorneys' fees in litigation against the minority); *cf. Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (declining to find that majority shareholder's salary, which had reached \$476,206, was unreasonable but noting that any future compensation increases might be viewed unfavorably by the court).

86. *See, e.g., McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701, 703 (8th Cir. 1998) (applying Minnesota law and granting minority shareholder's petition for a buyout alleging that the majority had offered to redeem his shares at an artificially low price); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 664 n.14 (Mass. 1976) (noting that the majority offered to purchase the minority's stock for a price that a member of the majority group would not accept for his own shares); *Patton v. Nicholas*, 279 S.W.2d 848, 852 (Tex. 1955) (noting majority shareholder's suggestion that "he would not buy the stock of [the minority] for even a small fraction of its value"). In contrast, courts have found no breach of fiduciary duty by the majority where the majority has offered to purchase the minority's interest at a fair price. *See Merola v. Exergen Corp.*, 668 N.E.2d 351 (Mass. 1996); *Ingle v. Glamore Motor Sales*, 535 N.E.2d 1311 (N.Y. 1989).

87. *See, e.g., Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976) (awarding a discharged minority shareholder the salary he would have received had he continued as an officer and director of the corporation).

88. *See, e.g., Patton v. Nicholas*, 279 S.W.2d 848 (Tex. 1955).

89. *See, e.g., Brenner v. Berkowitz*, 634 A.2d 1019, 1033 (N.J. 1993) (reinstating a minority

The remedy for illegal self-dealing might be compensation to the minority for the pro rata diminution in the value of the minority's stock plus an injunction forbidding such conduct in the future.⁹⁰

There are three difficulties with such purely compensatory forms of relief: (a) they involve the court in continued supervision of an acrimonious relationship; (b) by the time such shareholder disputes get to court, the relationship between the parties has usually deteriorated to such an extent that it is impractical to expect the parties to continue in business together; and (c) after substantial illegal conduct has been proved, it is unfair to a minority shareholder to require him to continue to trust the majority to treat him and his investment in a fair manner.

As a consequence of these difficulties, thirty-seven states have passed statutes that permit a court to dissolve a closely held corporation upon a finding that the majority has "oppressed" the minority.⁹¹ Dissolution allows the minority to receive a return on its capital representing the minority's pro rata share of the enterprise. Exactly what distinguishes oppression from a breach of fiduciary duty is hardly clear, although it seems that a substantial and continuing breach of fiduciary duty will constitute oppression.⁹² Although it was once thought detrimental to society to dissolve profitable corporations,⁹³ it is now recognized that the resources of such corporations will not be removed from public intercourse. If a corporation is truly profitable, a third party or one of the existing shareholders will probably purchase it at the dissolution sale and continue to operate the business.⁹⁴

In recent years, courts have developed an alternative to dissolution in cases where compensatory and injunctive relief are deemed inadequate. In these cases, the court may order the corporation or the majority to purchase the minority's stock at a fair value determined by the court in lieu of the

shareholder as a director).

90. *See, e.g.*, *Williams v. Shatz Mfg. Co.*, 449 F. Supp. 147 (S.D.N.Y. 1977) (requiring a return of excess compensation to the corporation); *Hirsch v. Cahn Elec. Co.*, 694 So. 2d 636 (La. Ct. App. 1997) (requiring corporation to pay a dividend with a large portion of bonuses returned to the corporation); *cf. Chambers v. Beaver-Advance Corp.*, 140 A.2d 808 (Pa. 1958) (noting that injunctive relief is available to prevent majority from siphoning off funds through unreasonable bonuses).

91. *See* Thompson, *supra* note 31, at 709 n.70 (collecting statutes). Of course, because dissolution is an equitable remedy, a court is always permitted to grant relief short of dissolution after finding the existence of oppressive conduct. *See, e.g.*, *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (finding oppression but ordering the reinstatement of a minority shareholder as a director rather than ordering dissolution).

92. *See* *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387, 394 (Or. 1973).

93. For a case exhibiting the traditional reluctance to dissolve a solvent corporation and viewing dissolution as an extreme remedy, see *Patton v. Nicholas*, 279 S.W.2d 848 (Tex. 1955) (finding oppression but ordering the payment of reasonable dividends rather than dissolution).

94. *See* *Hetherington & Dooley*, *supra* note 25, at 30-31.

statutory remedy of dissolution.⁹⁵ This form of relief is less harsh than dissolution and often gives both parties what they want most.⁹⁶ The majority gets to run the business as it sees fit, unfettered by the continued participation of the minority,⁹⁷ while, at the same time, the minority receives the fair value of its investment.

D. Conclusion

In conclusion, the classic freezeout scheme involves a financial aspect (failure to pay salary or dividends to the minority) and a participatory aspect (restricted access to corporate decision-making or information), is accompanied by majority self-dealing, and culminates in an attempt to force the minority to sell its stock to the majority at an unfairly low price. It bears noting, however, that not all of these elements need to be present for a court to find a breach of fiduciary duty. Any one of the elements may, by itself, be sufficient to sustain a breach of fiduciary duty finding.⁹⁸ Other unfair conduct by the majority also may lead to such a finding.⁹⁹ Preventing a freezeout,

95. See, e.g., *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980); *Sauer v. Moffitt*, 363 N.W.2d 269 (Iowa Ct. App. 1984); *Maddox v. Norman*, 669 P.2d 230 (Mont. 1983); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986); *In re Wiedy's Furniture Clearance Ctr. Co.*, 487 N.Y.S.2d 901 (N.Y. App. Div. 1985); *Delaney v. Georgia-Pacific Corp.*, 564 P.2d 277 (Or. 1977); *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988); but see *Gianotti v. Hamway*, 387 S.E.2d 725 (Va. 1990) (holding that statutory remedies are exclusive and court has no residual equitable power to order a buyout). Although it is usual for the court to order the corporation or the majority to buy the minority's shares at fair value upon a finding of oppression, one unusual case permitted the minority to purchase the majority's shares because the deal among the parties permitted the minority to run the enterprise. See *Muellerberg v. Bikon Corp.*, 669 A.2d 1382 (N.J. 1996).

96. See *Thompson*, *supra* note 31, at 721-22 (arguing that “[t]he recognition of the possibility of a buyout as a less drastic remedy undoubtedly has contributed to the breakdown of the traditional judicial and legislative resistance to granting relief where there is dissension among shareholders”).

97. In a number of jurisdictions, the majority may elect to purchase the minority's shares at fair value once a petition seeking dissolution for oppression is filed. See *id.* at 718-19 nn. 126, 127 (collecting statutes). This election removes fault issues from the case and converts the proceeding into one designed to appraise the value of the minority's shares. In jurisdictions permitting this procedure, the parties are in effect able to get a no-fault business divorce.

98. See, e.g., *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (finding oppression based solely on the minority's removal from the board of directors).

99. For example, in *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988), the minority shareholder did not challenge the lack of corporate employment and the jury found that dividends were not suppressed. The illegal conduct consisted of: (a) denying the 45% shareholder's interest on the ground that he had previously made a gift of that interest to the 55% shareholder; (b) contributing corporate funds to a profit sharing plan in which only the majority shareholder had an interest; and (c) spending the corporation's money to pay the majority shareholder's attorneys' fees. The appellate court noted the absence of “some of the typical ‘squeeze out’ techniques used in closely held corporations” but held that the majority's conduct constituted a breach of fiduciary duty and “oppression” for which dissolution might be ordered because it frustrated the minority's reasonable

however, is at the core of the special fiduciary duty rules applicable to shareholders in closely held corporations. Where such misconduct occurs, a court may provide traditional compensatory remedies, order dissolution, or compel a buyout of the minority interest at a judicially determined fair value.

II. DELAWARE LAW ON CLOSELY-HELD CORPORATIONS: DO ANY SPECIAL DUTIES EXIST?

A. *The Pre-Nixon Cases*

Prior to the Delaware Supreme Court's decision in *Nixon v. Blackwell*,¹⁰⁰ two Chancery Court cases considered the problem of shareholder duties in closely held corporations. These cases express divergent views on whether special shareholder duties exist in closely held corporations.

The first of the pre-*Nixon* cases, *Ueltzhoffer v. Fox Fire Development Co.*,¹⁰¹ denied in part a minority shareholder's petition for relief on grounds that might well be accepted in other jurisdictions. In this case, the Marta and Ueltzhoffer families formed two corporations that had roles in building and selling single family homes and townhouses on specific plots of land. The first of these corporations, Drummond Builders, Inc., was responsible for the construction work. Drummond's stock was evenly split between the two families. Ueltzhoffer drew a salary from Drummond in his capacity as construction supervisor. The second corporation, Fox Fire Development Co., was responsible for office matters, such as accounting and financial work, and sold the finished homes to purchasers. The stock in Fox Fire was split sixty/forty between the Marta and Ueltzhoffer families, although the court found that the families nevertheless agreed to split any profits equally.¹⁰²

The Fox Fire development project ran into difficulties that caused tension between the Marta and Ueltzhoffer families. Marta and his daughter believed that Ueltzhoffer was responsible for cost overruns and construction delays. Marta also came to believe that Ueltzhoffer was disloyal when he found out that Ueltzhoffer was discussing a new project with one of Drummond's electricians. Ueltzhoffer was removed from his position as construction supervisor of Drummond. Marta's daughter then formed a new corporation owned entirely by her to take over the construction duties at the Fox Fire

investment expectations. *Id.* at 381-82.

100. 626 A.2d 1366 (Del. 1993). *See also infra* Part II.B.

101. No. 9871, 1991 Del. Ch. LEXIS 204 (Del. Ch. Dec. 19, 1991), *aff'd*, 618 A.2d 90 (Del. 1992) (affirming based on the Chancery Court's opinion).

102. *See id.* at *2-*8.

project.¹⁰³ Ueltzhoffer sued the Marta family for, among other things, breach of fiduciary duty in discharging him from his position at Drummond. He sought lost wages and a dissolution of Drummond because it was hopelessly deadlocked and further asked the court to order a buyout of his family's Fox Fire shares at fair value.¹⁰⁴

The court declined to find that the Marta family had violated any fiduciary duty to Ueltzhoffer by discharging him from his employment at Drummond. Although the court found that Ueltzhoffer had performed his duties as construction supervisor competently,¹⁰⁵ the court also found that this question was not free from doubt and that the Marta family had acted out of competency concerns in firing Ueltzhoffer, and not solely for the "improper purpose of freezing him out of the corporate entities."¹⁰⁶ Consequently, the court found that the Marta family had a legitimate business purpose in firing Ueltzhoffer and denied Ueltzhoffer's claim for lost wages.¹⁰⁷

Ueltzhoffer presents a case in which it may be relevant whether the court measures the existence of special shareholder duties from the perspective of the majority or the minority.¹⁰⁸ Under the Massachusetts majority-centered view, the *Ueltzhoffer* result is not controversial. If the controlling parties fired *Ueltzhoffer* because they truly believed he was incompetent, this surely represents a legitimate business purpose that cannot be accomplished through any less harmful alternative. Presumably the controlling parties are entitled to act on their own view of an employee's competence without second-guessing by the court, as long as their motive is not pretextual. In contrast, under the New York minority-centered view, Ueltzhoffer's rights were violated. He invested in Drummond in part because he was looking for work at the time. The Marta family was aware of his interest in a job.¹⁰⁹ The Marta family could surely have fired Ueltzhoffer if he was incompetent, because no person has a reasonable expectation of continued employment in such circumstances. Because the court found Ueltzhoffer competent, however, his discharge violated his reasonable investment expectations at the time of Drummond's formation. As a consequence, *Ueltzhoffer* does not necessarily

103. *See id.* at *9-*10.

104. *See id.* at *1-*2.

105. *See id.* at *20.

106. *Id.* at *22.

107. *See id.*

108. *See supra* text accompanying notes 37-39.

109. *See Ueltzhoffer*, 1991 Del. Ch. LEXIS 204, at *3 (noting that the timing of the corporate project was excellent because "Ueltzhoffer was out of work and Marta apparently had some interest in finding a project that his daughter . . . could handle").

stand for anything other than the Chancellor's adherence to the Massachusetts rather than the New York view of shareholder duties in a closely held corporation.

Although unnecessary to the result, the *Ueltzhoffer* court also questioned the very existence of special shareholder duties. The court noted the absence of any Delaware authority following *Wilkes v. Springside Nursing Home, Inc.*¹¹⁰ It also suggested that the Marta family was statutorily entitled to have Drummond dissolved as a consequence of shareholder deadlock.¹¹¹ The court posited that a constructive dissolution was accomplished by the Marta family when it ceased to use Drummond as contractor on the Fox Fire project because Drummond had no other business, even though the Marta family did not petition a court to achieve statutory dissolution or to distribute Drummond's assets. For this reason, the court saw nothing improper in replacing Drummond as construction contractor with a corporation wholly owned by Marta's daughter.¹¹²

These comments by the *Ueltzhoffer* court are more troubling. The court was correct that no previous Delaware cases had followed *Wilkes*. As the court noted, however, there was no need to decide the status of *Wilkes* in Delaware because the Marta family had complied with the duties established by *Wilkes*. That the Marta family was entitled to transfer Drummond's business to a corporation owned entirely by one of its shareholders is highly questionable.

Contrary to the court's suggestion, Drummond was still an existing corporation at the time its business was diverted to the Marta family. This diversion would seem to violate two well-established bodies of law that are applicable to all corporations, whether publicly or closely held. First, the Marta family, as officers and directors of Drummond, appears to have usurped a corporate opportunity belonging to Drummond.¹¹³ Second, as a controlling group, the Marta family appears to have engaged in a self-dealing transaction that cannot satisfy the Delaware entire fairness test.¹¹⁴ These legal

110. 353 N.E.2d 657 (Mass. 1976). See *Ueltzhoffer*, 1991 Del. Ch. LEXIS 204, at *22; see also text accompanying notes 70-75.

111. See *Ueltzhoffer*, 1991 Del. Ch. LEXIS 204, at *22; see also DEL. CODE ANN. tit. 8, § 226 (1998) (giving the Chancery Court the power to appoint a custodian to dissolve a deadlocked corporation); § 273 (giving a 50% shareholder the power to dissolve a joint venture).

112. See *Ueltzhoffer*, 1991 Del. Ch. LEXIS 204, at *22 (arguing that the fiduciary duties of Marta's daughter "did not require that she continue in business with *Ueltzhoffer*").

113. When a business opportunity is presented to a corporation, an officer or director may not pursue the opportunity individually if it is in the corporation's line of business. See, e.g., *Kaplan v. Fenton*, 278 A.2d 834, 836 (Del. 1971); *Guth v. Loft, Inc.*, 5 A.2d 503, 514 (Del. 1939).

114. In *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), a minority shareholder of a 97%-owned subsidiary argued that the entire fairness test should apply to the parent's decision to allocate a

violations are significant because Drummond was to receive a fifteen percent profit from its construction work for Fox Fire. Even if Ueltzhoffer was legally discharged, his family, as fifty percent stockholders of Drummond, possessed a fifty percent interest in Drummond's corporate profits. By diverting Drummond's business after Ueltzhoffer's discharge, the Marta family essentially appropriated to itself the 7.5% of future profits that should have belonged to the Ueltzhoffers.

The court's suggestion that it would have been proper for the Marta family to dissolve Drummond for the purpose of appropriating its business also seems questionable. If controlling parties have duties not to divert corporate opportunities to themselves, can they accomplish such diversion merely by the expedient of dissolving the corporation first? Delaware authority, albeit in other contexts, supports the proposition that statutorily authorized action can be illegal if taken for an improper purpose.¹¹⁵ Authority from other jurisdictions holds that a court of equity should not grant a dissolution petition, even if shareholders are deadlocked, if the result would be to permit one shareholder group to divert the corporation's business to itself.¹¹⁶ A court of equity, in effect, will not permit itself to be used as an accomplice in one shareholder's breach of his fiduciary duty to another.

Perhaps the law of Delaware will eventually hold that, in a deadlock situation, any fifty percent shareholder has an absolute right to seek and receive corporate dissolution and then to pursue the dissolved corporation's business opportunities.¹¹⁷ In making this suggestion, however, the

business opportunity to itself rather than to the subsidiary. Because the opportunity was not within the subsidiary's line of business, the court rejected this claim and applied the business judgment rule in upholding the parent's conduct. *See id.* at 721-22. Had the opportunity been within the subsidiary's line of business, however, the entire fairness test presumably would have applied. In these circumstances, the majority would have to prove fair dealing and fair price in connection with the transaction. *See infra* Part III. The latter of these inquiries would seem to require the majority to prove that declining the business opportunity was a good business decision from the corporation's perspective. In *Ueltzhoffer*, it would seem that Drummond could only have benefitted from pursuing the opportunity.

115. *See Schnell v. Cris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (invalidating a board's statutorily authorized decision to advance the date of an annual meeting for the purpose of interfering with a proxy fight and noting that "inequitable action does not become permissible simply because it is legally possible").

116. *See, e.g., Smith-Shrader Co. v. Smith*, 483 N.E.2d 283 (Ill. App. Ct. 1985); *Wollman v. Littman*, 316 N.Y.S.2d 526 (N.Y. App. Div. 1970). This principle has been applied to prevent majority shareholders from using their board and shareholder power to dissolve a corporation for the purpose of appropriating its business. *See, e.g., In re Paine et al.*, 166 N.W. 1036 (Mich. 1918); *Grato v. Grato*, 639 A.2d 390 (N.J. Super. Ct. App. Div. 1994); *Levine v. Styleart Press, Inc.*, 217 N.Y.S.2d 688 (N.Y. Sup. Ct. 1961); *see also Page v. Page*, 359 P.2d 41, 44 (Cal. 1961) (noting that "a partner may not dissolve a partnership to gain the benefits of the business for himself").

117. This notion is contrary to *In re Arthur Treacher's Fish & Chips, Inc.*, 386 A.2d 1162 (Del. Ch. 1978). In that case, a 50% shareholder sought dissolution pursuant to DEL. CODE ANN. tit. 8, § 273

Ueltzhoffer court did not consider or respond to any of the obvious legal objections. As such, it is best viewed as a dictum entitled to little weight. *Ueltzhoffer*, therefore, should be understood as holding only that controlling shareholders breach no duty to the minority as a result of a discharge that is motivated by legitimate business concerns. *Ueltzhoffer* is not a freezeout case and does not hold that a freezeout is beyond the capacity of Delaware courts to remedy. The *Ueltzhoffer* court noted that a buyout of the Ueltzhoffers' stock in Fox Fire was not justified on the facts of the case.¹¹⁸ The implication is that another set of facts might justify such relief.

Just two months after *Ueltzhoffer* was decided, the Delaware Court of Chancery was presented with allegations of a classic shareholder freezeout in *Litle v. Waters*.¹¹⁹ The court's opinion in *Litle* is squarely within the national mainstream on the duties of shareholders in closely held corporations. In *Litle*, Waters provided the financing and obtained two-thirds of the stock of two corporations. Litle provided the management for both corporations and obtained one-third of the stock. Waters later discharged Litle as an executive of both corporations. He then merged the corporations into a single corporation that essentially maintained the existing division of stock ownership between himself and Litle. Waters dominated the board of directors of the new corporation. After the merger, the new corporation paid no dividends.¹²⁰

Litle's suit did not challenge his discharge. Rather, it challenged the corporation's failure to pay any dividends. Litle alleged that dividends were suppressed as part of a freezeout scheme designed to render his stock worthless so that Waters could acquire it at a bargain price.¹²¹ He argued that this scheme was especially effective because the corporation was a Subchapter S corporation. As a consequence, although Litle received no money from the corporation, he was fully taxable on his share of the

(1998) (allowing a 50% shareholder in a joint venture to obtain dissolution). The defendant, who also owned 50%, counterclaimed for breach of fiduciary duty. The court held that counterclaims are not permitted in a section 273 proceeding. The court also held, however, that allegations of breach of fiduciary duty are relevant in deciding whether to grant a petition for dissolution. For cases supporting this view of *Arthur Treacher's*, see *In re English Seafood (USA) Inc.*, 743 F. Supp. 281, 285 (D. Del. 1990); *In re Southern One-Stop, Inc.*, No. 7500, 1986 Del. Ch. LEXIS 492, at *3-*4 (Del. Ch. Dec. 3, 1986); *Bachman v. Ontell*, No. 7805, 1984 Del. Ch. LEXIS 569, at *3 (Del. Ch. Nov. 7, 1984). *But cf. In re Data Processing Consultants, Ltd.*, No. 8907, 1987 Del. Ch. LEXIS 519, at *13 (Del. Ch. Nov. 25, 1987) (arguing that "while Section 273 recognizes a power in this court to deny a petition that satisfies its minimum standards, such a power should be sparingly exercised").

118. See *Ueltzhoffer*, 1991 Del. Ch. LEXIS 204, at *24.

119. No. 12155, 1992 Del. Ch. LEXIS 25 (Del. Ch. Feb. 10, 1992).

120. See *id.* at *2-*4.

121. See *id.* at *5.

corporation's profits.¹²² Waters moved to dismiss the complaint for failure to state a claim on the ground that the board's dividend decisions were protected by the business judgment rule.¹²³

The court denied the motion to dismiss for two reasons. First, the court viewed the dividend decision as the equivalent of a self-dealing transaction that implicated the entire fairness test rather than the business judgment rule.¹²⁴ Second, the court accepted that a majority shareholder in a closely held corporation has a fiduciary duty of fairness to the minority that precludes the use of freezeout tactics.¹²⁵ The court also accepted the New York version of this standard and held that a majority shareholder breaches this duty whenever he violates the reasonable investment expectations of the minority or commits "a visible departure from the standards of fair dealing and a violation of fair play."¹²⁶

Perhaps the portion of *Little* adopting the New York fiduciary duty rules in closely held corporations has been overshadowed by the Delaware Supreme Court's opinion in *Nixon v. Blackwell*.¹²⁷ Nevertheless, *Little* is significant because it is the one Delaware case that deals squarely with the question of whether a freezeout of a minority shareholder in a closely held corporation is permissible and holds that it is not.

B. Nixon v. Blackwell

The Delaware Supreme Court first considered the problem of closely held corporations in *Nixon v. Blackwell*.¹²⁸ Nixon involved a corporation whose

122. See *id.* at *4-*5.

123. See *id.* at *8.

124. See *id.* at *8-*15.

125. See *id.* at *18-*26.

126. *Id.* at *22 (quoting *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1017 (1984)). A later pre-*Nixon* Chancery Court case, uncomfortable with the notion that *Little* had created a new cause of action for shareholder oppression based on the New York model, viewed *Little* as merely reiterating:

[T]he well-established principle of law that, under Delaware law, the declaration of a dividend, like any other action of the directors, rests in the discretion of the directors, but that the business judgment rule does not protect the directors if they grossly or fraudulently abuse the discretion entrusted to them by the shareholders.

Garza v. TV Answer, Inc., No. 12784, 1993 Del. Ch. LEXIS 40, at *19 (Del. Ch. Mar. 11, 1993).

If *Little* does nothing more than apply the business judgment rule and its little-used exceptions to dividend decisions in closely held corporations, then it provides little protection to minority shareholders. The business judgment rule is seldom overcome on dividend questions. See, e.g., *Blackwell v. Nixon*, No. 9041, 1991 Del. Ch. LEXIS 150, at *12 (Del. Ch. Sept. 26, 1991) (noting that "[f]ew, if any, cases have involved a set of facts egregious enough" to overturn a dividend decision subject to the business judgment rule), *rev'd on other grounds*, 626 A.2d 1366 (Del. 1993).

127. 626 A.2d 1366 (Del. 1993). See *infra* Part II.B.

128. 626 A.2d 1366 (Del. 1993).

capital structure was divided into Class A voting shares and Class B nonvoting shares. This structure was the result of a plan devised by the corporation's founder, which was designed to permit key executives to maintain control of the company while allowing family members to participate in the financial benefits. At the time of the lawsuit, all of the Class A shares and most of the Class B shares were owned by employees of the corporation and an Employee Stock Ownership Plan ("ESOP") formed by the corporation. The remaining Class B shares were owned by the stepchildren of the corporation's founder. The directors collectively owned 47.5% of the Class A shares. There was no public market for either class of shares.¹²⁹ The corporation retained most of its earnings and paid only modest dividends.¹³⁰

From time to time the corporation offered to purchase the Class B shares through a series of self-tender offers. The plaintiffs alleged that these offers occurred at unfairly low prices.¹³¹ However, the record did not contain enough information for the court to determine whether this allegation was true.¹³²

The corporation provided a measure of liquidity to the employee stockholders through two mechanisms. Upon retirement or termination of employment, employees were entitled to receive their interest in the ESOP in Class B shares or cash in lieu of shares.¹³³ Upon death or termination of employment, each Class A shareholder gave the corporation the option to call his Class A shares and substitute Class B shares. The corporation purchased key man life insurance policies so that it would have the funds to purchase Class B shares from the estates of deceased executives.¹³⁴

The nonemployee Class B stockholders brought suit challenging the low level of dividend payments, which they alleged were designed to force the plaintiffs to resell their stock to the corporation at bargain prices, the level of compensation paid to the executives, and the discriminatory basis upon which the corporation provided liquidity to employee-stockholders through the ESOP and key man life insurance policies. The Chancery Court rejected the first two claims, and no appeal was taken. On the third claim, the Chancery Court held that the directors and controlling stockholders breached

129. *See id.* at 1370-71.

130. *See id.* at 1373.

131. *See id.* at 1371.

132. *See id.* at 1371 n.3 (noting that "[t]he record does not clearly reveal the relationship of the various tender offer prices to the current fair value of the stock measured by any traditional valuation method").

133. *See id.* at 1371.

134. *See id.* at 1371-72.

their fiduciary duty to the nonemployee Class B stockholders by providing liquidity to the employee stockholders on a discriminatory basis.¹³⁵

The Supreme Court applied the entire fairness test to determine the legality of providing liquidity through the ESOP and key man life insurance policies.¹³⁶ The court held that the directors and controlling stockholders sustained their burden of proving entire fairness.¹³⁷ It relied heavily on the fact that the corporation's capital structure was a direct result of planning by the corporation's founding stockholder. The founder himself had begun the practice of purchasing key man life insurance policies to repurchase Class B stock of retiring or deceased employees.¹³⁸ The court also noted that the corporation received benefits by maintaining an ESOP and making certain that stock did not pass out of the hands of employees or the founder's relatives.¹³⁹ In these circumstances, the court squarely rejected the equal opportunity rule of *Donahue v. Rodd Electrotpe Co.*¹⁴⁰ and held that the corporation could provide liquidity to employee-stockholders that was not available to nonemployee-stockholders.¹⁴¹

Had the court gone no further, its opinion would not be controversial. The equal opportunity rule is disfavored in most jurisdictions that recognize the existence of special shareholder duties in closely held corporations.¹⁴² Indeed, the rule has been abandoned in Massachusetts, the jurisdiction that created it.¹⁴³ Moreover, the equal opportunity rule is of questionable legitimacy. It is facially in accord with Aristotle's first principle of justice: similarly situated people should be treated similarly.¹⁴⁴ It is not at all obvious, however, that the employee-stockholders in *Nixon* are in fact similarly situated relative to the nonemployee-stockholders. Perhaps their interest in stock ownership is congruent with employment in a way that is not applicable to nonemployee's stockholders.¹⁴⁵ If one were to take this view,

135. *See id.* at 1373.

136. *See id.* at 1375; *see also infra* Part III.

137. *See Nixon*, 626 A.2d at 1375-79.

138. *See id.* at 1379.

139. *See id.* at 1377, 1379.

140. 328 N.E.2d 505 (Mass. 1975). *See supra* text accompanying notes 31-34.

141. *See Nixon*, 626 A.2d at 1376-77 (distinguishing between equal and fair treatment).

142. *See supra* note 35.

143. *See supra* text accompanying note 36.

144. *See Aristotle, Nichomachean Ethics*, bk. V, ch. 2, in *THE BASIC WORKS OF ARISTOTLE* 1004 (McKeon ed., 1941).

145. The same might be said of the situation present in *Donahue* itself. In that case, a founding shareholder sought to sell his stock back to the company in anticipation of his retirement. The fairness of the sale price was not disputed. The minority stockholders were relatives of the other founder, who had died. The existing minority shareholders were not involved in management of the business. The minority shareholders objected to the corporation's purchase of the retiring shareholder's stock on the

then *Nixon* is justified by Aristotle's second principle of justice: dissimilarly situated people should be treated dissimilarly.¹⁴⁶

Judged by the standards of the jurisdictions that accept the existence of special shareholder duties in closely held corporations but reject the equal opportunity rule, the result in *Nixon* is unexceptional. Jurisdictions following the Massachusetts, majority-centered view would undoubtedly hold that the directors pursued legitimate business policies in providing liquidity to employee-stockholders through the ESOP and key man life insurance policies.¹⁴⁷ The question would be more difficult in jurisdictions that accept the New York, minority-centered view.¹⁴⁸ It is not at all clear how to apply the reasonable investment expectations test to cases involving stockholders who received their stock through gift or bequest rather than investment. Presumably, the reasonable expectations of the nonemployee-stockholders in *Nixon* would be derived from the nature and logic of the founding stockholder's plan.¹⁴⁹ Measured by this standard, jurisdictions following the New York approach would probably find no breach of fiduciary duty for the reasons given in *Nixon*.

The *Nixon* court did, however, go on to make additional statements regarding the law of closely held corporations that are significantly more controversial than its specific holding. The court noted that it wished to consider "[w]hether there should be any special, judicially-created rules to 'protect' minority stockholders of closely held Delaware corporations."¹⁵⁰ The court's answer was resoundingly in the negative. The court noted that Delaware has passed legislation enabling shareholders in closely held

ground that the minority did not have equal access to liquidity. See *Donahue*, 328 N.E.2d at 510-11. Although the *Donahue* court upheld this claim, the retiring founder might be seen as occupying a different position than the passive minority shareholders. The retiring founder never contemplated owning stock in a corporation he was not active in managing. See *id.*; see also Oesterle, *supra* note 39, at 894 (opposing the equal opportunity rule and noting that "[m]ost buy-outs of senior investors facilitate their retirement at a time when they are no longer productive managers").

146. Aristotle's second principle of justice requires that dissimilarly situated people be treated "proportionately, with reference to some rational, impersonal standard." Gareth Morley, *A Just Measure of Pain? Sentencing and Sentencing Reform in the Era of the Charter*, 55 U. TORONTO FAC. L. REV. 269, 270 (1997).

147. See *supra* text accompanying note 37.

148. See *supra* text accompanying notes 38-39.

149. For example, in *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993), the Supreme Court of New Jersey accepted the reasonable expectations test as the measure of oppression. See *id.* at 1029. The minority shareholders challenged the provision of jobs to the majority shareholder and his family but not to the son and daughter-in-law of the minority shareholder. See *id.* The court rejected this claim because the rationale of the founding shareholder's original disposition of stock was to allow the majority to run the business with the minority playing a passive role. See *id.* at 1033 (noting that "the corporate founders never intended that [the minority shareholder] manage" the corporation).

150. *Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993).

corporations to modify their relationships by contract.¹⁵¹ Consequently, the court believed that shareholders should protect themselves in this fashion rather than expecting courts to provide protection.¹⁵²

The court's suggestion that the power to contract reduces the need for judicial protection of minority shareholders in closely held corporations is plausible. Minority shareholders who invest in a closely held corporation (unlike the plaintiffs in *Nixon*, who received their stock by way of a testamentary gift and future transfers), may contract to secure employment, a given level of dividends, board membership, or anything else that is important to their decision to join the venture.¹⁵³ Minority shareholders may bargain for provisions limiting the compensation and other self-dealing opportunities of the majority. Minority shareholders may seek contracts that provide for dissolution or a buyout at a fair price, as determined by a neutral party or a court, under specified circumstances. In this manner, minority shareholders may protect themselves against most elements of a freezeout scheme. If majority stockholders do not agree to such provisions at the time the minority is to purchase its stock, the minority is fairly put to the choice of making the investment or foregoing special protection against future oppression.

There are, nevertheless, significant limitations on the minority's ability to protect itself by contract. The circumstances of potential future oppression cannot always be foreseen at the time of contracting.¹⁵⁴ To the extent such circumstances can be foreseen, it may be impossible to formulate contractual standards that are sufficiently certain and definite for a court to enforce.¹⁵⁵

151. See DEL. CODE ANN. tit. 8, §§ 341-356 (1998). In the absence of such statutory authority, contracts that unduly limit the board's discretion may be void as against public policy. See, e.g., *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934). The statutory close corporation provisions explicitly permit shareholder agreements that limit the board's discretion or replace the board entirely and provide for management by the shareholders. See DEL. CODE ANN. tit. 8, §§ 350, 351 (1998). Perhaps because so few eligible corporations take advantage of statutory close corporation status, see *infra* note 157, the Delaware legislature has now provided all corporations with broader contractual freedom. The current text of DEL. CODE ANN. tit. 8, § 141(a) (1998) states: "The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, *except as may be otherwise provided . . . in its certificate of incorporation.*" (emphasis added).

152. See *Nixon*, 626 A.2d at 1380.

153. For a catalogue of measures designed to protect minority shareholders against a freezeout, see 2 O'NEAL & THOMPSON, *OPPRESSION*, *supra* note 17, ch. 9.

154. In *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988), one of the chief factors supporting a finding of oppression and a court-ordered buyout of the minority interest was the majority's denial of the minority's very status as a shareholder. See *id.* at 381. The majority shareholder maintained that the minority shareholder had previously made a gift of his 45% interest to the majority. *Id.* It is hard to imagine a lawyer anticipating such oppressive conduct in advance and contracting for a buyout in the event it comes to fruition.

155. For example, in *Litle v. Waters*, No. 12155, 1992 Del. Ch. LEXIS 25 (Del. Ch. Feb. 10,

Most importantly, closely held corporations are the corporations least likely to involve lawyers making extensive efforts to assure that the corporation is formed in accordance with the wishes of all parties.¹⁵⁶ The smaller the enterprise, the larger the relative transaction costs of contracting for special relationships between shareholders. One simply cannot expect a two-person dry cleaning operation to run with the same level of attorney supervision as a Fortune 500 company. The fact that only a small percentage of eligible corporations elect to take advantage of statutory close corporation provisions of the type referenced in *Nixon* provides some evidence that closely held corporations tend to lack access to lawyers.¹⁵⁷

In other spheres, the law is relatively forgiving of the closely held corporation's lack of access to lawyering. For example, although a corporation's bylaws may normally be amended only through the procedures specified in the bylaws themselves, courts have recognized that amendments may be accomplished by conduct where all the parties with the power to amend the bylaws act in a manner inconsistent with the bylaws for a significant period of time.¹⁵⁸ To take another example, board action normally takes place only at a duly called meeting.¹⁵⁹ Courts, however, have legitimized conduct taken with the assent or acquiescence of all directors or shareholders, even though no board meeting to approve the conduct occurred.¹⁶⁰ One cannot imagine either of these examples being applied to a

1992), a closely held corporation elected Subchapter S tax status. This status provides for pass-through taxation and makes every shareholder liable to pay tax on his pro rata share of the corporation's profits whether or not the corporation pays dividends. The minority shareholder alleged that he consented to the Subchapter S election based on a promise that the corporation would pay dividends sufficient to allow the minority shareholder to pay his portion of the tax on the corporation's profits. The court agreed with the majority's argument that "the alleged agreement [was] too vague and indefinite to be enforceable as a contract." *Id.* at *16.

156. See 1 O'NEAL & THOMPSON, CLOSE CORPORATIONS, *supra* note 17, § 2.20, at 54 (noting "[t]he widespread reluctance of the participants in small businesses to obtain competent legal advice"). The authors do suggest, however, that "preventive legal advice is inexpensive when compared to the cost of litigation which may result from the failure to seek out competent legal assistance." *Id.*

157. See *id.* § 1.19 (noting that only about 5% of eligible corporations nationwide elect statutory close corporation status).

158. See, e.g., *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930); *Schraft v. Lewis*, 686 P.2d 865 (Kan. 1984); *Baywood Country Club v. Estep*, 929 S.W.2d 532 (Tex. App. 1996). For example, in the leading case of *Keating v. K-C-K Corp.*, 383 S.W.2d 69 (Tex. App. 1964), the bylaws provided for a board composed of three directors. In 1957 and 1958, three directors were elected. Without any formal action to amend the bylaws, however, four directors were elected in 1959, 1960, 1961, and 1962. The court held that this consistent course of conduct was in itself sufficient to effect an amendment to the bylaws to create four directorships, so that the number of directors could not thereafter be reduced to three without a new bylaw amendment. See *id.* at 71.

159. See, e.g., DEL. CODE ANN. tit. 8, § 141(f) (1998) (providing that board action without a meeting requires unanimous written consent).

160. See, e.g., WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 294-98 (7th ed. 1995).

publicly held corporation, in which the regularity of procedures provides substantial protection to passive shareholders who take no part in corporate affairs and in which substantial staffs of lawyers are on hand to guarantee such regularity.

One wonders, therefore, at *Nixon's* suggestion that minority shareholders seeking protection from majority oppression need only make sufficient contracts.¹⁶¹ It would seem to be the courts' job to either enforce the spirit of the deal between the parties, even in cases where no formal contract exists,¹⁶² or to ask what protections the parties would have contracted for had they considered a particular question at the corporation's inception.¹⁶³

As a consequence of the foregoing, there is substantial reason to question whether *Nixon* has permanently established that Delaware will not recognize any common law protections for minority shareholders in closely held corporations. As presented to the Delaware Supreme Court, *Nixon* was not a freezeout case, and the court was therefore not required to consider whether closely held corporations require special rules.¹⁶⁴ Moreover, the *Nixon* court's reliance on contract as a means for safeguarding the interests of minority shareholders in closely held corporations is, at the very least, open to serious debate and received only cursory consideration from the court. This debate is better reserved for a case in which something turns on the court's determination of the legal status of closely held corporations.

161. In arguing against this aspect of *Nixon*, one commentator has suggested that the participants in a closely held corporation usually choose the corporate form to achieve limited liability and corporate tax attributes rather than to vary the governance rules that would ordinarily apply to partnerships. See Robert B. Thompson, *The Taming of Limited Liability Companies*, 66 U. COLO. L. REV. 921, 935 (1995).

162. For a discussion of the quasi-contractual nature of the duties owed to minority shareholders in closely held corporations, see *supra* note 39.

163. This is the approach suggested by two leading commentators. See EASTERBROOK & FISCHER, *supra* note 6, at 250 (arguing that "[t]he right inquiry is always what the parties would have contracted for had transaction costs been nil"). Judge Easterbrook and Professor Fischer recognize:

It makes sense . . . to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgment rule.

The same approach could be used with salary, dividend, and employment decisions in closely held corporations where the risks of conflicts of interest are greater.

Id. at 245. These commentators also stress, however, that heightened fiduciary duty standards in closely held corporations may be difficult to administer. See *id.* at 247-48.

164. In its posture before the Delaware Supreme Court, *Nixon* was not a freezeout case because the Chancery Court's decision upholding the majority's refusal to pay significant dividends was not appealed, and there was no evidence before the court relating to the fairness of the price at which the corporation offered to purchase the minority interest through a series of self-tender offers. See *supra* text accompanying notes 131, 134. Had these issues been present, the Delaware Supreme Court would have been required to consider classic freezeout allegations.

C. Riblet Products Corp. v. Nagy

Since their decision in *Nixon*, the Delaware Supreme Court has returned to the problem of closely held corporations in only one case, *Riblet Products Corp. v. Nagy*,¹⁶⁵ which the court received through a circuitous route. This case involved a minority shareholder who was also president and chief executive officer of a corporation. The executive's employment contract stipulated that if he was fired other than for cause, he was entitled to certain stipulated benefits. The executive was fired. He brought suit against the contracting shareholders in federal district court in Indiana seeking contractual benefits on the ground that he was fired without cause. He also sued the controlling shareholders for breach of fiduciary duty.¹⁶⁶

The jury found that the executive had been fired without cause and awarded full contractual benefits payable by the corporation.¹⁶⁷ Judgment was entered on these findings, and this portion of the judgment was affirmed by the Seventh Circuit. The trial court also entered a judgment making the controlling shareholders jointly and severally liable for the corporation's contractual payments and requiring the controlling shareholders to pay \$375,000 in punitive damages.¹⁶⁸ The controlling shareholders' liability depended on their conduct constituting a breach of fiduciary duty to the minority shareholder.¹⁶⁹

In considering "the question whether corporate law requires controlling shareholders to act as fiduciaries toward minority shareholder-employees,"¹⁷⁰ the Seventh Circuit noted that Indiana would answer this question in the affirmative in accordance with *Wilkes v. Springside Nursing Home, Inc.*¹⁷¹ However, Delaware substantive law governed the case. The Seventh Circuit noted that there was some question whether Delaware would follow *Wilkes* and stated that "[t]he Supreme Court of Delaware has never addressed the question."¹⁷² The Seventh Circuit's failure even to cite the Delaware Supreme Court's opinion in *Nixon v. Blackwell* provides eloquent testimony that *Nixon* may not have settled as much as the broad language of the opinion suggests. The Seventh Circuit viewed *Ueltzhoffer v. Fox Fire Development*

165. 683 A.2d 37 (Del. 1996).

166. *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 573-74 (7th Cir. 1996) (*Nagy*).

167. *See id.* at 574.

168. *See id.* at 574-75.

169. *See id.* at 574.

170. *Id.* at 576; *see supra* text accompanying notes 70-75.

171. 353 N.E.2d 657 (Mass. 1976).

172. *Nagy*, 79 F.3d at 577.

*Co.*¹⁷³ as the only relevant Delaware authority. As the Seventh Circuit noted correctly, *Ueltzhoffer* does not settle whether Delaware recognizes special fiduciary duties in closely held corporations.¹⁷⁴

“Recognizing the nationwide application of Delaware corporate law, and the benefits of making that law certain,” the Seventh Circuit certified the question regarding the existence and extent of the controlling shareholders’ fiduciary duties to the Delaware Supreme Court.¹⁷⁵ The Delaware Supreme Court accepted the certification. As reformulated by the Delaware Supreme Court, the certified question was: “[w]hether majority stockholders of a Delaware corporation may be held liable for violation of a fiduciary duty to a minority stockholder who is an employee of the corporation under an employment contract with respect to issues involving that employment.”¹⁷⁶

It is worth noting that the Delaware Supreme Court formulated an extremely narrow question. The Court might have asked whether majority stockholders have any fiduciary duty to minority stockholders. Although the Seventh Circuit noted that the most likely source of any such duty was *Wilkes’s* idea that the majority in a closely held corporation owes a special fiduciary duty to the minority, the Delaware Supreme Court might simply have answered this question in the negative on the authority of *Nixon v. Blackwell*.¹⁷⁷

Addressing the certified question, the court took the view that the employment contract was dispositive of the plaintiff’s rights.¹⁷⁸ Therefore, the plaintiff’s remedies were solely against the corporation for breach of the employment contract and were limited to the contractually stipulated damages. No relief lay against the controlling shareholders. This result seems entirely correct. Although one may argue whether courts should create special fiduciary duties to protect minority shareholders where no explicit contract between the parties exists, there is no cause for judicial protection of minority rights where the minority has negotiated an extensive contract directly addressing the relevant issues.¹⁷⁹

After answering the certified question in the negative, the *Riblet* court gave a clue as to why it formulated such a narrow question. The court suggested that it wanted to leave open the possibility that Delaware law may

173. No. 9871, 1991 Del. Ch. LEXIS 204 (Del. Ch. Dec. 19, 1991).

174. *See Nagy*, 79 F.3d at 577; *see also supra* text accompanying notes 101-18.

175. *Id.*

176. *Riblet Prod. Corp. v. Nagy*, 683 A.2d 37, 39 (Del. 1996) (*Riblet*).

177. *See supra* Part II.B.

178. *Riblet*, 683 A.2d at 40.

179. *See Nagy*, 79 F.3d at 577 (noting that “the label ‘fiduciary’ does not trump a real contract; it is a gap-filling approach”).

find a breach of the majority's fiduciary duty to the minority in other circumstances. The court specifically noted: "This is not a case of breach of fiduciary duty to Nagy *qua* stockholder. . . . Nagy does not allege that his termination amounted to a wrongful freeze out of his stock interest . . . nor does he contend that he was harmed as a stockholder by being terminated."¹⁸⁰ Because the *Riblet* court reaffirmed *Nixon*'s principle that the duties of majority shareholders are no different in closely and publicly held corporations and noted that "*Wilkes* has not been adopted as Delaware law,"¹⁸¹ the implication is that protection for minority shareholders against freezeout techniques must flow from the general fiduciary duties that majority stockholders owe to the minority in all corporations. This possibility is the subject of Part III.

D. Conclusion

In conclusion, three Delaware cases, *Nixon v. Blackwell*, *Riblet Products Corp. v. Nagy*, and *Ueltzhoffer v. Fox Fire Development Co.*, have suggested that the controlling parties of a closely held corporation owe no special fiduciary duties to the minority. However, none of these cases involved a classic freezeout. There is, therefore, some hope that, when confronted with real evidence of a freezeout, the Delaware Supreme Court may reconsider its views in *Nixon* and *Riblet* and hold, as the Chancery Court held in *Litle v. Waters*, that the majority owes a fiduciary duty of fairness to the minority in the close corporation context.

It is worth noting in this regard that the Delaware Supreme Court has been particularly flexible when it believes that past holdings or dicta were mistaken. For example, in a trilogy of cases decided between 1977 and 1979, the Delaware Supreme Court held that the majority could not effect a freezeout merger for the sole purpose of eliminating the minority interest.¹⁸² In 1983, the court reversed itself and endorsed freezeout mergers subject to the majority's duty to deal fairly with the minority and pay a fair price.¹⁸³ Similarly, in 1990 the Delaware Supreme Court suggested in dicta that selling control of a corporation did not trigger the strict rules of judicial review applicable to takeover defense when the target company's board decides to sell the entire company.¹⁸⁴ In 1994, when confronted with a case

180. *Riblet*, 683 A.2d at 40.

181. *Id.* at 39; *see also id.* at 39-40 n.2.

182. *See* *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979); *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977); *Tanzer v. Int'l General Indus., Inc.*, 379 A.2d 1121 (Del. 1977).

183. *See* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

184. *See* *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150-51 (Del. 1990).

squarely raising the issue, the Delaware Supreme Court held that the same rules of judicial review apply to takeover defenses when only control of a company is sold as apply when the entire company is sold.¹⁸⁵ Thus, it seems that the Delaware Supreme Court agrees with Emerson that “a foolish consistency is the hobgoblin of little minds.”¹⁸⁶

Moreover, even if the Delaware Supreme Court stands firm in its refusal to create special rules for closely held corporations, there is no reason the Delaware courts cannot employ Delaware’s general law on the fiduciary duties of majority shareholders to prevent freezeouts in closely held corporations. *Riblet* almost invites such a result in a future case.

III. THE ENTIRE FAIRNESS TEST AS A METHOD OF PROTECTING MINORITY SHAREHOLDERS AGAINST OPPRESSION

Generally, shareholders have no rights or obligations relative to the corporation or the other shareholders save those contained in their stock contracts.¹⁸⁷ Controlling shareholders, however, have a fiduciary duty to the minority in all corporations, including publicly held corporations.¹⁸⁸ This duty is a consequence of the power that controlling shareholders have to direct the corporation’s affairs. Although the traditional corporate model posits that directors, rather than shareholders, direct corporate activity, this model breaks down where a single shareholder or group of shareholders owns a controlling interest. In such situations, the board is usually just a proxy for the controlling shareholder or group. The power incident to control gives rise to equivalent responsibility.

185. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994). For an analysis of *QVC*’s effect on Delaware takeover jurisprudence, see Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of QVC and its Progeny*, 32 HOUS. L. REV. 945 (1995).

186. RALPH W. EMERSON, *SELF RELIANCE AND OTHER ESSAYS* 24 (Dover Thrift 1993).

187. Indeed, a controlling shareholder is not required to sell his stock even if such refusal forces the corporation to forego a beneficial transaction. See, e.g., *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987). If the controlling shareholder does sell his block, he is allowed to keep any premium and need not share it with the minority. See, e.g., *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 442 (Del. 1996). A director has no more duty to the minority when he acts with respect to his shares than a controlling shareholder. See, e.g., *Freedman v. Restaurant Assocs. Indus., Inc.*, [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,617, at 97,887 (Del. Ch. Sept. 19, 1990) (holding that a management buyout group, which owned 48% of the corporation’s stock and controlled a majority of board seats, had no duty to sell to a competing bidder “merely because the sale would profit the minority” (quoting *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987))).

188. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (noting that “[a] director is a fiduciary,” and “[s]o is a dominant or controlling stockholder or group of stockholders”); *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 487-88 (1919) (noting that “[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors”).

As long as all stockholders share proportionately in the costs and benefits of corporate decisions, controlling stockholders may direct corporate activity in whatever manner they choose. The controlling interest simply conveys this privilege. If the minority is treated the same as the majority, the decisions of the controlling shareholder's proxies on the board are protected by the business judgment rule and may not be second-guessed by the minority.¹⁸⁹ Where the controlling shareholder or group allocates disproportionate benefits to itself, however, different rules apply. In such circumstances, the controlling shareholders and their directors are not protected by the business judgment rule and must carry the burden of proving the "entire fairness" of any self-dealing transaction to have their conduct upheld.¹⁹⁰ The entire fairness test requires the majority to proceed in a manner that is both procedurally and substantively fair.¹⁹¹ It has been applied rigorously by the Delaware courts.

The fair dealing prong of the entire fairness test "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, and disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."¹⁹² The fair price prong of the entire fairness test embodies the concept that the challenged transaction must be fair to the minority as a substantive business matter.¹⁹³ Whereas the business judgment rule generally insulates the majority's conduct from substantive judicial review in cases subject to the rule, the entire fairness test requires the court to exercise its independent business judgment. The self-dealing party has the burden of proof in showing the transaction's entire fairness.¹⁹⁴ This burden is

189. *See, e.g.*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

190. *See id.* (holding that the entire fairness test applies whenever the majority "receives something from the [corporation] to the exclusion of, and detriment to, the minority stockholders").

191. Although cases generally analyze the entire fairness test in terms of its fair dealing and fair price prongs, the test is theoretically unitary in that the court will weigh the totality of all factors relating to either prong to arrive at a determination of whether a self-dealing transaction is entirely fair. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (noting that "[t]he test for fairness is not a bifurcated one as between fair dealing and fair price," and "[a]ll aspects of the issue must be examined as a whole since the question is one of entire fairness"). As a consequence, the majority can satisfy its burden of proving entire fairness even if some misconduct is found. *See Kahn v. Lynch Communications Sys., Inc.*, 669 A.2d 79 (Del. 1995) (finding the entire fairness test satisfied despite coercive conduct by a controlling shareholder); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) (finding the entire fairness test satisfied despite a lack of due care by the board).

192. *Weinberger*, 457 A.2d at 711.

193. *See, e.g., id.*

194. *See id.* at 703. The burden shifts to the party challenging a self-dealing transaction if the transaction is approved by a properly functioning committee of disinterested directors, *see, e.g., Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (noting that "the majority . . . must not dictate the terms of the merger" and that "the special committee must have real bargaining power that it can exercise with the majority . . . on an arms length basis"), or a majority of

difficult to meet under Delaware law. The Delaware courts have viewed the invocation of the entire fairness test as bordering on outcome-determinative because “the standard of entire fairness [is] so exacting.”¹⁹⁵

This Part considers the extent to which the Delaware entire fairness test protects minority shareholders in closely held corporations against oppression by the majority. First, Section A considers the application of the entire fairness test in the context of explicit freezeout mergers. Section B then considers the application of the entire fairness test to cases in which the freezeout scheme is more subtle. Finally, Section C considers the remedies available under Delaware law for violation of the entire fairness test.

A. Freezeout Mergers

The majority in a closely held corporation may eliminate the minority explicitly by effecting a freezeout merger. An example will illustrate the mechanics of such a merger. Assume that the majority shareholder owns seventy percent of Corporation A and the minority owns thirty percent. The majority forms a new entity (Corporation B) of which it owns one hundred percent. The majority shareholder then forces a merger of Corporation A into Corporation B with Corporation B surviving the merger and the minority shareholder of Corporation A receiving cash as the merger consideration.¹⁹⁶ The end result is that the majority shareholder owns one hundred percent of Corporation B, which succeeds to all the assets and liabilities of Corporation A,¹⁹⁷ and the minority shareholder has been removed from the business. The majority has achieved a forced sale of the minority’s shares for the merger consideration.

The Delaware Supreme Court has explicitly endorsed the legitimacy of the majority using a freezeout merger to eliminate the minority.¹⁹⁸ The entire

disinterested shareholders acting after full disclosure, see, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997).

195. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1988) (quoting *AC Acquisitions v. Anderson*, 519 A.2d 103, 111 (Del. Ch. 1986)).

196. Effecting the merger of a Delaware corporation requires approval by the board and a simple majority of shares. See DEL. CODE ANN. §§ 251(b), (c) (1998). As a consequence, the 70% shareholder in our example has the raw power to effect a freezeout merger. Further, there is no difficulty in using cash as the merger consideration. See DEL. CODE ANN. tit. 8, § 251(b)(5) (1998) (requiring the plan of merger to contain the merger consideration, which may be “cash”).

197. This is a legal consequence of the merger. See DEL. CODE ANN. tit. 8, § 259(a) (1998).

198. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court reversed a trilogy of cases decided within the preceding six years, see *supra* note 182, and held that the majority may effect a freezeout merger for no purpose other than eliminating minority interests. This rule is not universally accepted. See *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112 (Mass. 1986); *Alpert v. 28 William St. Corp.*, 473 N.E.2d 19 (N.Y. 1984).

fairness test applies to such self-interested mergers.¹⁹⁹ Most litigated cases have involved publicly held corporations. Although many of the same issues apply to freezeout mergers in closely held corporations, some of these issues have a different gloss in the close corporation context.

The fair dealing prong of the entire fairness test requires the majority to employ fair procedures in effecting a freezeout merger. The most common fair dealing violations fall into three categories. First, the majority fails to apply procedures that replicate independent, arms-length bargaining.²⁰⁰ Although the failure to achieve arms-length bargaining is not fatal per se,²⁰¹ the Delaware cases emphasize the importance of such actions as forming an independent board committee to consider the majority's merger proposal²⁰² or putting the merger proposal to a majority vote of the disinterested shareholders.²⁰³ In closely held corporations, such procedures are likely to be

Presumably, the Delaware courts would apply the *Weinberger* rule to closely held corporations. There is, however, a potential basis for distinction. In publicly held corporations, most shareholders make impersonal investments. They care only about the total value of their investments rather than whether such value inheres in stock or cash. See Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1374-75 (1978). As a result, a freezeout does not work any hardship as long as the minority receives fair treatment and a fair price. In contrast, shareholders in closely held corporations often view their investments in a more personal manner. Thus, the shareholder's investment in a close corporation may be protected by property rules (the shareholder may not be deprived of his stock involuntarily) rather than liability rules (the shareholder may be deprived of his stock only upon payment of fair compensation). See *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir. 1974) (refusing to allow a freezeout merger in a closely held corporation). But see David C. Crago, *Fiduciary Duties and Reasonable Expectations: Cash-Out Mergers in Close Corporations*, 49 OKLA. L. REV. 1, 27 (1996) (arguing that the majority should be allowed to employ a freezeout merger at a fair price to resolve disputes in closely held corporations). On the distinction between property rules and liability rules, see Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

199. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

200. See, e.g., *Seagraves v. Urstadt Property Co.*, No. 10307, 1996 Del. Ch. LEXIS 36, at *16 (Del. Ch. Apr. 1, 1996) (noting that the failure to institute procedural safeguards "is a factor evidenc[ing] the absence of fair dealing"); *MacLane Gas Co., v. Enserch Corp.*, No. 10760, 1992 Del. Ch. LEXIS 260, at *30 (Del. Ch. Dec. 9, 1992) (finding unfair dealing based on "a total lack of procedural safeguards"), *aff'd*, 633 A.2d 369 (Del. 1993).

201. See, e.g., *Wiegand v. Berry Petroleum Co.*, No. 9316, 1991 Del. Ch. LEXIS 37, at *21 n.10 (Del. Ch. Mar. 27, 1991) (noting that the failure to furnish procedural safeguards "constitute[s] evidence of unfair dealing" but does not "necessarily establish unfair dealing as a matter of law"); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) (commenting that the presence of procedural safeguards typically constitutes "indicia of fairness" but that their absence "does not itself establish any breach of duty").

202. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983) (noting that the result "could have been entirely different if [the corporation] had appointed an independent negotiating committee of its outside directors to deal with [the majority] at arms length."); *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1337 (Del. Ch. 1987) (criticizing the fact that "[n]o independent directors were put on [the corporation's] board").

203. See, e.g., *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 692 n.12 (Del. Ch. 1996) (stating that, although a disinterested shareholder vote is not required, "utilization of that structural safeguard, or its absence, is a factor that this Court will consider in determining whether there was fair dealing"),

unavailing because there are usually no disinterested directors or shareholders other than the minority, and, if the minority supports the transaction, no further difficulties should arise.

There is, however, one procedural feature that is as applicable to closely held corporations as to publicly held corporations. The courts have been suspicious of transactions in which publicly held corporations did not hire independent financial and legal advisors to assess the objective fairness of the transaction.²⁰⁴ Presumably, in the close corporation context, the majority should try to reach agreement with the minority on an outside expert to value the corporation's shares prior to fixing the merger consideration.²⁰⁵ Given the larger relative transaction costs in closely held corporations, it may be unnecessary to hire independent lawyers if the corporation's lawyer takes a neutral position.²⁰⁶ Where the corporation's lawyer is also in effect acting as the majority's counsel, however, the minority deserves to be represented by an independent lawyer at the corporation's expense.²⁰⁷

Second, failure to make full disclosure is a common ground relied upon by courts in finding a violation of the fair dealing prong of the entire fairness test.²⁰⁸ Violating this requirement is especially problematic in a closely held corporation if it hinders the minority's ability to exercise appraisal rights in an intelligent fashion.

Third, the Delaware courts have found unfair dealing when the majority

aff'd, 693 A.2d 1082 (Del. 1997).

204. See, e.g., *Ryan*, 709 A.2d at 691-93; *Sealy Mattress Co.*, 532 A.2d at 1337.

205. A unilateral attempt by the majority to hire a financial expert to give a fairness opinion would be suspect. In the context of determining whether the existence of a special committee justifies shifting the burden of proof on entire fairness, one court noted that a "critical factor in assessing the reliability and independence of the process employed by a special committee" is the method by which the committee's financial and legal advisors are selected. *Kahn v. Dairy Mart Convenience Stores*, No. 12489, 1996 Del. Ch. LEXIS 38, at *22 n.6 (Del. Ch. Mar. 29, 1996). In this case, the court noted that the procedure used "raises questions," because the special committee's legal and financial advisors were referred to the committee by the controlling shareholder's attorney. *Id.*

206. In contrast, in a public corporation, the Delaware Chancery Court has noted that "[a] desire to control costs cannot relieve corporate fiduciaries from their duty to assure that the interests of minority shareholders in a self-dealing transaction are adequately protected." *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 693 (Del. Ch. 1996), *aff'd*, 693 A.2d 1082 (Del. 1997).

207. On the propriety of equal access to legal services in the close corporation context, see *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988) (finding oppression based in part on the majority's use of corporate funds to pay attorneys' fees in litigation against the minority).

208. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708-09, 712 (Del. 1983) (relying on the majority's failure to disclose a feasibility study showing that the majority had the capacity to pay extra merger consideration); *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1339 (Del. Ch. 1987) (noting that "few, if any, of the facts material to an informed investment decision were disclosed, and the facts that were disclosed were, in the main, highly misleading"); *Kumar v. Racing Corp. of Am., Inc.*, [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,896, at 99,422-23 (Del. Ch. Apr. 26, 1991) (granting a preliminary injunction and criticizing the majority's "deliberate effort to keep plaintiffs in the dark and thereby prevent them from protecting their rights").

uses its power to place the minority in an unfavorable bargaining position with respect to a freezeout merger. The most common tactics used by the majority include timing the merger to give the majority an advantage at the minority's expense,²⁰⁹ manipulating the market price to make the merger consideration seem fair,²¹⁰ and engaging in a hurried rather than deliberative process in approving the merger.²¹¹ The courts have also questioned tactics that, although legal in an arms-length bargaining situation, suggest less than the "exacting" standard required by the entire fairness test.²¹²

The typical freezeout tactics in a closely held corporation, if used in conjunction with a cash-out merger, would seem clearly to violate the fair dealing prong of the entire fairness test, especially the portion of that prong that prohibits sharp tactics. Presumably the majority could not fire minority shareholders, suppress dividends, or deny the minority access to corporate decision-making and financial records in order to force minority acceptance of a cash-out merger. Similarly, it should be clear that the majority could not engage in illegal self-dealing, such as paying itself excessive compensation, for the purpose of decreasing the corporation's value prior to effecting a freezeout merger.

209. See, e.g., *MacLane Gas Co., v. Enserch Corp.*, No. 10760, 1992 Del. Ch. LEXIS 260, at *30 (Del. Ch. Dec. 9, 1992) (finding unfair dealing where the timing of a merger was designed to benefit the majority), *aff'd*, 633 A.2d 369 (Del. 1993); *Kumar v. Racing Corp. of Am., Inc.*, [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,896, at 99,422-23 (Del. Ch. Apr. 26, 1991) (granting a preliminary injunction based in part on the abusive timing of a merger).

210. See, e.g., *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1336 (Del. Ch. 1987) (finding that the majority engaged in "a calculated effort to depress the price of [the company's stock] until the minority stockholders were eliminated by merger or some other form of acquisition").

211. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 706-07, 711 (Del. 1983) (criticizing a "hurriedly prepared" fairness opinion and noting that the transaction was approved in four business days).

212. One such case is *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985). In that case, Olin Corporation purchased 63.4% of Philip A. Hunt Chemical Corporation at a price of \$25 per share. Olin promised the seller that it would pay the same price for any minority shares acquired within one year of the transaction. Shortly after the one-year commitment expired, Olin effected a freezeout merger in which the minority shareholders received \$20 per share. The minority did not challenge the fairness of the \$20 price based on traditional valuation criteria. Rather, the minority argued that Olin had failed in its duty of entire fairness by waiting until the one-year period had elapsed to effect the merger. The Delaware Supreme Court denied a motion to dismiss the complaint and held that "the facts alleged by the plaintiffs regarding Olin's avoidance of the one year commitment support a claim of unfair dealing." *Id.* at 1106. Although the court recognized that Olin "had no legal obligation to effect the cash-out merger during the one year period," the court noted that "inequitable conduct will not be protected merely because it is legal." *Id.* at 1106-07. On remand, the Chancery Court held, after a full trial, that Olin had not engaged in unfair dealing because there was no proof that Olin had timed the freezeout merger to avoid the one-year commitment. See *Rabkin v. Olin Corp.*, [1990 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,255, 96,164-68 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990). The clear implication of the Supreme Court's opinion in *Rabkin*, however, is that the literal wording of the contract notwithstanding, it would have constituted unfair dealing to delay a freezeout merger for the purpose of avoiding the one-year commitment.

The Delaware courts have also applied the fair price prong of the entire fairness test to protect minority rights in freezeout mergers. Traditionally, the courts employed the Delaware block method to appraise the value of minority shares dissenting from a merger. This method involved computing a weighted average of market value, capitalization of earnings value, and liquidation value the corporation's.²¹³ It has been criticized as unduly conservative.²¹⁴ In *Weinberger v. UOP, Inc.*,²¹⁵ the Delaware Supreme Court expanded the valuation techniques that a court may use to include "any techniques or methods which are generally considered acceptable by the financial community."²¹⁶ In particular, the *Weinberger* court approved use of the discounted cash flow method to value the minority's shares in a freezeout merger.²¹⁷

There is a second valuation context in which the Delaware Supreme Court has been generous to minority shareholders. In appraising minority shares dissenting from a merger, a common issue is whether minority shares should be discounted for minority status and/or illiquidity. Were the minority to sell its shares in an arms-length transaction, such discounts would surely be applied by the market. In *Cavalier Oil Corp. v. Harnett*,²¹⁸ however, the Delaware Supreme Court held that in an appraisal proceeding the minority is entitled to its full pro rata share of the corporation's value and that no discounts should be applied.²¹⁹ In part, the court relied on the fact that the cash received in an appraisal was a substitute for the minority's surrender of its pro rata interest in the corporation "as a 'going concern.'"²²⁰ In addition,

213. See, e.g., *Piemonte v. New Boston Garden Corp.*, 387 N.E.2d 1145 (Mass. 1979).

214. Presumably a corporation's value is the higher of going concern value, of which the earnings value may be a reasonable estimate, and liquidation value. The corporation's board should follow whichever course generates the higher value. The Delaware block method understates the value of the corporation by reducing the value of the corporation's best option to account for the value of less valuable options that should not be pursued. See Zenichi Shishido, *The Fair Value of Minority Stock in Closely Held Corporations*, 62 *FORDHAM L. REV.* 65, 72 (1993).

215. 457 A.2d 701 (Del. 1983).

216. *Id.* at 712-13.

217. See *id.* at 712; see also Joseph E. Calio, *New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding*, 32 *AM. BUS. L.J.* 1, 48-49 (1994) (noting that "[s]ince *Weinberger*, . . . the 'discounted cash flow' method has become the valuation 'methodology of choice' in Delaware appraisal proceedings").

218. 564 A.2d 1137 (Del. 1989).

219. See *id.* at 1144-45. Maine followed *Cavalier Oil* in *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989); see also *Brown v. Allied Corrugated Box Co.*, 154 Cal. Rptr. 170 (Cal. Ct. App. 1979) (declining to apply minority or liquidity discount in valuing minority's shares pursuant to statutory buyout proceeding); *Charland v. Country View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991) (same). But see *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. 1986) (giving the trial judge discretion to decide whether to apply a minority discount); *Blake v. Blake Agency, Inc.*, 486 N.Y.S.2d 341 (N.Y. App. Div. 1985) (applying an illiquidity discount).

220. *Cavalier Oil*, 564 A.2d at 1145.

the court noted that applying discounts “unfairly enriches the majority shareholder who may reap a windfall from the appraisal process by cashing out a dissenting shareholder.”²²¹

Thus, the entire fairness test provides substantial protection to minority shareholders in a closely held (or any other) corporation who are subjected to an explicit freezeout merger. Typical freezeout tactics are a violation of the fair dealing prong of the test. The Delaware Supreme Court has also vigorously defended the minority’s right to receive a fair price for its shares.

B. Subtle Freezeout Schemes

Although the entire fairness test may provide minority protection against explicit freezeout mergers, the freezeout schemes that have been invalidated in jurisdictions that recognize special fiduciary duties in closely held corporations are usually more subtle. Consider *Wilkes v. Springside Nursing Home, Inc.*²²² In that case, the majority shareholders fired a minority shareholder, paid no dividends, and removed the minority shareholder from the board of directors. Then, instead of effecting an explicit freezeout merger, a member of the majority group offered to purchase the minority’s shares for an amount that the court perceived as unfair.²²³

The majority is normally not subject to fiduciary duty obligations when it proposes a voluntary purchase transaction to the minority.²²⁴ Does this mean that Wilkes’s rights would not have been infringed in a Delaware corporation? The specific result in *Wilkes* might well be reached in Delaware. The rule that majority shareholders owe no duty to the minority when offering to purchase stock in a voluntary transaction is subject to the requirements that full disclosure be made and coercion not be used.²²⁵ Where

221. *Id.*

222. 353 N.E.2d 657 (Mass. 1976).

223. See *supra* text accompanying notes 71-75.

224. It is, for example, well established that a majority shareholder has no obligation to make a tender offer for the minority interest at a fair price. See, e.g., *Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996); *In re Marriott Hotel Properties II Ltd. Partnership Unitholders Litig.*, No. 14961, 1997 Del. Ch. LEXIS 128 (Del. Ch. Sept. 17, 1997); *In re Ocean Drilling & Exploration Co. Shareholders Litig.*, [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (Del. Ch. Apr. 30, 1991).

225. See, e.g., *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 39-40 (Del. 1996) (noting that “in the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue”); *In re Marriott Hotel Properties II Ltd. Partnership Unitholders Litig.*, No. 14961, 1996 Del. Ch. LEXIS 60, at *27 (Del. Ch. June 12, 1996) (stating that “if the transaction is seen as non-voluntary, then plainly, the fiduciary would act under a duty only to pay a fair price in the tender offer”); *Kahn v. United States Sugar Corp.*, No. 7313, 1985 Del. Ch. LEXIS 522, at *17 (Del. Ch. Dec. 10, 1985) (holding that “because of the highly leveraged nature of the transaction it was coercive and therefore defendants had an obligation to offer a fair price”); *Joseph v. Shell Oil Co.*, 482

the majority engages in a financial and participatory freezeout by discharging the minority from employment, suppressing dividends, and removing the minority from the board to assist a purchase offer, Delaware law has presumably been violated.

Changing one of the facts in *Wilkes* makes this a harder case. Suppose the majority had not offered to purchase Wilkes's shares at an unfair price. A freezeout scheme can be equally effective if the majority engages in a financial and participatory freezeout and then simply waits for the minority to offer its stock at a bargain price. Does the result in *Wilkes* change under Delaware law simply because the minority, under intense pressure, initiates sale discussions? The result in *Wilkes* should not change under Delaware law merely because the majority is sufficiently patient to wait for the minority to ask to be bought out at a bargain price. If the majority is not permitted to effect a freezeout merger to acquire Wilkes's stock at an unfair price or employ coercive tactics to force Wilkes to accept a purchase offer at an unfair price, the majority should not be permitted to accomplish indirectly what it could not accomplish directly.

In *Litle v. Waters*,²²⁶ the Delaware Chancery Court had no difficulty applying the entire fairness test to a *Wilkes*-like freezeout scheme in a closely held corporation. In *Litle*, a majority shareholder discharged a minority shareholder and prevented the declaration of any dividends, leaving the minority shareholder to pay his share of the taxes of a Subchapter S corporation from independent sources. The minority shareholder alleged that the majority's failure to pay dividends was intended to force a sale of the minority interest at a bargain price. The court denied a motion to dismiss the complaint in part on the ground that the allegations implicated the entire fairness test rather than the business judgment rule.²²⁷

The court had no difficulty identifying the aspects of self-dealing that triggered the entire fairness test. The majority shareholder, who also controlled the board of directors, had two selfish interests in preventing the declaration of dividends: allowing the corporation to keep its profits facilitated the retirement of certain loans he had made to the corporation; and suppressing dividends put pressure on the minority shareholder to sell his stock to the majority shareholder at the cheapest possible price.²²⁸ The court viewed a second director, who was also an executive, as having a conflict of

A.2d 335, 341 (Del. Ch. 1984) (holding that the general rule does not apply where an unfair price is offered and "the disclosures are unlikely to call the unwary stockholder's attention to the unfairness").

226. No. 12155, 1992 Del. Ch. LEXIS 25 (Del. Ch. Feb. 10, 1992).

227. See *supra* text accompanying notes 119-26.

228. See *Litle*, 1992 Del. Ch. LEXIS, at *12-*13.

interest on dividend decisions because withholding dividends increased the value of his stock appreciation rights.²²⁹ In this context, the entire fairness test presumably requires the majority to prove that it used a fair process in deciding to withhold dividends and that the withholding of dividends was a good business decision from the corporation's perspective. To the extent the majority withheld dividends to force the minority to sell its stock at a cheap price or to accomplish other selfish purposes, the entire fairness test would be violated.

It seems natural to characterize the usual elements of a freezeout scheme as self-dealing and thereby invoke the entire fairness test to invalidate such conduct.²³⁰ A majority shareholder engages in a freezeout scheme for the purpose of advancing its interests at the expense of the minority, the very type of conduct that the entire fairness test is designed to place under close judicial scrutiny. The difficulty with this approach is that it causes some tension with the central tenet of *Nixon v. Blackwell*²³¹ that there are no special rules governing closely held corporations.²³² In publicly held corporations with a majority stockholder, refusing to pay dividends, a central component of most freezeout schemes,²³³ is not thought to involve a self-dealing transaction.²³⁴ This is the square holding of the Delaware Supreme Court in *Sinclair Oil Corp. v. Levien*.²³⁵

In *Sinclair Oil*, the court held that the business judgment rule protects conduct by majority shareholders unless the majority receives a benefit at the expense of, or to the exclusion of, the minority.²³⁶ Minority shareholders alleged that a ninety-seven percent parent had required a subsidiary to pay dividends, rather than reinvest profits, because the parent was in need of cash. The court rejected the argument that the entire fairness test applied to these dividend decisions and applied the business judgment rule in sustaining the majority's conduct. The court reasoned that because all shares received

229. See *id.* at *13.

230. For an argument that the entire fairness test might apply to disputes in closely held corporations, see Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 492-95 (1985).

231. 626 A.2d 1366 (Del. 1993).

232. See *id.* at 1379-81; see also *supra* Part II.A.

233. See *supra* Part I.B.2.

234. Discharging a minority shareholder where the majority is employed might, in contrast, involve a situation where the majority enjoys a benefit to the minority's exclusion. Such a discharge might, therefore, fit more comfortably into the rubric of entire fairness analysis. Even this conclusion, however, requires the assumption that there is a relationship between the minority's job and the minority's investment, which would not be accepted in the context of a publicly held corporation.

235. 280 A.2d 717 (Del. 1971).

236. See *id.* at 720.

the same pro rata dividend payment, no self-dealing was involved.²³⁷

The decision in *Sinclair Oil* is questionable because the minority alleged that the parent forced the declaration of dividends to advance the parent's selfish interests rather than for any reasons having to do with the business opportunities of the subsidiary. Presumably, the parent should have reinvested profits to the extent the subsidiary had available business opportunities promising expected returns in excess of the corporation's cost of capital.²³⁸ If the majority shareholders were indeed making such a calculation unfettered by any conflicts, application of the business judgment rule would be appropriate. It would not be the court's province to second-guess the majority's cost-benefit calculus. The minority's claim, however, was that from the subsidiary's perspective, the majority was not making a business judgment decision at all.

Sinclair Oil is representative of a strain of Delaware law that considers the impact of corporate action by measuring its effect on shares and refuses to look through the shares to measure the impact on shareholders. So long as the shares themselves are treated equally, any disproportionate impact on shareholders is irrelevant. For example, although shares of the same class must be treated equally,²³⁹ the Delaware Supreme Court once approved a weighted voting scheme (in which every shareholder received one vote for each of the first fifty shares owned and one vote for every twenty shares owned thereafter) that reduced a twenty-eight percent shareholder to three percent of the voting power.²⁴⁰ In this scheme, the shares themselves suffered no voting disability. They would have had full voting rights if transferred to another shareholder owning fewer than fifty shares. It was only the status of their owner, who owned more than fifty shares, that caused the voting disability.²⁴¹ The Delaware courts have similarly approved: (a) poison pill plans that allow all shareholders, other than shareholders exceeding certain ownership thresholds, to purchase stock at bargain prices upon certain triggering conditions;²⁴² and (b) a self-tender offer open to all shareholders

237. *See id.* at 721-22.

238. *See supra* text accompanying notes 62-64.

239. This rule flows from the statutory requirement that the attributes of each class of stock must be stated in the certificate of incorporation. *See* DEL. CODE ANN. tit. 8, § 151(a) (1998).

240. *See* *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977). In addition to the holding noted in the text, the court also upheld the weighted voting scheme on the ground that the Delaware corporation statute explicitly permits deviations from the one share-one vote standard. *See id.* at 123; DEL. CODE ANN. tit. 8, § 212(a) (1998).

241. *See* *Providence & Worcester*, 378 A.2d at 123 (arguing that the voting limitations "are limitations upon the voting rights of the shareholder, not variations in the voting powers of the stock per se").

242. *See* I DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE* 1097 (5th ed. 1998) (noting

except a purported acquiror.²⁴³

Delaware's insistence on the distinction between shares and shareholders is controversial even in publicly held corporations.²⁴⁴ This distinction is less tenable in the context of closely held corporations.²⁴⁵ The impact of freezeout tactics on the minority in closely held corporations is larger than the impact of potential self-dealing in publicly held corporations. For example, although the minority in *Sinclair Oil* was not disinterested on the dividend question, this question was marginal relative to the situation of the minority in a closely held corporation. The minority in *Sinclair Oil*, assuming the truth of its allegations, was denied the difference between the returns the corporation could have obtained by reinvesting its profits and the returns the shareholders obtained individually by investing the dividend payments in external sources. In a closely held corporation where the minority shareholder does not have a job, dividend payments are the difference between the minority receiving its pro rata share of the corporation's income stream and the minority receiving no return whatsoever.

Moreover, the problem of self-dealing (broadly understood) in a closely held corporation is omnipresent. Almost every decision made by the majority that affects the minority's employment, participation, or dividends has a potential freezeout effect and the potential to grant the majority a disproportionate share of the corporation's income stream. The majority is usually employed, which makes every compensation decision a self-dealing problem. By contrast, the most important self-dealing transactions in publicly

that, in light of *Providence & Worcester*, courts have presumed that discriminatory poison pill plans are legal in Delaware).

243. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957-58 (Del. 1985).

244. For example, a number of jurisdictions have invalidated poison pill plans with discriminatory effects on shareholders. See, e.g., *West Point-Pepperell, Inc. v. Farley Inc.*, 711 F. Supp. 1088, 1094-95 (N.D. Ga. 1988); *Amalgamated Sugar Co. v. NL Indus., Inc.*, 644 F. Supp. 1229, 1234, 1239 (S.D.N.Y. 1986) (applying New Jersey law); *R.D. Smith & Co. v. Preway, Inc.*, 644 F. Supp. 868, 873-75 (W.D. Wis. 1986). In reaching this result, the *NL Industries* court specifically found that *Providence & Worcester* would not be accepted in New Jersey. See *NL Industries*, 644 F. Supp. at 1235.

245. In the context of a closely held corporation, the court in *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798 (Mass. Ct. App. 1981) took a view sharply divergent from *Sinclair Oil*. In *Smith*, a 25% shareholder had veto power over dividend decisions. Because this shareholder repeatedly exercised this veto, the corporation ended up paying tax penalties for retaining too large a portion of its earnings. Had the court taken a *Sinclair Oil* approach, it would have viewed all stockholders as being in the same situation because each stockholder received a pro rata tax benefit from withholding dividends and each stockholder took a pro rata risk that a tax penalty would result. In upholding the majority stockholders' charge of breach of fiduciary duty, however, the court noted that the vetoing stockholder had relatively more to gain from withholding dividends because he was in a higher tax bracket. See *id.* at 802 n.8. Thus, the *Smith* court was more than willing to look through the impact on the shares to see the impact on the stockholders in a closely held corporation.

held corporations are obvious because the majority stands on both sides of the transaction. In these cases, the entire fairness test is manifestly applicable to protect the minority. Subtle self-dealing—the kind that requires us to look behind the effect on shares to see the effect on shareholders—is a much smaller problem in publicly held corporations.

In sum, unless the same unique attributes of closely held corporations that are deemed to justify special fiduciary duty rules in states outside of Delaware are also deemed to change the nature of what is a self-dealing transaction in Delaware, the Delaware entire fairness test cannot be employed to prevent subtle freezeout schemes. With this caveat, *Litle's* application of the entire fairness test to freezeout tactics in a closely held corporation does not cause any great breach in Delaware law. It offers the same protection from subtle freezeout schemes that the entire fairness test manifestly offers in the context of explicit freezeout schemes.

C. Remedies

Ordinarily, appraisal is the exclusive remedy available in Delaware to a minority shareholder challenging only the fairness of the merger consideration in a freezeout merger.²⁴⁶ A minority shareholder, however, may still challenge a merger on breach of fiduciary duty grounds where an appraisal remedy is inadequate, “particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved.”²⁴⁷ The most typical ground justifying a breach of fiduciary duty action in the freezeout merger context involves allegations of failure to satisfy the fair dealing prong of the entire fairness test.²⁴⁸

If fair dealing claims are made prior to the consummation of a merger, an injunction may be granted.²⁴⁹ However, where the merger has been consummated, relief presents something of a problem. Injunctive relief to rescind a consummated merger is a disfavored remedy.²⁵⁰ If the courts were to grant purely compensatory relief, the plaintiff would receive the difference between a fair price and the merger consideration. Where the merger

246. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983). Indeed, the only issue that may be considered in an appraisal proceeding is the fairness of the merger consideration. See *Alabama By-Products Corp. v. Neal*, 588 A.2d 255, 256-57 (Del. 1991).

247. *Weinberger*, 457 A.2d at 714.

248. See, e.g., *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099, 1105 (Del. 1985).

249. See *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1342 (Del. Ch. 1987) (noting that injunctive relief is still permissible despite Delaware Supreme Court cases referring to the exclusivity of the appraisal remedy).

250. See, e.g., *Klang v. Smith's Food & Drug Ctrs., Inc.*, No. 15012, 1997 Del. Ch. LEXIS 73 (Del. Ch. May 13, 1997), *aff'd on other grounds*, 702 A.2d 150 (Del. 1997).

consideration is fair, however, strict compensatory relief produces no damages.²⁵¹ Strict compensatory relief essentially eliminates the independent significance of the fair dealing prong of the entire fairness test.

As a consequence, the Delaware Supreme Court has held out the possibility that a plaintiff may receive rescissory damages upon a finding that the entire fairness test has been violated.²⁵² If the merger consideration is fair at the time of consummation, and the value of the plaintiff's corporation increases subsequent to the merger, rescissory damages will produce a positive recovery. This form of relief demonstrates that the Delaware Supreme Court has gone to great lengths to infuse the fair dealing prong of the entire fairness test with significance.²⁵³ It also demonstrates that the Delaware Supreme Court has been creative in fashioning relief to redress minority shareholder grievances.

Should the entire fairness test come to prevent freezeout schemes in closely held corporations that do not involve explicit freezeout mergers, compensatory and equitable relief of the type available nationwide should also be available in Delaware.²⁵⁴ Two staples of national relief are more questionable in Delaware: the right to order dissolution for oppression and a buyout of the minority interest in lieu of dissolution.²⁵⁵

Unlike other states, Delaware does not have a statute permitting a court of equity to dissolve a corporation based on a finding of oppression. In 1960, the Delaware Supreme Court recognized a limited common law power to dissolve a solvent corporation based on misconduct.²⁵⁶ This case, which was decided before the modern trend liberalizing use of the dissolution remedy began, characterizes dissolution as an extreme remedy applicable in only

251. *Cf. Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924) (L. Hand, J.) (requiring proof of damage causation to allow recovery for breach of the duty of care).

252. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 370-71 (Del. 1993); *Weinberger*, 457 A.2d at 714. Rescissory damages can, however, be difficult to measure in the merger context unless the successor corporation preserves the business of the disappearing corporation in its original form. Perhaps for this reason, the *Weinberger* court noted that the Chancellor may award rescissory damages if he "considers them susceptible of proof and a remedy appropriate to all the issues of fairness before him." *Weinberger*, 457 A.2d at 714.

253. Other jurisdictions have not been as vigilant. *See Pittsburgh Terminal Corp. v. Baltimore Ohio R.R.*, 875 F.2d 549, 554 (6th Cir. 1989) (concluding that "Maryland law, unlike Delaware law . . . does not explicitly require consideration of the fairness of the defendants' valuation procedures" and that "even if Maryland had adopted the [Delaware] approach, the dominant consideration of the fairness of a transaction remains price").

254. *See supra* text accompanying notes 87-90.

255. *See supra* text accompanying notes 91-97.

256. *See Hall v. John Isaacs & Sons Farms*, 163 A.2d 288, 293 (Del. 1960); *see also Tansey v. Oil Producing Royalties, Inc.*, 133 A.2d 141 (Del. Ch. 1957) (dissolving a solvent corporation based on majority misconduct).

very limited circumstances.²⁵⁷ It remains to be seen whether the Delaware courts will join the modern trend.

The Delaware Supreme Court's decision in *Weinberger v. UOP, Inc.*²⁵⁸ provides some hope that liberal, equitable remedies may be available in Delaware. In this case, the court liberalized appraisal valuation procedures to bring them into line with modern finance theory.²⁵⁹ *Weinberger* also expanded the equitable relief available to remedy breaches of fiduciary duty in entire fairness cases:

The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate.²⁶⁰

Freezeout schemes in closely held corporations would seem to involve the types of misconduct identified by *Weinberger* as justifying expanded equitable relief. Indeed, such schemes are essentially one large self-dealing enterprise characterized by "gross and palpable overreaching."²⁶¹ Thus, *Weinberger*'s liberalizing spirit may expand the bases of equitable relief to include dissolution for oppression.²⁶²

Should the Delaware courts recognize dissolution as an appropriate remedy for oppression in closely held corporations, there would seem to be no impediment to allowing a court to decree a buyout of the minority interest at a fair price in lieu of dissolution. In other states, courts must find that the statute permitting dissolution for oppression is not an exclusive remedy to

257. *Hall v. John Isaacs & Sons Farms*, 163 A.2d 288, 293 (Del. 1960) (noting that the power to dissolve a solvent corporation "is always exercised with great restraint and only upon a showing of gross mismanagement, positive misconduct by the corporate officers, breach of trust, or extreme circumstances showing imminent danger of great loss to the corporation").

258. 457 A.2d 701 (Del. 1983).

259. See text accompanying notes 215-17.

260. *Weinberger*, 457 A.2d at 714 (citation omitted).

261. *Id.*

262. In recognizing that a court of equity may order a buyout in lieu of the statutory remedy of dissolution, one court noted:

The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. . . . Whenever a situation exists which is contrary to the principles of equity and which can be redressed within the scope of judicial action, a court of equity will devise a remedy to meet the situation though no similar relief has been granted before.

Davis v. Sheerin, 754 S.W.2d 375, 380 (Tex. App. 1988) (citations omitted).

order a buyout.²⁶³ Since Delaware has no such dissolution statute, the power to decree a buyout would seem to be a lesser included power of any common law power to decree dissolution for oppression. The buyout remedy is less harsh than the remedy of dissolution.²⁶⁴ Although a buyout, like dissolution, gives the minority the ability to exit the enterprise on fair terms, it allows the majority to continue running the enterprise. Thus, any Delaware court with the power to decree dissolution for oppression should also have the power to decree a buyout.

D. Conclusion

In conclusion, the Delaware entire fairness test provides substantial protection to the minority in a closely held corporation in connection with an explicit freezeout merger. Application of the entire fairness test to more subtle freezeout schemes is less clear. In a publicly held corporation, a freezeout merger is normally the only means to accomplish a freezeout of the minority interest. Otherwise, the main focus is on the prevention of self-dealing transactions by the majority. In contrast, in a closely held corporation, a freezeout can be accomplished as effectively without a freezeout merger as with one. As a consequence, application of the entire fairness test to prevent subtle minority freezeouts would represent a natural development of Delaware law. Similarly, permitting courts to grant dissolution for oppression, or a buyout in lieu of dissolution, would represent an extension of Delaware law, but one in accordance with *Weinberger's* liberalizing spirit.

IV. CONCLUSION

This article has argued that, despite the pronouncement of *Nixon v. Blackwell* that there are no special rules for closely held corporations, the death of special shareholder duties in Delaware corporations has been greatly exaggerated. No Delaware case squarely holds that such duties do not exist, and the most recent Delaware Supreme Court case, *Riblet Products Corp. v. Nagy*,²⁶⁵ suggests that Delaware law may provide relief to minority shareholders in freezeout cases.

If the Delaware courts do not develop special categories of duties to

263. See *supra* note 95.

264. This is the ground on which courts in jurisdictions with dissolution for oppression statutes rely in granting a buyout in lieu of dissolution. See, e.g., *Davis v. Sheerin*, 754 S.W.2d 375, 379 (Tex. App. 1988).

265. 683 A.2d 37 (Del. 1996).

protect minority shareholders in closely held corporations, the Delaware entire fairness test may come to provide similar protection. Despite its general enabling philosophy, the Delaware courts have vigorously employed the entire fairness test to defend minority rights in self-dealing cases. In this regard, the depiction of Delaware as a jurisdiction that favors managerial flexibility over the rights of individual shareholders is something of a caricature. The only obstacle that prevents application of the entire fairness test to freezeout transactions is the definition of the elements of a freezeout (discharge of the minority, failure to pay dividends, precluding the minority from participation on the board or management of the enterprise) as a form of self-dealing. Defining self-dealing in this manner would be in accordance with the practical realities of closely held corporations.

Should Delaware law come to define the freezeout of a minority shareholder in a closely held corporation as a breach of fiduciary duty and a form of shareholder oppression, the Delaware courts will have to consider the remedies available for such misconduct. A logical development would be the development of a full range of remedies, including compensatory monetary relief, preventive injunctive relief, forced dissolution in cases of serious misconduct, or a buyout of the minority interest at a fair price in lieu of dissolution.

Should Delaware law develop in the directions suggested in this article, the modern course of corporate law development will be reversed. Instead of the rest of the country following Delaware's lead, Delaware will have followed the nation's lead. There is room for hope that Delaware has as much to learn from the nation as the nation has learned from Delaware.