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The Use and Misuse of the Business Judgment Rule in the Close Corporation

*Ralph A. Peeples**

The business judgment rule occupies a venerable position among corporate law principles. The rule is uniformly noted in major law school casebooks and hornbooks[1] and is cited frequently by the courts.[2] The business judgment rule invariably appears in any distillation of general corporate law.[3] However, this piece of "black letter law" is under assault today from courts and commentators alike.[4] Critics have questioned both the vitality and validity of the rule. The challenges have been sporadic and less than successful, but persistent nonetheless.

This article explores the application of the business judgment rule in the context of the close corporation. Part I describes the operation of the business judgment rule and the rule's premises. Part II examines and questions the assumptions and functions of the rule as it is applied to the closely held corporation. Part III considers alternatives to the business judgment rule.

I. The Business Judgment Rule in Theory and Practice

A. *Formulations, Confusion, and Justifications*

Although arguably codified by the Model Business Corporation Act,[5] the business judgment rule is derived from the common

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1 *See, e.g.*, H. BALLANTINE, BALLENTINE ON CORPORATIONS 161 (1946); W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 537-53 (5th ed. 1980); 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (rev. perm. ed. 1975); R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 695-714 (2d ed. 1981); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS 661-63 (3d ed. 1983); 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 437 (1959).

2 *See, e.g.*, cases collected in W. FLETCHER, *supra* note 1; H. HENN & J. ALEXANDER, *supra* note 1; G. HORNSTEIN, *supra* note 1.

3 *See* notes 1-2 *supra*. The importance of the business judgment rule is reflected in the efforts of the American Law Institute to draft a codification of the rule to function as a "safe harbor" for officers and directors. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 3, 1984) comment to § 4.01(d) at 54-55 [hereinafter cited as PRINCIPLES OF GOVERNANCE].

4 *See* notes 58-78 *infra* and accompanying text.

5 The relevant portion of the Act provides:

> A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and

law.[6] Justice Brandeis recognized and described the rule in 1917.[7] Various commentators have traced the use of the rule to the late nineteenth century,[8] and possibly even to the Civil War era.[9]

In its narrowest form, the business judgment rule determines judicial conduct.[10] Application of the rule requires judicial deference to corporate decisions and thus non-interference by the court.[11] Not surprisingly, confusion has arisen about the proper application of this frequently used rule. The countless formulations have caused uncertainty about the rule's contents.[12]

For example, the rule is commonly described as insulating corporate directors and officers from personal liability[13] or as "validat[ing] corporate dealings."[14] Other descriptions are more extreme. Consider, for example, the remarks of the Pennsylvania Supreme Court over one hundred years ago in *Spering's Appeal*: "[Directors] are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope

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> with such care as an ordinarily prudent person in a like position would use under similar circumstances.

MODEL BUSINESS CORP. ACT § 35 (1979).

See MODEL BUSINESS CORP. ACT ANN. § 35 (1977 Supp.); Arsht & Hinsey, *Codified Standard—Same Harbor But Charted Channel: A Response*, 35 BUS. LAW. 947, 948 (1980). *But see* PRINCIPLES OF GOVERNANCE, *supra* note 3, noting that "[t]here are no statutory formulations of the business judgment rule." *Id.* comment to § 4.01(d) at 54.

6 PRINCIPLES OF GOVERNANCE, *supra* note 3, comment to § 4.01(d) at 54; Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

7 Justice Brandeis stated:

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment . . . .

United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

8 *See, e.g.*, Note, *The Continuing Viability of the Business Judgment Rule As A Guide For Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 565-56 (1967).

9 Arsht, *supra* note 6, at 98-99.

10 Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967); Note, *supra* note 8, at 564-65.

11 H. HENN & J. ALEXANDER, *supra* note 1, at 661, n.4; Fischel, *The Race to the Bottom Revisted*, 76 NW. U.L. REV. 913, 937 (1982); Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 39 (1977); Manne, *supra* note 10, at 271.

12 PRINCIPLES OF GOVERNANCE, *supra* note 3, comment to § 4.01(d) at 54; Arsht, *supra* note 6, at 111; *cf.* the cases collected in W. FLETCHER, *supra* note 1, H. HENN & J. ALEXANDER, *supra* note 1.

13 *See* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). *See also* Arsht, *supra* note 6, at 95.

14 Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 243 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973).

of the powers and discretion confided to the managing body."[15] The Delaware courts have often stated that a showing of "gross and palpable overreaching" would be necessary to prevent the application of the business judgment rule.[16]

The many versions of the rule[17] and the resulting confusion have not gone unnoticed. Both commentators and courts have deplored the inexact and expansive language that frequently is used to describe the purposes and functions of the business judgment rule.[18] The Delaware Supreme Court recently acknowledged that the Delaware cases describing the rule have been imprecise and have contributed to confusion and to misuse of the rule.[19]

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15 71 Pa. 11, 24 (1872).

16 *See, e.g.*, Sinclair Oil Co. v. Levien, 280 A.2d 717, 722 (Del. 1971); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 794 (Del. Ch. 1967). *See also* Arsht, *supra* note 6, at 102-06. The "gross and palpable overreaching" standard has been borrowed by other courts as well. *See, e.g.*, *In re* Reading Co., 711 F.2d 509, 520 (3d Cir. 1983), *rev'g* 551 F. Supp. 1205 (E.D. Pa. 1982).

17 Many versions of the business judgment rule are presently in circulation. They illustrate the ambiguities the rule embodies. Compare, for example, the following descriptions:

> [A] court will not disturb the judgments of a board of directors "if they can be attributed to any rational business purpose."

E. FOLK, THE DELAWARE GENERAL COPORATION LAW 75-77 (1972).

> [T]he law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes. And that is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs. This rule is commonly referred to as the "business judgment rule". . . .

W. FLETCHER, *supra* note 1, § 1039.

> If in the course of management, directors arrive at a decision, within the corporation's powers (*intra vires*) and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss.

H. HENN & J. ALEXANDER, *supra* note 1, at 661.

> (d) A director or officer does not violate his duty under this Section with respect to the consequences of a business judgment if he:
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> (1) was informed with respect to the subject of the business judgment to the extent he reasonably believed to be appropriate under the circumstances;
>
> (2) was not interested in the subject of the business judgment and made the judgment in good faith; and
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> (3) had a rational basis for believing that the business judgment was in the best interests of the corporation.

PRINCIPLES OF GOVERNANCE, *supra* note 3, § 4.01(d).

18 Arsht, *supra* note 6, at 95, 100-02; Manne, *supra* note 10, at 270; Note, *supra* note 8, at 562. The draft comment to § 4.01(d) contained in PRINCIPLES OF GOVERNANCE, simply notes that "judicial formulations of the rule have varied." PRINCIPLES OF GOVERNANCE, *supra* note 3, comment to § 4.01(d) at 54.

19 Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984). Compare the director's Foreword to PRINCIPLES OF GOVERNANCE, which acknowledges that "there is a school of thought that holds it unwise to try to state the content of the business judgment rule, taking the view

Consensus as to the effect of the rule is easier to establish than is agreement about the circumstances which trigger the rule's application. Application of the rule results in judicial deference to corporate decisions satisfying the particular court's criteria for the rule's invocation.[20] In practice, the rule operates as a rebuttable presumption in favor of the corporation's officers and directors.[21]

Disagreement and confusion arise over the criteria required to trigger the rule. "Independence," "good faith," "informed judgment," and "rational basis" appear frequently as requirements for applying the rule, but usually are not defined.[22] Requirements to defeat the presumption, such as a showing of "gross and palpable overreaching"[23] or of "clear and gross negligence,"[24] occasionally appear as well. The requirements are sometimes stated in negative terms: the business judgment rule may be invoked "in the absence of evidence of bad faith, fraud, conflict of interest, or illegality."[25] Both courts and commentators have noted this definition problem.[26] In *Aronson v. Lewis*,[27] the Delaware Supreme Court attempted to restate the rule and its function:

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[28]

The *Aronson* court recognized significant limitations to the rule. First, the rule protects only "disinterested" directors; thus, in-

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that the inherent tendency of such articulation is to point toward narrowing its exculpative scope." PRINCIPLES OF GOVERNANCE, *supra* note 3, Foreword at vii.

20 *See* note 17 *supra*. Whether approached from the standpoint of exoneration, *e.g.*, the approach taken in § 4.01(d) of PRINCIPLES OF GOVERNANCE, *supra* note 17, or a reluctance to interfere with or second-guess the decisions of management, *see, e.g.*, H. HENN & J. ALEXANDER, *supra* note 17, the effect is the same.

21 Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Arsht, *supra* note 6, at 130-33; Lynch, *The Business Judgment Rule Reconsidered*, 17 FORUM 452 (1981).

22 *See* H. HENN & J. ALEXANDER, *supra* note 1, at 661-62; *cf.* the cases collected in PRINCIPLES OF GOVERNANCE, *supra* note 3, reporter's note at 70. *See also* Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

23 *See* note 16 *supra*.

24 N. LATTIN, THE LAW OF CORPORATIONS 274 (1971).

25 Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 594 (1983).

26 Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984); PRINCIPLES OF GOVERNANCE, *supra* note 3, comment to § 4.01(d) at 55; Arsht, *supra* note 6, at 93-94; Manne, *supra* note 10, at 270-81.

27 473 A.2d 805 (Del. 1984).

28 *Id.* at 812.

dependent judgment is assumed.[29] Second, the rule protects only directors who make informed decisions based on all available material information.[30] Third, the rule protects only "decisions." The business judgment rule does not shield dereliction of duty.[31] The limitations noted in *Aronson* are hardly revolutionary.[32] The court's recognition of these restrictions, however, is significant.

Where corporate actions satisfy these criteria, the business judgment rule has a significant result: a relaxed standard of review. The *Aronson* court "predicated [liability] on a standard which is less exacting than simple negligence."[33] Conduct equivalent to "gross negligence" would have to be established to defeat the presumption.[34] Thus, under the *Aronson* restatement, the business judgment rule functions as more than a rebuttable presumption or a rule of judicial behavior. The rule also establishes a standard of conduct for officers and directors.[35]

As *Aronson* suggests, applying the business judgment rule adversely affects a plaintiff's chance for success. Plaintiffs therefore typically strive to avoid the presumption.[36] The most common rebuttal to a defendant's reliance on the business judgment rule is an allegation of lack of independence, usually a claim that the defendant had an "interest" in the transaction.[37] "Interest" quite often translates into "self dealing." When interest is established, the burden shifts to the defendant to establish the "intrinsic fairness" of the challenged transaction.[38] Thus, the presence of interest pre-

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29 *Id.*

30 *Id.*

31 *Id.* at 813.

32 Very similar criteria, for example, were applied forty years earlier in Casey v. Woodruff, 49 N.Y.S.2d 625, 642-47 (Sup. Ct. 1944). *See also* Arsht, *supra* note 6, at 111-12; Arsht & Hinsey, *supra* note 5, at 958-62. Section § 4.01(d) of PRINCIPLES OF GOVERNANCE, *supra* note 17, is also quite similar.

33 473 A.2d at 812 n.6.

34 *Id.* at 812. The appropriateness of a standard less exacting than a simple negligence standard has been questioned. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 299-300 (7th Cir.) (Cudahy, J., dissenting), *cert. denied*, 454 U.S. 1092 (1981); Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 66 (1972). *See generally* Cohn, *supra* note 25.

35 *See, e.g.*, Manne, *supra* note 10, at 270-73. Note, *supra* note 8, at 564. Although labeled as a "safe harbor," the ALI's draft § 4.01(d) in PRINCIPLES OF GOVERNANCE, also has the effect of establishing a minimum level of directorial conduct. *See* note 17 *supra*.

36 *See* Hetherington & Dooley, *supra* note 11, at 39 (plaintiffs likely to prevail only when "management conduct deviates from accepted business norms by a very wide margin"). *See also* Joy v. North, 692 F.2d 880, 885-86 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Lewis v. S. L. & E., Inc., 629 F.2d 764, 768-69 (2d Cir. 1980).

37 For example, an allegation of "interest" on the part of the board of directors usually underlies a derivative plaintiff's claim that demand on the board of directors should be excused as futile. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

38 *See In re* Reading Co., 711 F.2d 509, 517-18 (3d Cir. 1983); Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Lewis v. S. L. & E., Inc., 629 F.2d at 768, *rev'g* 551

vents the application of the rule because " 'the business judgment rule' yields to the rule of undivided loyalty."[39]

The burden of proving lack of good faith, or independence, or the existence of gross negligence, is substantial.[40] Several rationales are commonly advanced to justify the rule's apparent bias towards management. First, the observation that courts are not competent to make, much less to second-guess, business decisions is often cited as a justification.[41] The business judgment rule has been analogized to the standard of care for professionals such as doctors, lawyers, and accountants.[42] Second, courts often observe that directors need broad discretion to function effectively.[43] Courts have stated that managerial risk-taking must be encouraged and that honest mistakes must not be condemned.[44] Third, concern that qualified managers would not serve as officers and directors without judicial nonintervention arguably justifies the rule.[45] Finally, the rule allegedly discourages frivolous litigation and therefore promotes both judicial and business efficiency.[46]

Underlying all of these plausible rationales, however, is a more basic premise which is less frequently recognized. The business judgment rule becomes relevant when a shareholder sues a manager.[47] Courts have deferred to managerial decisions because of the assumption that a shareholder has an alternate course of action: selling the interest in the corporation. If the assumption of an available alternative is accepted, the plaintiff's position arouses less judicial sympathy. The courts presume that with a free and efficient capital market, the economic remedy is more efficient than the legal remedy. The market would not only redress an individual injury,

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F. Supp. 1205 (E.D. Pa. 1982); Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 n.17 (Del. 1981).

39 W. FLETCHER, *supra* note 1, § 1039.

40 *See* note 36 *supra*. "[T]he fact is that liability is rarely imposed upon corporate defendants or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule." Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983). The practical difficulty of showing "interest" on the part of the board of directors is underscored in cases such as Aronson v. Lewis, 473 A.2d 805 (Del. 1984), which insist that the plaintiff, at the complaint stage, provide detailed allegations of specific facts which show "interest." *Cf.* Cohn, *supra* note 25, at 594.

41 *See, e.g.*, Joy v. North, 692 F.2d at 885-86; Shlensky v. Wrigley, 95 Ill. App. 2d 173, 180-81, 237 N.E.2d 776, 780 (1968); Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); Fischel, *supra* note 11, at 939.

42 Arsht, *supra* note 6, at 97; Lynch, *supra* note 21, at 452.

43 Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (2d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *cf.* W. FLETCHER, *supra* note 1, § 1039.

44 *Joy*, 692 F.2d at 885-86. *See also* PRINCIPLES OF GOVERNANCE, *supra* note 3, introductory note at 2; Lynch, *supra* note 21, at 454.

45 Arsht, *supra* note 6, at 98-99; Lynch, *supra* note 21, at 453.

46 Arsht, *supra* note 6, at 95.

47 Of course, the lawsuit will ordinarily take the form of a derivative action.

but also regulate management conduct more efficiently.[48] In short, judicial deference to managerial decisions is based on an assumption of stock liquidity. Relaxed review would make sense only if the court assumed that a shareholder has an economic remedy.[49]

In summary, the business judgment rule in practice operates both as a restraint on judicial behavior and a standard of managerial conduct.[50] The rule is properly invoked only when an independent and informed board of directors has made a decision in good faith.[51] Once invoked, the rule imposes a substantial burden of proof on the plaintiff.[52] The traditional justifications for the rule include: 1) the idea that judges are not business experts;[53] 2) the conviction that risk-taking must be encouraged;[54] 3) the belief that the rule provides necessary reassurance for capable managers;[55] and 4) the concern for the efficient operation of business and the courts.[56] The rule is premised on the existence of an alternative economic remedy for an aggrieved shareholder.[57]

B. *Evidence of Stress*

The rule's venerable position in corporate law has not prevented occasional expressions of doubt as to its continuing utility,[58] such as Professor Cary's criticisms a decade ago.[59] In recent years, however, the questioning has become more frequent.[60]

1. Publicly Held Corporations

Cases such as *Zapata Corp. v. Maldonado*[61] and *Joy v. North*[62] provide evidence of dissatisfaction with the use of the rule in pub-

48 *See* Hetherington & Dooley, *supra* note 11, at 39-44. *See generally* Fischel, *supra* note 11.

49 Note, *supra* note 8, at 569. Closely related to this premise is an attitude akin to the tort principle of assumption of risk: the belief that "[s]ince shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of a bad business judgment." 692 F.2d at 885.

50 *See* note 20 *supra*.

51 *See* note 40 *supra* and accompanying text.

52 *See* note 40 *supra*.

53 *See* note 41 *supra*.

54 *See* notes 43-44 *supra*.

55 *See* note 45 *supra*.

56 *See* note 46 *supra*.

57 *See* notes 48-49 *supra*.

58 *See* Cary & Harris, *supra* note 34, at 66; S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1533C (W. Jaeger ed. 1970); *cf.* Arsht, *supra* note 6, at 93 n.2.

59 Cary & Harris, *supra* note 34, at 66.

60 *See, e.g.*, F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 9.04 (1975); Cohn, *supra* note 25, at 594, 616-27; Lynch, *supra* note 21, at 452. *But cf.* Johnson & Osbourne, *The Role of the Business Judgment Rule in a Litigious Society*, 15 VAL. U.L. REV. 49, 77 (1980).

61 430 A.2d 779 (Del. 1981).

62 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

licly held corporations. Both cases involved challenges to the use of the business judgment rule to dismiss shareholder derivative litigation where demand on the board of directors was excused. Typically, when demand is excused, the board of directors appoints a special committee, usually consisting of the disinterested directors. The committee investigates the shareholder's complaint and makes a recommendation to the full board. Ordinarily the decision whether to prosecute a claim falls within the discretion of the board of directors. Therefore, a recommendation to dismiss the derivative suit invokes the protection of the business judgment rule. Application of the rule requires the court to defer to the judgment of the board, acting on the recommendation of its committee. The technique, though controversial, has generally met with approval.[63]

In *Zapata*, however, the Delaware Supreme Court declined to endorse the unqualified use of the special litigation committee. Instead, the *Zapata* court held that two conditions must be satisfied when a corporation, acting through a special litigation committee, seeks to dismiss a shareholder's derivative suit where demand on the board is excused. The corporation first must establish the independence and good faith of the committee, as well as a reasonable investigation by the committee.[64] If this first condition is satisfied, then the trial court applies its own independent business judgment in deciding whether to dismiss the suit.[65]

This second requirement indicates the *Zapata* court's uneasiness with the traditional operation of the business judgment rule. The court remarked: "We are not satisfied that acceptance of the 'business judgment' rationale at this stage of derivative litigation is a proper balancing point."[66] The court's uneasiness originated in the belief that a board-appointed committee could not easily arrive at a truly disinterested decision.[67] The court, in fact, analogized its approach to that of shifting the burden of proof when interest is shown and requiring the directors to establish the intrinsic fairness of the challenged transaction.[68]

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63 There is general agreement that a decision by a board of directors not to prosecute a derivative action will ordinarily be dispositive. *See, e.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917). *See also* note 7 *supra*. Disagreement arises primarily in situations where prior demand on the board is sought to be excused as futile, usually due to the alleged conflicting interests on the part of the board as managers and defendants. Cases prior to *Zapata* had generally approved the use of the special litigation committee technique in "demand excused" situations. *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508, 516-17 (S.D.N.Y. 1976); Auerbach v. Bennett, 47 N.Y.2d 619, 624, 635-36, 393 N.E.2d 994, 1001-02, 419 N.Y.S.2d 920, 922, 929 (1979).

64 430 A.2d at 788.

65 *Id.* at 789.

66 *Id.* at 787.

67 *Id.*

68 *Id.* at 788-89 n.17.

In *Joy v. North*, the Second Circuit restated the Delaware Supreme Court's misgivings about unrestricted application of the business judgment rule. As in *Zapata*, the issue in *Joy* was the use of the business judgment rule to dismiss derivative lawsuits. Like the court in *Zapata*, the Second Circuit doubted the ability of a special committee of the board of directors to operate completely independently, good intentions notwithstanding. Noting that "the business judgment rule extends only as far as the reasons which justify its existence,"[69] the *Joy* court concluded that "the wide discretion afforded directors under the business judgment rule does not apply when a special litigation committee recommends dismissal of a suit."[70]

Thus, within eighteen months, two prestigious appellate courts challenged the routine application of the business judgment rule.[71] Significantly, both cases involved the same type of corporation: a large, publicly held corporation. Moreover, both courts conditioned invocation of the rule on the existence of independence and good faith. The courts also expressed doubt that such conditions typically exist in this context.

The impact of these two cases on the business judgment rule should not, however, be overemphasized. Indeed, the business judgment rule's impact has not been diminished. The *Aronson* court's restatement of the functions and limitations of the rule strongly indicates that the business judgment rule retains its position in corporate law. The American Law Institute's recent attempt to codify the business judgment rule also supports the continued vitality of the rule.[72]

2. Close Corporations

The dissatisfaction and doubt surrounding the application of the business judgment rule is easier to trace with closely held cor-

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69 692 F.2d at 886.

70 *Id.* at 889.

71 Judicial dissatisfaction with the business judgment rule predated *Zapata* and *Joy*, however, and has arisen in contexts other than the special litigation committee. For example, there is Judge Cudahy's dissent in Panter v. Marshall Field & Co., 646 F.2d 279 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Frustrated by the majority's conclusion that use of the business judgment rule was appropriate in situations where a corporate takeover is resisted by a board apparently preoccupied with staying in office, Judge Cudahy complained: "I emphatically disagree that the business judgment rule should clothe directors . . . with an almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion." *Id.* at 279 (Cudahy, J., dissenting). Dissatisfaction with unrestricted application of the business judgment rule can also be detected in Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

72 PRINCIPLES OF GOVERNANCE, *supra* notes 3, 17. Some commentators believe the use of the rule should be broadened. *See, e.g.*, Johnson & Osbourne, *supra* note 60, at 77.

porations than with publicly held corporations. Professor O'Neal, for example, has consistently criticized the use of the business judgment rule in the closely held corporation.[73] A quarter century ago, the Seventh Circuit expressed concern about the potential for unfairness to minority shareholders resulting from the use of the business judgment rule.[74] More recently, courts in Massachusetts,[75] New Jersey,[76] New York,[77] and North Carolina[78] have indicated some discomfort with the use of the business judgment rule in the close corporation context. The remainder of this article examines the operation of the business judgment rule in that setting.

II. The Business Judgment Rule and the Close Corporation

A. *The Special Nature of the Close Corporation*

Like the business judgment rule itself, the term "close corporation" defies precise definition. Mr. Israels has described a close corporation as a corporation "where management and ownership are substantially identical to the extent that the independent judgment of the directors is, in fact, a fiction."[79] Though appealing for its simplicity, that definition is overinclusive. Several courts and legislatures insist that a close corporation has a limited number of shareholders.[80] Also, the absence of a ready market for the corpo-

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73 *See generally* F. O'NEAL, *supra* note 60.

74 Santarelli v. Katz, 270 F.2d 672, 678 (7th Cir. 1959).

75 *See* Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 851, 353 N.E.2d 657, 663 (1976); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 593, 328 N.E.2d 505, 515-17 (1975).

76 *See* Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 150-52, 400 A.2d 554, 559-60 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980).

77 *In re* Topper, 107 Misc. 2d 25, 32-33, 433 N.Y.S.2d 359, 364-66 (Sup. Ct. 1980).

78 Meiselman v. Meiselman, 309 N.C. 279, 301-06, 307 S.E.2d 551, 564-67 (1983).

79 Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778, 778 (1952).

80 *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1965); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 585, 328 N.E.2d 505, 511 (1975); *cf.* W. CARY & M. EISENBERG, *supra* note 1, at 366; H. HENN & J. ALEXANDER, *supra* note 1, at 694-95; F. O'NEAL, *supra* note 60, § 1.01 n.1.

Several legislatures have attempted to define the close corporation. Delaware, for example, defines a "close corporation" as follows:

> (a) A close corporation is a corporation organized under this chapter whose certificate of incorporation contains the provisions required by § 102 of this title and, in addition, provides that:
>
> (1) All of the corporation's issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of persons, not exceeding 30; and
>
> (2) All of the issued stock of all classes shall be subject to 1 or more of the restrictions on transfer permitted by § 202 of this title; and
>
> (3) The corporation shall make no offering of any of its stock of any class which would constitute a "public offering" within the meaning of the United States Securities Act of 1933 [15 U.S.C. § 77 (1982)], as it may be amended from time to time.

ration's shares is often used as a characteristic.[81]

These latter two attributes would certainly be expected to exist in the type of corporation which Israels described. However, a more detailed and more lengthy definition, such as the one devised by the Massachusetts Supreme Judicial Court, is preferable: "We deem a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation."[82]

This tripartite description of the close corporation identifies the differences between close and publicly held corporations. The close identity between owners and managers in the close corporation contrasts sharply with the separation of ownership from control in the publicly held corporation.[83] The relatively small number of shareholders in a close corporation is, of course, a logical prerequisite to any such identity between ownership and management. The small pool of shareholders also prevents the development of any ready market for the corporate stock. The lack of a meaningful secondary market leads to the other critical distinction between the close and the publicly held corporation: the free transferability of interests assumed for the publicly held corporation[84] does not exist for the close corporation.

Particularly since the late 1950's, the general proposition that close corporations are in fact unique has been frequently acknowledged. At least four states have enacted special close corporation codes over the past three decades.[85] A number of other states have provided special recognition for close corporations in the general corporation statute.[86] The special nature of the close corporation

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DEL. CODE ANN. tit. 8, § 342 (1983).

Kansas and Pennsylvania have taken very similar approaches. KAN. STAT. ANN. § 17-7202 (1981); PA. STAT. ANN. tit. 15, §§ 1002(4), 1372 (Purdon Supp. 1984). Maryland essentially confers "close corporation" status on any corporation whose shareholders unanimously agree to such designation. MD. CORPS. & ASS'NS CODE ANN. §§ 4-101, 4-201 (1975). *See generally* O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978).

81 *See* Galler v. Galler, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583 (1965). *See also* W. CARY & M. EISENBERG, *supra* note 1, at 366; H. HENN & J. ALEXANDER, *supra* note 1, at 695; F. O'NEAL, *supra* note 60, § 1.01 n.1.

82 Donahue v. Rodd Electrotype Co., 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975).

83 W. CARY & M. EISENBERG, *supra* note 1, at 18-19; R. HAMILTON, *supra* note 1, at 18-19; H. HENN & J. ALEXANDER, *supra* note 1, at 128-29.

84 R. HAMILTON, *supra* note 1, at 19-20; H. HENN & J. ALEXANDER, *supra* note 1, at 131.

85 These states are Delaware, Kansas, Maryland, and Pennsylvania. *See* note 80 *supra*.

86 There are a number of different legislative approaches currently in use which are intended to address the special concerns of closely held corporations. They are summarized in W. CARY & M. EISENBERG, *supra* note 1, at 400-05. *See also* O'Neal, *supra* note 80, at 878-81; Note, *Involuntary Dissolution of Close Corporations For Mistreatment of Minority Shareholders*, 60 WASH. U.L.Q. 1119, 1119 n.2 (1982).

has likewise been recognized by the courts, but often in dicta and rarely as an essential part of a rationale.[87] For example, courts have referred to a close corporation as an incorporated partnership,[88] a seemingly appropriate analogy in light of the previous description of the close corporation.[89]

Despite the sharp distinctions in function and appearance between publicly held and closely held corporations, most statutory and common law applies equally to these two forms of business organization.[90] Most of the fundamental principles of corporate law apply, or are made to apply, to all corporations. The organization of law school casebooks illustrates the pattern: a collection of cases and materials about corporations in general, and then, perhaps towards the end, a separate chapter on close corporations.[91]

The business judgment rule is no exception. None of the casebooks and few of the treatises even question whether the business judgment rule should apply to the close corporation.[92] Neither the commentary in the Model Business Corporation Act, which prescribes the standard of care for directors, nor the most recent proposals of the American Law Institute relating to corporate governance, consider the special problem the business judgment rule might present in the close corporation.[93] The lack of attention to the issue is not surprising because the cases themselves seldom suggest any problem with the use of the rule in close corporations. If raised, the question is usually addressed in a brief aside.

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87 *See, e.g.*, Galbreath v. Scott, 433 So. 2d 454, 457 (Ala. 1983); Galler v. Galler, 32 Ill. 2d 16, 26-31, 203 N.E.2d 577, 583-84 (1965); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 152, 400 A.2d 554, 560 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947); Meiselman v. Meiselman, 309 N.C. 279, 288-89, 307 S.E.2d 551, 557 (1983); Masinter v. WEBCO Co., 262 S.E.2d 433, 435 (W. Va. 1980).

88 *See, e.g.*, Donahue v. Rodd Electrotype Co., 367 Mass. 578, 586, 328 N.E.2d 505, 512 (1975); Kruger v. Gerth, 16 N.Y.2d 802, 805, 210 N.E.2d 355, 356, 263 N.Y.S.2d 1, 3 (1965) (Desmond, C.J., dissenting); *In re* Topper, 107 Misc. 2d 25, 31-32, 433 N.Y.S.2d 359, 364 (Sup. Ct. 1980); Meiselman v. Meiselman, 309 N.C. 279, 289, 307 S.E.2d 551, 557 (1983).

89 *See* W. CARY & M. EISENBERG, *supra* note 1, at 366. Indeed, the *Donahue* opinion emphasizes the close parallels between the close corporation and the partnership. Donahue v. Rodd Electrotype Co., 367 Mass. 578, 586-87, 328 N.E.2d 505, 512 (1975).

90 Special "codes" or "subchapters" for close corporations are not common among the states. *See* notes 85-86 *supra*. Explicit recognition of close corporation status is also not automatic in the reported decisions.

91 *See, e.g.*, W. CARY & M. EISENBERG, *supra* note 1 (one of 10 chapters is devoted to the special problems of the close corporation); R. JENNINGS & R. BUXBAUM, CORPORATIONS (1979) (one of 10 chapters); D. VAGTS, BASIC CORPORATION LAW (1979) (one 46 page chapter in an 822 page book expressly deals with the close corporation). *But see* R. HAMILTON, *supra* note 1 (approximately one-half of the book is formally allocated to the close corporation).

92 One of the few exceptions is found in F. O'NEAL, *supra* note 60, § 9.04, at 582.

93 PRINCIPLES OF GOVERNANCE, *supra* note 3.

Rarely, if ever, does a result turn on whether the business judgment rule should apply to close corporations.[94]

B. *The Rule's Shortcomings*

In both public and close corporations, the board of directors is vested with basic management powers.[95] The board's management decisions are implemented by officers appointed by the board and by employees chosen by the officers.[96] Thus, all decisions about dividend policy, employment and compensation, stock issuance and purchase, and changes in corporate structure such as merger, consolidation or dissolution either originate with or can be ultimately

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94 The question is indirectly raised in Donahue v. Rodd Electrotype Co., 367 Mass. 578, 589-91, 328 N.E.2d 505, 513-14 (1975); in Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 154-55, 400 A.2d 554, 561 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); and in Meiselman v. Meiselman, 309 N.C. 279, 291, 307 S.E.2d 551, 559 (1983). The question is alluded to in Santarelli v. Katz, 270 F.2d 762, 768 (7th Cir. 1959); and in *In re* Topper, 107 Misc. 2d 25, 28, 433 N.Y.S.2d 359, 362 (Sup. Ct. 1980). In Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1326 (S.D. Iowa 1981), the plaintiff apparently raised unsuccessfully the question of the business judgment rule's applicability in closely held corporations.

95 The basis for the vesting of such power is always statutory. For example, the first sentence of § 35 of the Model Business Corporation Act provides:

> All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this Act or the articles of incorporation.

MODEL BUSINESS CORP. ACT § 35 (1979). The corresponding Delaware provision is found in § 141(a):

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (1983). *See also* CAL. CORP. CODE ANN. § 300(a) (West 1977 and Supp. 1985); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1984-85). *See generally* H. HENN & ALEXANDER, *supra* note 1, at 562-64.

Many state codes now recognize and validate the more informal management system typical of many close corporations. One such technique is to include a clause such as "except as may be otherwise provided in the articles of incorporation," as in § 35 of the Model Act and § 141(a) of the Delaware Code. Another technique is illustrated by § 300(b) of the California Corp. Code:

> Notwithstanding subdivision (a) or any other provision of this division, but subject to subdivision (c), no shareholders' agreement, which relates to any phase of the affairs of a close corporation, including but not limited to management of its business, division of its profits or distribution of its assets on liquidation, shall be invalid as between the parties thereto on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board or that it is an attempt to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners.

CAL. CORP. CODE § 300(b) (West 1977 and Supp. 1985). *See generally* H. HENN & J. ALEXANDER, *supra* note 1, at 717.

96 *See* MODEL BUSINESS CORP. ACT § 50 (1979); DEL. CODE ANN. tit. 8, § 142(a) (1983); W. CARY & M. EISENBERG, *supra* note 1, at 178; H. HENN & J. ALEXANDER, *supra* note 1, at 564, 586.

attributed to the corporation's officers and directors.[97] The business judgment rule ordinarily applies to these types of decisions.[98] Scrutinizing the impact of these types of decisions suggests the shortcomings of the business judgment rule in the context of a close corporation.

1. Dividends and Compensation

Normally, shareholders receive a return on their investment through the payment of dividends.[99] The declaration of dividends is always at the discretion of the board of directors.[100] The business judgment rule protects such a decision.[101] The rule has been consistently applied in dividend cases involving either a publicly held or a close corporation.[102] In fact, several classic statements of the business judgment rule have resulted from challenges to dividend policy in close corporations. For example, in *Gottfried v. Gottfried*, the New York Superior Court expressed this view:

> [T]he mere existence of an adequate corporate surplus is not sufficient to invoke court action to compel . . . a dividend. There must also be bad faith on the part of the directors. . . . The court is not concerned with the direction which the exercise of the judgment of the Board of Directors may take, provided only that such exercise of judgment be made in good faith. It is axiomatic that the court will not substitute its judgment for that of the Board of Directors.[103]

But most closely held corporations rarely pay dividends.[104] Instead, compensation for services is the principal return on the shareholders' investment in a close corporation.[105] Corporate law

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97 *See* W. CARY & M. EISENBERG, *supra* note 1, at 141-49.

98 *See* notes 27-33 *supra* and accompanying text. It is generally assumed that the protection afforded by the business judgment rule extends to officers as well as directors. W. FLETCHER, *supra* note 1, § 1039 (cases cited therein); H. HENN & J. ALEXANDER, *supra* note 1, at 663.

99 *See* W. CARY & M. EISENBERG, *supra* note 1, at 1335; H. HENN & J. ALEXANDER, *supra* note 1, at 869-70.

100 *Cf.* 2 W. FLETCHER, *supra* note 1, § 526; H. HENN & J. ALEXANDER, *supra* note 1, at 913, 913 n.3.

101 *Id. See also* notes 108-68 *infra* and accompanying text.

102 *See, e.g.*, H. HENN & J. ALEXANDER, *supra* note 1, at 694; Manne, *supra* note 10, at 280-81; Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630, 1639 (1961); Note, *supra* note 86, at 1119. *See generally* Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

103 73 N.Y.S.2d at 695.

104 *See* F. O'NEAL, *supra* note 60, § 3.06; Note, *Executive Compensation in Close Corporations: The Need for a Modified Judicial Approach to the Reasonableness Test*, DUKE L.J. 1251, 1257 (1972). *But see* Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 6.01, 6-3 (1980).

105 *See* Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 850, 353 N.E.2d 657, 662 (1976); Hallahan v. Haltom Corp., 7 Mass. App. 68, 70, 385 N.E.2d 1033, 1034 (1979); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 696 (Sup. Ct. 1947). *See also* 1 F. O'NEAL, CLOSE

considerations generally do not determine the distribution of dividends and compensation. Federal tax laws usually shape dividend policy in the closely held corporation. The payment of compensation reduces the corporation's taxable income, but the payment of dividends does not. Tax strategists therefore advocate maximizing salaries and minimizing the payment of dividends.[106] Thus, unlike the situation in the publicly held corporation, compensation and dividend policies in the closely held corporation are related. This correlation, however, has not affected judicial use of the business judgment rule. Instead, courts ordinarily have analyzed compensation and dividend questions separately.[107] That approach has produced confused and often unfair results.

Gottfried v. Gottfried[108] exemplifies this traditional approach. In *Gottfried*, the minority shareholders sued to compel a profitable, family-owned bakery to declare a dividend.[109] The case contained the classic characteristics of a minority shareholder derivative suit in a close corporation: stock ownership unevenly weighted to favor one side of the family,[110] substantial intra-family discord,[111] and an employment pattern mirroring the stock ownership.[112]

The plaintiffs contended that the presence of the majority shareholders on the corporate payroll ensured that dividends would rarely be paid.[113] Although conceding that the defendants' compensation was "substantial"[114] and acknowledging the existence of "bitter dissension and personal hostility,"[115] the court nevertheless refused to compel a dividend. The requisite level of bad faith by the directors had not been demonstrated.[116] The court's adoption of a bad faith requirement suggests that the court applied the business judgment rule[117] and ignored the identity between the board of directors and the majority shareholders.

The court thus separated the compensation issue from the divi-

CORPORATIONS § 1.07 (2d ed. 1971); F. O'NEAL, *supra* note 60, § 3.06; Note, *supra* note 104, at 1257.

106 *See* Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 277 (Alaska 1980); Z. CAVITCH, *supra* note 104, § 1.01 [3][a] 1-13; R. HAMILTON, *supra* note 1, at 12-13; Note, *supra* note 104, at 1257.

107 *See* notes 108-18, 133-45, and 148-53 *infra* and accompanying text.

108 73 N.Y.S.2d 692 (Sup. Ct. 1947).

109 *Id.* at 693-94.

110 *Id.* at 694.

111 *Id.* at 696.

112 *Id.*

113 *Id.* at 695.

114 *Id.* at 696.

115 *Id.*

116 *Id.* at 695, 701. The result is all the more remarkable in light of the court's acknowledgement that "closely held corporations are easily subject to abuse on the part of dominant shareholders." *Id.* at 695.

117 *Id.* at 695.

dend question. But the separation is artificial: dividends and compensation merely represent two different methods to transfer the close corporation's earnings to its owners. If only certain shareholders received dividends, the business judgment rule would not bar a court from granting relief to the excluded shareholders.[118] Courts therefore should scrutinize the compensation levels in a close corporation in light of the relationship between compensation and dividend payments.

The older case of *Dodge v. Ford Motor Co.*[119] both foreshadowed the *Gottfried* result and suggested a different analysis. In *Dodge*, the plaintiffs sued to halt expansion of the business and, as in *Gottfried*, to compel the payment of dividends.[120] The court discussed at length the traditional judicial reluctance to interfere with a matter ordinarily left to the directors' discretion. However, the court ultimately found for the plaintiffs on the dividend issue.[121] The plaintiffs, nevertheless, did not prevail on the question of expansion. The court instead deferred to the management's business judgment and abstained from reviewing the merits of the expansion decision.[122]

Both dividend policy and business expansion decisions represent classic situations to apply the business judgment rule. Yet in *Dodge*, management prevailed on only one of these two issues. The key to understanding this apparent inconsistency lies in the court's criticism of Henry Ford's expressed intention to forego dividends indefinitely. Ford's dividend decision indicated that the business would no longer be operated for the shareholders' economic benefit as a private, for-profit corporation should be operated. The court felt judicial intervention to be appropriate in such a situation:

> A business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes . . . it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of

118 Such conduct would presumably lack the "rational basis" required for the invocation of the business judgment rule. It would also strongly indicate lack of good faith. *Cf.* Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 277 (Alaska 1980); Gray v. Hall, 10 Ill. App. 3d 1030, 295 N.E.2d 506 (1973).

119 204 Mich. 459, 170 N.W. 668 (1919).

120 *Id.* at 474, 170 N.W. at 673. Ford Motor Co. at the time was a closely held corporation. Henry Ford alone owned 58% of the stock. *Id.* at 467, 170 N.W. at 671.

121 *Id.* at 499-508, 170 N.W. at 681-84.

122 *Id.* at 507-08, 170 N.W. at 684.

shareholders. . . .[123]

The directors' sin in *Dodge* was in a sense misfeasance. The directors failed to operate the business for the economic benefit of the owners.

The significance of *Dodge* is its tacit recognition of a restriction on the use of the business judgment rule. When management ceases to operate a for-profit corporation for profit, the protection of the business judgment rule should not be available. That restriction, seldom recognized in subsequent cases, suggests a major flaw in the application of the business judgment rule to the close corporation. The close corporation is an enterprise cast in the form of a corporation, but decisions in the close corporation are often based on non-corporate considerations.[124] As in *Dodge*, personal goals are easily transformed into corporate "policy."[125] The apparent ease of the transformation can be an overwhelming temptation.

The recent case of *In re Reading Co.*[126] illustrates the problem of eliminating personal considerations from corporate decision-making. The trustee in bankruptcy of Reading Company sued to compel a buy-out of Trailer Train Company stock held by Reading.[127] Trailer Train was a corporation originally organized by a number of railroads, including Reading, to provide a pool of standardized railroad flat cars at the lowest possible cost.[128] In effect, Trailer Train was a closely held corporation whose majority shareholders, the railroads, controlled the corporation's operations.[129]

Reading entered bankruptcy reorganization proceedings and subsequently abandoned all rail operations.[130] When Reading's

123 *Id.* at 507, 170 N.W. at 684.

124 Tax considerations typically dictate the operation of the close corporation. For example, there is usually strong impetus to distribute corporate earnings as compensation and to virtually eliminate dividends because the corporation cannot deduct dividends paid to shareholders. Such a strategy can obviously work to the detriment of non-employee shareholders. The cases are replete with examples. *See, e.g.*, Alaska Plastics, Inc. v. Coppock, 621 P.2d 270 (Alaska 1980); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983). *See also* notes 104-07 *supra*.

125 Personal relationships are of great importance in most close corporations, as the analogy to a partnership suggests. Donahue v. Rodd Electrotype Co., 367 Mass. 578, 586, 328 N.W.2d 505, 512 (1975). *See* 2 F. O'NEAL, *supra* note 105, § 9.02; Hetherington & Dooley, *supra* note 11, at 2. As a result, there is an inherent tendency for personal goals to obscure corporate goals. When the trust and confidence among the principals deteriorates, objective corporate decision-making becomes difficult.

126 711 F.2d 509 (3d Cir. 1983), *rev'g* 551 F. Supp. 1205 (E.D. Pa. 1982).

127 *Id.* at 512. In the alternative, the trustee requested an order compelling Trailer Train to convert the stock held by Reading to debt or preferred stock or to pay dividends.

128 *Id.* at 512-13.

129 *Id.* at 513. Trailer Train's stock was held by 33 shareholders, 30 of whom were operating railroads.

130 *Id.* at 512.

need for Trailer Train's services disappeared, the trustee in bankruptcy attempted to force Trailer Train to buy back its stock held by Reading.[131] The Third Circuit denied the trustee any relief. The court relied heavily on the business judgment rule to justify Trailer Train's policies of lowest possible car leasing rates, no declaration of dividends, and consistent reinvestment of earnings in new equipment.[132] But, as the captive subsidiary of the railroads, the Trailer Train Company was managed more like a cooperative than a corporation. In such circumstances, the Trailer Train board could hardly have exercised any business judgment at all.

As *Reading* indicates, the limitations suggested in *Dodge* have not been widely accepted. Instead, the *Gottfried* court's conclusion that a shareholder must show bad faith on the part of the board to compel dividends and the court's failure to link compensation practice with dividend policy have established the pattern for most of the subsequent litigation in this area.[133] *Dodge*, when used at all, is cited for the view that dividend policy is essentially a management decision.[134]

For example, in *Gay v. Gay's Supermarkets*,[135] the corporation fired the minority shareholder.[136] When the board decided shortly thereafter not to declare dividends for the preceding year, the minority shareholder sued to compel dividends.[137] Relying on *Gottfried*, the court dismissed the suit, holding that the plaintiff must show fraud, bad faith or abuse of discretion by the board in order to prevail. The court noted that judicial intervention is appropriate only in "extreme cases."[138] The case presents a textbook application of the business judgment rule. If a plausible business purpose for the failure to pay dividends can be shown, judicial deference follows. The case's significance lies in the narrowness of the court's review. The court ignored the closely held status of the corpora-

131 *Id.*

132 *Id.* at 520. Before invoking the business judgment rule, the court first disposed of the trustee's main argument that the business judgment rule was inapplicable because of self-dealing. Application of the business judgment rule produced an interesting and somewhat circular analysis. The court justified the low rate, no dividend, reinvestment policy by pointing out that: (1) keeping rates as low as possible keeps demand for the cars high; and (2) not paying dividends keeps rates low because the need for a surplus is eliminated. The company's policy, the court suggested, must have been on target because "under the challenged policies Trailer Train has undergone remarkable growth." *Id.* at 520.

133 *See* notes 135-45 and 148-53 *infra* and accompanying text.

134 *See, e.g.*, Miller v. Magline Inc., 76 Mich. App. 284, 285, 256 N.W.2d 761, 769 (1977); Zidell v. Zidell Inc., 277 Or. 413, 419, 560 P.2d 1086, 1089 (1977). Oddly enough, the language most often cited from *Dodge* are passages which the *Dodge* court quoted at length from earlier sources.

135 343 A.2d 577 (Me. 1975).

136 *Id.* at 578.

137 *Id.*

138 *Id.* at 580, 582.

tion[139] and the possibility of a link between compensation and dividends.

Two years later, in *Zidell v. Zidell, Inc.*,[140] the Oregon Supreme Court took the same approach. Again, a close corporation was the setting for a dispute between minority and majority shareholders over the payment of dividends. The plaintiff, a former employee, sued to compel dividends.[141] The trial court granted relief; on appeal, the Oregon Supreme Court reversed. In the face of undisputed hostility between the minority and the majority shareholders,[142] and concededly generous salaries and bonuses for shareholder-employees,[143] the court nonetheless insisted that the plaintiff had failed to show bad faith on the part of the board.[144] That failure was fatal. Absent such a showing, on the strength of *Gottfried* and *Gay*, the court reinstated the board's decision. As in *Gottfried* and *Gay*, the court never considered the special nature of the close corporation. Moreover, the court ignored the subsequent increase in compensation for shareholder-employees after the plaintiff's departure.[145]

Zidell, however, expanded the scope of the business judgment rule. In one paragraph, the *Zidell* court not only conceded the existence of a fiduciary duty owed by those in control to minority shareholders but also restated the business judgment rule.[146] This juxtaposition suggests that the controlling shareholders have satisfied the duty to the minority[147] if a corporate decision is made in apparent good faith and for a legitimate business purpose. The inference, of course, is that the business judgment rule is a complete defense to a claim of breach of a fiduciary duty. This would include not only the duty of care and loyalty but also the duty owed by those in control to the minority. This new development in effect

139 Fifty-one percent of the common stock was held by Hannaford Bros. Co. The remaining stock was owned in equal portions by the plaintiff and his brother.

140 277 Or. 413, 560 P.2d 1086 (1977).

141 *Id.* at 417, 560 P.2d at 1087, 1088.

142 *Id.* at 416-17, 560 P.2d at 1088.

143 *Id.* at 417-19, 560 P.2d at 1088, 1089.

144 *Id.* at 421, 560 P.2d at 1090.

145 *Id.* at 417, 560 P.2d at 1088. The dispute apparently surfaced when the plaintiff demanded a raise. When his request was denied, he resigned his position. Shortly thereafter the board substantially increased its employees' compensation.

146 *Id.* at 418, 560 P.2d at 1089.

147 A variety of courts in a number of states have concluded that controlling shareholders owe a fiduciary duty to minority shareholders. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 108-12, 460 P.2d 464, 471-74, 81 Cal. Rptr. 592, 599-602 (1969); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 592-93, 328 N.E.2d 505, 515 (1975); Gaines v. Long Mfg. Co., 234 N.C. 340, 345, 67 S.E.2d 350, 353-54 (1951); Baker v. Commercial Body Builders, Inc., 264 Or. 614, 629, 507 P.2d 387, 394 (1973), and the cases collected in Masinter v. WEBCO Co., 262 S.E.2d 433, 438 n.5 (W. Va. 1980). *See generally* notes 306-08 *infra* and accompanying text.

would eliminate the judicially-imposed duty of the majority to the minority.

The single-minded insistence in *Gottfried*, *Gay*, and *Zidell* that the business judgment rule requires deference to the board's dividend policy, regardless of the circumstances, has surfaced in even more egregious situations. For example, in *Romanik v. Lurie Home Supply Center, Inc.*,[148] the court invoked the business judgment rule to sustain the board's no-dividend policy against a backdrop of widespread self-dealing by the majority shareholder. The self-dealing included the execution of a one-sided lease,[149] the payment of generous compensation to the majority shareholder,[150] the extension of unsecured loans to the majority shareholder's estate,[151] and the subsequent payment of a death benefit to the majority shareholder's widow.[152] The case's result and the presence of the business judgment rule in the rationale are surprising because the minority shareholders actually prevailed on several other issues.[153]

Courts, of course, have also shown another approach to deference under the rule. The homage paid to the business judgment rule is frequently followed by a recital that equity will intervene in cases of true oppression.[154] Occasionally, a decision acknowledges the connection between compensation practice and dividend policy. Even in such cases, however, the business judgment rule often inhibits proper analysis.

148 105 Ill. App. 3d 1118, 435 N.E.2d 712 (1982).

149 *Id.* at 1123, 1129-30, 435 N.E.2d at 715, 719-20. The lease was for five years and provided for an annual rental of $36,000 on property appraised at $41,000.

150 *Id.* at 1123, 1125-27, 435 N.E.2d at 715, 717-18. In 1974, when the majority shareholder, Mr. Lurie, was 69, the corporation agreed to a five year employment contract, with an option for renewal. Mr. Lurie's base compensation was set at $54,600, representing a $15,000 raise. The agreement also provided for deferred compensation of 60% of base salary for ten years, in the event of retirement, disability, or death.

151 *Id.* at 1124, 1132-33, 435 N.E.2d at 716, 722. Unsecured loans totaling almost $17,000 were extended at below-market rates at a time when a first loan of $53,988 was in default.

152 *Id.* at 1123, 1127-28, 435 N.E.2d at 715, 718-19. The board, consisting of the widow's two sons, authorized a payment of $5000. The payment was not required under the decedent-majority shareholder's employment contract.

153 No dividends were, in fact, ever paid during the life of the corporation. *Id.* at 1134, 435 N.E.2d at 723. Overall, the corporation was run as if it were owned solely by the majority shareholder. Relief was granted regarding the lease, the excessive term of the deferred compensation agreement (reduced to five years), and the below-market interest rates on the notes. The striking aspect of the case is how the business judgment rule could plausibly be invoked on the dividend issue against this backdrop of events, all of which suggest lack of independence and good faith. The court simply posited that "[c]ourts are reluctant to interfere with the exercise of the directors' business judgment unless the withholding is fraudulent, oppressive, or *totally without merit.*" *Id.* (emphasis added) (citation omitted).

154 *See, e.g.*, Santarelli v. Katz, 270 F.2d 762, 768 (7th Cir. 1959); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 696 (Sup. Ct. 1947).

Thus, in *Alaska Plastics, Inc. v. Coppock,*[155] the Alaska Supreme Court noted that compensation, fringe benefits, and perquisites not related to the reasonable value of the recipient's services constitute constructive dividends. Such dividends should be shared among all the shareholders.[156] The court declined, however, to venture further and shortly thereafter restated and endorsed the business judgment rule.[157]

Once again, the tenacity of the doctrine is striking. Given the link between compensation and dividends,[158] the business judgment rule should not have entered the picture. An obvious potential for self-dealing exists when the same group establishes its own salaries and decides on dividend payments for non-shareholder employees. This potential should prevent the use of the business judgment rule.[159]

Miller v. Magline, Inc.[160] illustrates the confusion caused by applying the rule in this area. In *Miller*, two minority shareholders sued to compel dividends and to recover allegedly excessive compensation paid to employee-shareholders.[161] The plaintiffs once had been employees themselves, but they no longer worked for the business.[162] As a result, the plaintiffs were dissatisfied with the no-dividend policy which had served everyone's interest in past years.[163] On both issues—dividends and compensation—the appellate court concluded that the burden of proof was properly placed on the plaintiffs.[164]

The plaintiffs convinced the court to consider more than just dividend policy because a close corporation was involved.[165] That success led to a partial victory: the court affirmed the chancellor's finding that dividends should be declared and paid.[166] The plaintiff's attack on the level of compensation of the shareholder-employees, however, was unsuccessful.[167] On the compensation issue, the court emphasized the technical abstention of each director-em-

155 621 P.2d 270 (Alaska 1980).

156 *Id.* at 277.

157 *Id.* at 278.

158 *See* notes 104-06, 117-18 *supra* and accompanying text.

159 Use of the business judgment rule assumes an independent board of directors, unfettered by a conflict of interest. *See* note 29 *supra* and accompanying text.

160 76 Mich. App. 284, 256 N.W.2d 761 (1977).

161 *Id.* at 288, 289, 256 N.W.2d at 762, 763. The two plaintiffs owned 41% of the stock. The remaining 59% was held by the six individual defendants.

162 *Id.* at 290, 256 N.W.2d at 763.

163 *Id.* at 291, 256 N.W.2d at 763.

164 *Id.* at 295, 256 N.W.2d at 765-66.

165 *Id.* at 304-08, 256 N.W.2d at 765-66.

166 *Id.* at 300-02, 256 N.W.2d at 770-71.

167 *Id.* at 295, 256 N.W.2d at 768.

ployee on his own salary.[168]

On the dividend policy question, the court cited *Dodge v. Ford Motor Co.* for the proposition that in the absence of bad faith, wilful neglect, or abuse of discretion, the board decision will be respected.[169] The court struggled for a rationale and apparently chose breach of the directors' fiduciary duty to the shareholders.[170] The opinion reflects the difficulty the court encountered in articulating how the directors breached that duty. The court simultaneously approved the director-determined levels of shareholder-employee compensation and criticized the paucity of dividend payments.

Both determinations are classic management decisions protected by the business judgment rule. Both determinations also transfer profits from the close corporation into the hands of at least some of the owners. The source of either dividend or compensation payments is the same. The constructive dividend approach mentioned in *Alaska Plastics*, however, remained untried in *Miller*.[171]

The confusion in such cases as *Miller* and *Zidell* is unnecessary. The courts' acknowledgement of the relevance of the business judgment rule to the close corporation caused that confusion. The rationale in any opinion is equally as important as the correctness of the result. Travelling through the terrain of the close corporation, however, presents many obstacles when the compass is the business judgment rule.

2. Employment Matters

a. *Compensation*

The hiring, firing, and compensation of employees are ultimately board decisions and have always qualified as management decisions protected by the business judgment rule.[172] The connection between compensation and dividend policy has been previously discussed.[173] Compensation practice alone, however, raises questions about the appropriateness of the business judgment rule in the close corporation. Customarily the directors who make compensation decisions are also employees in a close corporation.[174]

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168 *Id.* at 296, 256 N.W.2d at 766.

169 *Id.* at 303, 256 N.W.2d at 769.

170 *Id.* at 304-05, 256 N.W.2d at 769-70.

171 The case for a "constructive dividend" theory was particularly appealing. The compensation levels of the shareholder-employees were pegged directly to corporate earnings through low base salaries and percentage incentive bonuses. *Id.* at 290-91, 256 N.W.2d at 763-64.

172 *See* H. HENN & J. ALEXANDER, *supra* note 1, at 661-63; Note, *supra* note 104, at 1260.

173 *See* notes 104-07, 117-18 *supra* and accompanying text.

174 *See* F. O'NEAL, *supra* note 60, § 9.04; Note, *supra* note 104, at 1256, 1264. Such was the case, for example, in *Gottfried, Dodge, Romanik, Miller, Alaska Plastics,* and *Zidell.*

In short, compensation decisions are made by the same people who will receive the compensation. As a result, at least the possibility of self-dealing is always present.[175]

Self-dealing, of course, traditionally triggers an "intrinsic fairness" inquiry, usually a more exacting standard of review than the business judgment rule.[176] In practice, the intrinsic fairness standard shifts the burden of proof from the plaintiffs to the defendants.[177] Such a shift, however, does not always make the business judgment rule inapplicable. For example, the court in *Romanik v. Lurie Home Supply Center, Inc.*,[178] after finding that self-dealing existed when the majority shareholder's compensation was determined, concluded that the defendant had the burden to prove "reasonableness."[179] The court then reluctantly noted the applicability of the business judgment rule and upheld the majority shareholder's compensation.[180]

The rule can also surface in seemingly impartial situations, as when a director-employee formally abstains from the vote on his or her own salary.[181] This technique makes the board's decision seem objective and makes the relaxed review of the business judgment rule seem appropriate.[182] Nevertheless, judicial review of compensation in the close corporation does not significantly differ from such review in the publicly held corporation. Although the ordinary standard of review for both is the business judgment rule,[183] that standard is not always appropriate in the closely held

175 *See* F. O'NEAL, *supra* note 60, § 9.04; Note, *supra* note 104, at 1255-56, 1264.

176 *See* Lewis v. S. L. & E., Inc., 629 F.2d 764, 768 (2d Cir. 1980); Santarelli v. Katz, 270 F.2d 762, 769 (7th Cir. 1959); Zapata Corp. v. Maldonado, 430 A.2d 779, 788 n.17 (Del. 1981). *See also* Arsht, *supra* note 6, at 115-16; notes 37-39 *supra* and accompanying text. *But see Recent Cases—Close Corporations—Stockholders' Duty of "Utmost Good Faith and Loyalty" Requires Controlling Shareholder Selling a Close Corporation Its Own Shares to Cause the Corporation to Offer to Purchase a Ratable Number of Shares from Minority*, 89 HARV. L. REV. 423, 425-26 (1975) [hereinafter cited as *Stockholders' Duty*].

177 Lewis v. S. L. & E., Inc., 629 F.2d 764, 768 (2d Cir. 1980). *See* Arsht, *supra* note 6, at 116; notes 37-39 *supra* and accompanying text.

178 105 Ill. App. 3d 1118, 435 N.E.2d 712 (1982).

179 *Id.* at 1126, 435 N.E.2d at 717.

180 *Id.* at 1127, 435 N.E.2d at 718.

181 *See, e.g.*, Miller v. Magline, Inc., 76 Mich. App. 284, 294-96, 256 N.W.2d 761, 765-66 (1977).

182 *Id.*

183 Note, *supra* note 104, at 1264. DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1980), illustrates a particularly egregious situation. The New Cal board of directors approved payment of a $40,000 "management fee" to one of the three individual defendants in connection with the development of unimproved real property. The three defendants owned well over half of the corporation's stock. The board consisted of the three individual defendants, who also served as the officers of the corporation. Relying on the business judgment rule, the appellate court upheld the corporate payments to the defendant, without discussion of any apparent conflict of interest or self-dealing.

corporation.[184]

b. *Termination of Employment*

Litigation to compel dividends often arises from a decision, either by the shareholder or the corporation, to terminate a shareholder's employment.[185] Separating employment from ownership destroys the shareholders' common interest in maximizing compensation and in minimizing dividend payments.[186]

Considered alone, an employment decision appears to warrant the deference suggested by the business judgment rule.[187] Because of its connection to dividend policy, however, such a decision in a close corporation should rarely be reviewed in isolation.[188] Nonetheless, courts often decide personnel issues in isolation.[189] The approach resembles the strategy of dividing and conquering. Viewed separately, challenges to dividend policy, compensation practice, or personnel decisions rarely survive the invocation of the business judgment rule. Such fragmentation is inappropriate in the close corporation, however, because of the close connection between these three issues.

3. Other Contexts

Dividend policy, compensation practice, and employment matters most frequently provide the setting for the use of the business judgment rule in the close corporation. However, any management decision triggers the rule.[190] Thus, decisions to issue additional stock,[191] to repurchase outstanding stock,[192] to merge with another corporation,[193] or to seek dismissal of a derivative suit[194] have

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184 *See* notes 219-54 *infra* and accompanying text.

185 *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Gay v. Gay's Supermarkets, 343 A.2d 577 (Me. 1975) (plaintiff fired). *Cf.* Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977); Zidell v. Zidell, Inc., 277 Or. 413, 560 P.2d 1086 (1977) (plaintiffs resigned more or less voluntarily).

186 Note, *supra* note 104, at 1256. *See* notes 104-07 *supra* and accompanying text.

187 Personnel decisions are a basic part of management authority and ordinarily qualify as "business judgments" protected by the business judgment rule. Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 851, 353 N.E.2d 657, 663 (1976). *See* H. HENN & J. ALEXANDER, *supra* note 1, at 661-63. *See also* notes 20-32 *supra* and accompanying text.

188 *See* note 186 *supra*.

189 *See, e.g.*, Baker v. Commercial Body Builders, 264 Or. 614, 507 P.2d 387 (1973); Campbell v. Ford Indus., Inc., 266 Or. 479, 513 P.2d 1153 (1973). *See also* F. O'NEAL, *supra* note 60, § 3.06. *But see* Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 852-53, 353 N.E.2d 657, 663-64 (1976); Meiselman v. Meiselman, 309 N.C. 279, 288, 307 S.E.2d 551, 557 (1983).

190 *See* notes 20-32 *supra* and accompanying text.

191 *See, e.g.*, Ski Roundtop, Inc. v. Hall, 658 P.2d 1071 (Mont. 1983).

192 *See, e.g.*, Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

193 *See, e.g.*, Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973).

caused litigation involving the business judgment rule in the close corporation. Furthermore, allegations of misfeasance in the ordinary conduct of business[195] have prompted a similar inquiry.

A pattern in these cases is not immediately discernible. Most courts simply assume the business judgment rule should apply, without considering the special nature of the enterprise involved.[196] In the only case where the plaintiff posed the issue directly, the court brushed the argument aside.[197] Occasionally, a court will note the closely held nature of the corporation and will criticize in dicta the operation of the business judgment rule.[198] But the close status of the subject corporation has affected the holding in only a few cases.[199] Typically, the courts unquestioningly apply the business judgment rule, occasionally tempering the opinion with the qualification that evidence of self-dealing will cause stricter scrutiny and will shift the burden of proof to the defendants.[200] In any event, no court has explicitly rejected the rule's validity in the closely held corporation.[201]

4. A Restatement

The problem in this area is not the results in any of the previously described cases, but rather the process used to reach these results. Review of the cases indicates that the process itself needs refinement. The opinions are characterized by the confusing and

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194 *See, e.g.*, Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981).

195 *See, e.g.*, Lewis v. S. L. & E., Inc., 629 F.2d 764 (2d Cir. 1980); Lussier v. Mau-Van Dev., Inc., 667 P.2d 804 (Hawaii Ct. App. 1983); DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1980).

196 *See, e.g.*, *In re* Reading Co., 711 F.2d 509 (3d Cir. 1983), *rev'g* 551 F. Supp. 1205 (E.D. Pa. 1982); Lewis v. S. L. & E., Inc., 629 F.2d 764 (2d Cir. 1980); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973); Lussier v. Mau-Van Dev., Inc., 667 P.2d 804 (Hawaii Ct. App. 1983); Ski Roundtop, Inc. v. Hall, 658 P.2d 1071 (Mont. 1983); DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1980).

197 In Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981), the district court stated: "Plaintiffs argue that the business judgment rule is inapposite in cases such as the one at bar where director fraud is alleged and where the nominal corporate defendant is closely held . . . . [T]he Court is satisfied that the welfare of minority shareholders is adequately protected under the *Zapata* test." *Id.* at 1326.

198 *See, e.g.*, Santarelli v. Katz, 270 F.2d 762, 768 (7th Cir. 1959); Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118, 1127, 435 N.E.2d 712, 718 (1982) (criticizing "exaggerated judicial deference to the business judgment of directors"); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 154, 400 A.2d 554, 561 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980).

199 *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

200 *See, e.g.*, the cases collected at notes 195-96 *supra*.

201 Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975), and Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983), probably come the closest to outright rejection of the rule. In *In re* Topper, 107 Misc. 2d 25, 28, 433 N.Y.S.2d 359, 362 (Sup. Ct. 1980), the court simply describes the business judgment rule as "irrelevant."

frequently inconsistent use of various corporate law doctrines. A rationale rarely can be identified.[202]

The business judgment rule adds to the confusion because its use encourages piecemeal review of management decisions which are actually related parts of a pattern.[203] Decisions, innocuous when viewed alone, may suggest a serious problem if examined in context.[204] The events generally known as a "freeze-out" illustrate this point.

Like most terms in this area, a freeze-out[205] is easier to describe than to define. Invariably, the purpose of a freeze-out is to eliminate or to suppress one or more minority interests through facially neutral means.[206] Those means include the elimination of dividends or the conversion of dividends into an expense deductible for the corporation and payable to less than all the shareholders, such as inflated rents or salaries. Other methods employed are the termination of employment, the sale of corporate assets—often to the majority interest at a favorable price—the issuance of new stock, a merger or consolidation, or the alteration of the voting rights.[207] An effective freeze-out is often a combination of these techniques.[208] Strikingly, each of these freeze-out techniques represents the sort of decision covered by the business judgment rule. Thus, the rule offers a comprehensive defense for objectionable conduct.[209] In fact, at least one court has suggested that if the offensive conduct falls under the business judgment rule, no claim of oppression will lie.[210]

The business judgment rule forces litigation of oppressive con-

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202 Cases such as Lussier v. Mau-Van Dev., Inc., 667 P.2d 804 (Hawaii App. Ct. 1983); Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118, 435 N.E.2d 712 (1982); Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977); DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1980); and Zidell v. Zidell, Inc., 277 Or. 413, 560 P.2d 1086 (1977), are particularly illustrative.

203 *See* notes 117, 118, and 186 *supra* and accompanying text.

204 *See* F. O'NEAL, *supra* note 60, §§ 3.01-3.02.

205 Professor O'Neal favors the term "squeeze-out." F. O'NEAL, *supra* note 60, § 1.-1.

206 F. O'NEAL, *supra* note 60, § 1.01. *See generally* Note, *supra* note 102.

207 F. O'NEAL, *supra* note 60, § 3.02. *See generally* Note, *supra* note 102.

208 *See* note 204 *supra*. Cases such as Alaska Plastics, Inc., v. Coppock, 621 P.2d 270 (Alaska 1980); Gay v. Gay's Supermarkets, Inc., 343 A.2d 577 (Me. 1975); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919); Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977); Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947); and Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983), illustrate combinations of several freeze-out techniques.

209 F. O'NEAL, *supra* note 60, § 9.04.

210 *See* Polikoff v. Dole & Clark Bldg. Corp., 37 Ill. App. 2d 29, 37, 38, 184 N.E.2d 792, 796 (1962); *see also* Zidell v. Zidell, Inc., 277 Or. 413, 418, 560 P.2d 1086, 1089 (1977). In addition, the result, if not the language, of DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1980), supports this view.

duct into a tight, formalistic pattern. This pattern makes challenging such conduct more difficult and thus makes oppressive conduct more attractive. Ordinarily, a shareholder will find a derivative action neither available nor attractive. Injury to the corporation will often be difficult to show.[211] If injury can in fact be shown, a corporate recovery will primarily benefit the majority shareholders. Such a distribution of the recovery would make a derivative lawsuit undesirable.[212]

Furthermore, under the rule, the plaintiff must show bad faith, fraud, or abuse of discretion.[213] Because the defendants usually can identify at least a colorable business purpose for any action, the plaintiff has a considerable burden. Ordinarily, the plaintiff has difficulty establishing that the defendants' primary purpose was to eliminate the plaintiff's interest.[214] In addition, the plaintiff encounters similar problems with the main method to avoid the business judgment rule—proving self-dealing by the directors. The alleged self-dealing must be well proven. The appearance of self-dealing, however, often can be avoided by techniques such as formal abstention by "interested" directors.[215]

Not surprisingly, several courts and commentators have criticized the use of the business judgment rule in freeze-out situations.[216] The danger, however, is not universally acknowledged, nor do the cases suggest that courts will always recognize a freeze-out.[217] Of course, inconsistency inevitably occurs as equitable principles are applied to the unique facts of each case.[218] Nonetheless,

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211 Donahue v. Rodd Electrotype Co., 367 Mass. 578, 579 n.4, 589 n.14, 328 N.E.2d 505, 508 n.4, 513 n.14 (1975).

212 Hetherington & Dooley, *supra* note 11, at 41 n.132.

213 *See* notes 20-32 *supra* and accompanying text.

214 *See* Cohn, *supra* note 25, at 593-94; Note, *supra* note 104, at 1269; Note, *supra* note 102, at 1638.

215 *Stockholders' Duty*, *supra* note 176, at 426 n.28. *See, e.g.*, Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977). Sometimes a court refuses to acknowledge the apparent existence of self-dealing, as in DiIaconi v. New Cal Corp., 97 N.M. 782, 643 P.2d 1234 (1982), or its likely existence, as in Lussier v. Mau-Van Dev., Inc., 667 P.2d 804 (Hawaii Ct. App. 1983). *Cf.* Note, *supra* note 104, at 1269.

216 As expressed by the court in *Wilkes*: "This 'freezeout' technique has been successful because courts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control." 370 Mass. at 842, 353 N.E.2d at 662. *See also* Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 400 A.2d 554 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983); F. O'NEAL, *supra* note 60, § 9.04; Note, *supra* note 104, at 1253, 1269; *Stockholders' Duty*, *supra* note 176, at 424-26.

217 The factual patterns in cases such as *DiIaconi*, *Nanfito*, *Miller*, *Gottfried*, *Gay*, and *Alaska Plastics* all strongly suggest the existence of a freeze-out.

218 For example, the frequently mentioned requirement that a plaintiff show "bad faith"

use of the rule contributes to these inconsistent results and simultaneously hinders meaningful judicial review in this area.

C. *Identifying The Problem: The Business Judgment Rule's Justifications and Assumptions*

The business judgment rule should apply to the close corporation only to the extent that the traditional assumptions and rationales for the rule justify its use.[219] But these assumptions and justifications rarely apply in the closely held corporation. As a result, the rule should have an extremely limited role in the close corporation.

1. Justifications

The traditional justifications include the belief that the rule reassures capable managers;[220] the conviction that managers should be encouraged to take risks;[221] the notion that judges are not business experts;[222] and the concern for the efficient operation of business and the courts.[223]

a. *Reassuring capable managers*

One of the attributes of the close corporation is the identity of management and ownership.[224] If the owners also manage the corporation, reassuring the management seems unnecessary and useless. This identity of management and ownership also undercuts the assumption that fear of managerial liability deters insiders such as principal shareholders and key employees from serving on the board.[225] Instead, the need to reassure potential managers and directors should arise only if outsiders are involved. In fact, in a close corporation the board of directors normally represents only a legal formality. Service on the board, therefore, seldom causes great concern or requires lengthy consideration.[226]

b. *Encouraging Risk-Taking*

Intelligent risk-taking is as desirable and necessary in the close

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or "oppression" to defeat a facially valid corporate transaction inevitably implicates equitable principles.

219 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Aronson v. Lewis, 473 A.2d 805, 812-13 (Del. 1984). *Cf.* Zapata Corp. v. Maldonado, 430 A.2d 779, 787, 788-89 (Del. 1981).

220 *See* note 45 *supra*. *See generally* notes 41-46 *supra* and accompanying text.

221 *See* note 44 *supra*.

222 *See* note 41 *supra*.

223 *See* note 46 *supra*.

224 *See* notes 79-83 *supra* and accompanying text.

225 Cary & Harris, *supra* note 34, at 65.

226 O'Neal, *supra* note 80, at 880-82.

corporation as in the publicly held corporation. Presumably, however, the business judgment rule should encourage only business-related risks.[227] Non-business motivations abound in a close corporation and often avoid detection. Thus a given management decision may not represent a true business-related risk.[228]

As with the desire to reassure capable managers, this justification assumes that fear of liability significantly affects a manager's decision-making process. The realities of the close corporation, however, undermine that assumption's validity. If the principal shareholders are also the managers, the principals already recognize the risk of economic failure. Potential legal liability therefore is arguably ignored in the decision-making process.

c. *Judicial Inability to Review Business Decisions*

Recent cases involving the use of special litigation committees in derivative suits have undermined the traditional view that judges are not capable of reviewing business decisions. *Zapata Corp. v. Maldonado*,[229] *Joy v. North*,[230] and similar cases indicate a new judicial willingness to substantively review business judgments.[231] Professor O'Neal has suggested that a court has less reason to question its substantive expertise in business matters in the close corporation context.[232] The problems are generally not as complex as in a large publicly held corporation. In *Zapata*, the Delaware Supreme Court captured the general unease with Professor O'Neal's suggestion in its comment that "under our system of law, courts and not litigants should decide the merits of litigation."[233]

d. *Concern for Efficiency*

The danger for abuse of the derivative lawsuit is widely recog-

227 The business judgment rule "does not apply in cases . . . in which the corporate decision lacks a business purpose . . . ." Joy v. North, 692 F.2d at 886. The rule, after all, protects *business* judgments. *See* notes 123-25 *supra* and accompanying text. Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), illustrates this point. The *Dodge* court viewed Henry Ford's decision to suspend dividend payments indefinitely as motivated by political and economic goals unrelated to the business of making and selling automobiles. *See* notes 119-25 *supra* and accompanying text.

228 *See* notes 124-25 *supra* and accompanying text. The close connection between dividends, compensation, and employment exacerbates the danger. The typical fact pattern of a freeze-out illustrates the problem. When do facially valid corporate actions mask non-business related motives?

229 430 A.2d 779 (Del. 1981).

230 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

231 *See* notes 62-71 *supra* and accompanying text.

232 F. O'NEAL, *supra* note 60, § 9.04.

233 430 A.2d at 789 n.18 (quoting decision below, 413 A.2d 1251, 1263 (Del. Ch. 1980)).

nized.[234] Using the business judgment rule to favor the defendant may discourage frivolous complaints.[235] With a smaller pool of potential plaintiffs, however, the danger of ill-founded lawsuits for the close corporation is ordinarily less severe than for the publicly held corporation.[236] Often close corporation shareholders lack the incentive to file a derivative lawsuit because the bulk of any recovery usually will accrue, directly or indirectly, to the alleged wrongdoers in their capacity as majority shareholders.[237] Furthermore, a derivative suit for a close corporation generally will be less complex, and therefore less costly and less time-consuming to defend.[238]

2. Assumptions

a. *Independence*

The business judgment rule presumes independent judgment and therefore is properly invoked only when the directors or officers involved are disinterested.[239] In the close corporation, however, the assumption of independence may be invalid. When the owners also serve as employees and as directors, potential conflicts of interest are always present.[240] As a result, personal interest often is not separated from the corporate welfare.[241] Because of the principals' tripartite identity,[242] conflicts can arise over compensation, other employment matters, dividend policy, or a myriad of other

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234 *See, e.g.*, W. CARY & M. EISENBERG, *supra* note 1, at 887; H. HENN & J. ALEXANDER, *supra* note 1, at 1039.

235 Arsht, *supra* note 6, at 95.

236 F. O'NEAL, *supra* note 60, § 9.04.

237 Hetherington & Dooley, *supra* note 11, at 41 n.132. Ordinarily, the recovery from a shareholder derivative suit goes to the corporation. *Id.* In certain circumstances, however, pro rata distribution of the recovery to the shareholders is allowed. Grenier, *Prorata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Justice*, 19 WASH. & LEE L. REV. 165, 167 (1962). In a close corporation, the benefit of such a pro rata distribution would inure primarily to the majority shareholders.

238 F. O'NEAL, *supra* note 60, § 9.04. By definition the set of potential plaintiffs is relatively small in a close corporation. Class actions, therefore, and the problems associated with them would not be expected. There may also be fewer causes of action which can be asserted. For example, a closely held corporation will ordinarily not be subject to the reporting requirements imposed by the Securities Exchange Act of 1934. Thus, complying with proxy regulations and the strictures of § 16(b) is not likely to be a problem. Furthermore, liability under § 11 or § 12(1) of the Securities Act of 1933 is also unlikely because a closely held corporation ordinarily will not have undergone the registration process outlined in § 5 of the 1933 Act. *But see* Hetherington & Dooley, *supra* note 11, at 16 n.42 (enforcement costs are likely to be high in the close corporation because of the increased likelihood of friction between the parties).

239 *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); H. HENN & J. ALEXANDER, *supra* note 1, at 661; Arsht, *supra* note 6, at 115-18.

240 F. O'NEAL, *supra* note 60, § 9.04.

241 Galler v. Galler, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1965).

242 This identity is as shareholders, employees, and directors. *See* F. O'NEAL, *supra* note 60, § 9.04; Note, *supra* note 104, at 1256.

issues. Controlling shareholders usually have the power to manipulate corporate decisions for their personal benefit.

The business judgment rule evolved from the publicly held corporation where management is separate from ownership.[243] The rule is thus based on the perception that independent managers, rather than the courts or shareholder-managers, best serve shareholders' interests.[244] This perception suggests that the business judgment rule should not apply to the close corporation.

b. *External Controls on Management Conduct*

The business judgment rule assumes that external factors regulate management conduct and make judicial deference appropriate. Unlike their counterparts in the close corporation, officers and directors in a publicly held corporation typically encounter numerous restraints on their behavior. For example, the federal securities laws restrict short swing trading by insiders of publicly held corporations[245] and require periodic reporting and disclosure of basic corporate information.[246] By providing additional means of encouraging responsible conduct by officers and directors, federal securities regulation theoretically supports reliance on the business judgment rule.[247] In addition, the pressures of the marketplace appreciably affect the conduct of management in a publicly held company. Poorly managed companies with faltering stock prices become vulnerable to various takeover attempts when the stock is perceived to be undervalued.[248]

However, the value of the derivative lawsuit as a regulator of management conduct is even more doubtful in the close corporation than it is in the publicly held corporation.[249] Ratable distribution to the shareholders lessens the incentive for a close corporation shareholder to sue derivatively.[250]

243 *See* note 83 *supra*. The definitive history of the business judgment rule remains to be written. A useful synopsis of its development can be found in Arsht, *supra* note 6, at 97-100. Most of the pivotal cases have involved publicly held corporations.

244 "The fundamental premise of the business judgment rule is that shareholders' welfare is maximized if business decisions are made by managers rather than by courts or shareholders." Fischel, *supra* note 11, at 937-38. In the close corporation, business decisions are made by shareholders who are also managers.

245 15 U.S.C. § 78p (1982) (§ 16(b) of the Securities Exchange Act of 1934).

246 15 U.S.C. § 78m (1982) (§ 13 of the Securities Exchange Act of 1934). *See* note 238 *supra*.

247 Note, *supra* note 104, at 1253, 1254. *Cf.* Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1326 (S.D. Iowa 1981).

248 Hetherington & Dooley, *supra* note 11, at 40.

249 The utility of the derivative lawsuit as a regulator of corporate conduct continues to be questioned. *See* Manne, *supra* note 10, at 272 (derivative lawsuits can only be used to police egregious wrongdoing). *See also* Aronson v. Lewis, 473 A.2d 805, 811 n.5, 812 (Del. 1984) (director liability "is predicated upon concepts of gross negligence").

250 Hetherington & Dooley, *supra* note 11, at 41 n.132. *See* note 237 *supra*.

c. *Existence of Alternative Remedies*

The business judgment rule's relaxed review is appropriate only if aggrieved shareholders have an alternative to litigation.[251] In a publicly held corporation, a dissatisfied shareholder can simply sell his shares. The shareholder in a close corporation, however, does not have this option because no market typically exists for the stock.[252]

The illiquidity of investment in the close corporation suggests two related conclusions. First, illiquidity makes freeze-outs more effective by removing the control group's incentive to compromise.[253] Second, the absence of an efficient, nonjudicial remedy to perceived oppressive conduct militates against the use of the business judgment rule's relaxed standard of review. A court has less reason to rely on the rule when an aggrieved shareholder's only recourse is litigation.[254]

Thus, the business judgment rule obscures judicial analysis and contributes to oppression in the close corporation. Fundamentally, however, the business judgment rule simply should not apply to the close corporation. The basic justifications and assumptions underlying the business judgment rule cannot be transferred automatically from the publicly held to the close corporation model. The courts should refrain from applying the business judgment rule to close corporations and should find a suitable replacement for this venerable principle.

III. Alleviating the Stress

A. *Statutory Solutions*

1. The Shortcomings of the Statutes

State statutes have not effectively addressed the problems of a close corporation minority shareholder. Existing statutes typically permit, but never require, a court of equity to order dissolution when one or more shareholders petition and prove the existence of

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251 *See* notes 48-49 *supra* and accompanying text.

252 *See* Hetherington & Dooley, *supra* note 11, at 5-6; Manne, *supra* note 10, at 280-81; Note, *supra* note 8, at 568-70; notes 81-82 *supra*. The cases reflect a steadily developing awareness of the illiquidity problem in the close corporation. *See, e.g.*, Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 273, 277 (Alaska 1980); Galler v. Galler, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1965); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 591, 599, 328 N.E.2d 505, 514, 518 (1975); Darvin v. Belmont Indus., Inc., 40 Mich. App. 672, 677, 199 N.W.2d 542, 544 (1972); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 152, 400 A.2d 554, 560 (Law. Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); Meiselman v. Meiselman, 309 N.C. 279, 291, 307 S.E.2d 551, 559 (1983).

253 Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 273, 274 (Alaska 1980). *See* Hetherington & Dooley, *supra* note 11, at 43.

254 Manne, *supra* note 10, at 280-81; Note, *supra* note 7, at 568-70.

certain conditions.[255] In addition to recognizing the minority shareholder's perilous position, however, the statutes should describe the circumstances entitling an aggrieved shareholder to relief and should specify the available relief.[256]

Although virtually every state has some statutory provision enabling a court to order dissolution,[257] the standards for seeking and obtaining relief vary widely. The threshold requirements for seeking relief range from "any shareholder" to fifty percent ownership,[258] and the requirements for obtaining relief differ. In general, the qualifications for relief are demanding.[259] Usually the plaintiff must show "oppression" or "oppressive conduct" to obtain relief.[260] These terms have eluded definition and have inspired both narrowly and broadly phrased descriptions. The descriptions, however, are usually tailored to the specific factual setting.[261] A few states have established a different standard and have authorized the courts to order dissolution if "reasonably necessary for the protection of the rights and interests" of one or more shareholders.[262]

On the whole, the various statutes at best offer uncertain relief. Prospective plaintiffs rarely know if the often cryptic statutory language would apply to their situation. In addition, involuntary dissolution statutes are usually construed narrowly.[263] Relief under these statutes is neither frequent nor predictable, particularly for

255 The statutes are collected in Note, *supra* note 86, at 1129-35. *Cf.* Hetherington & Dooley, *supra* note 11, at 17 nn.45-48.

256 The cases illustrate the many ways minority interests can be injured. Frequently withheld dividends and loss of company employment, either alone or in combination, cause injury. Other causes include the issuance of additional stock, the selective repurchase of outstanding stock, dismissal of derivative litigation, and merger with another corporation. *See* notes 190-95 *supra* and accompanying text. *Cf.* F. O'NEAL, *supra* note 60 (chapters 3-6).

257 Note, *supra* note 86, at 1147.

258 North Carolina, for example, simply permits "a shareholder" to sue for appropriate relief, including dissolution. N.C. GEN. STAT. § 55-125, 125.1 (1982). Ohio requires a 50% interest in order to seek dissolution. OHIO REV. CODE ANN. § 1701.91 (Page 1978). Various other threshold requirements are summarized in *In re* Topper, 107 Misc. 2d 25, 31-32, 433 N.Y.S.2d 359, 364 (Sup. Ct. 1980) and in Hetherington & Dooley, *supra* note 11, at 17 nn.45-48.

259 Hetherington & Dooley, *supra* note 11, at 18-19; Note, *supra* note 86, at 1123.

260 F. O'NEAL, *supra* note 60, § 7.15; Hetherington & Dooley, *supra* note 11, at 17 n.45; Note, *supra* note 86, at 1129, 1132.

261 Note, *supra* note 86, at 1135-39. Oppressive conduct, for example, has been described as "a visible departure from the standards of fair dealing," Ski Roundtop, Inc. v. Hall, 658 P.2d 1071, 1080 (Mont. 1983); as distinct from illegal or fraudulent conduct, on the order of "burdensome, harsh, and wrongful conduct," Baker v. Commercial Body Builders, Inc., 264 Or. 614, 628, 507 P.2d 387, 393-94 (1973); as involving a test similar to that used in breach of fiduciary duty cases, Masinter v. WEBCO Co., 262 S.E.2d 433, 440 (W. Va. 1980); or as implicating a "reasonable expectations" test, *In re* Taines, 111 Misc. 2d 559, 564-65, 444 N.Y.S.2d 540, 543-44 (Sup. Ct. 1981).

262 *See, e.g.*, CAL. CORP. CODE § 1800(b)(5) (West 1977); N.Y. BUS. CORP. LAW § 1104-a(b)(2) (McKinney Supp. 1984); N.C. GEN. STAT. §§ 55-125(a)(4) (1982).

263 Hetherington & Dooley, *supra* note 11, at 18-19, 31-32; Note, *supra* note 86, at 1123.

minority interests. In fact, a dissolution proceeding may be brought under these statutes primarily to facilitate a buy-out.[264]

The current dissolution statutes and the business judgment rule are interrelated. The rule condones facially neutral corporate actions, obscures the underlying dynamics of the situation, and thus makes a showing of oppression more difficult.[265]

2. "No Fault" Withdrawal

Several years ago, Professors Hetherington and Dooley proposed a simple, yet radical, statutory solution to eliminate the morass of involuntary dissolution statutes.[266] Starting with the premise that illiquidity allows exploitation of the minority shareholder, Hetherington and Dooley argued that shareholders in a closely held corporation should have the right to resell their shares to the corporation at any time.[267] Shareholders should be entitled by statute to a "no fault" buy-out at "fair value."[268]

In a sense, the proposal was the culmination of the argument first advanced by Israels that the perpetual existence of close corporations should be re-examined.[269] The proposal provoked much criticism.[270] The proposal's central tenet proved problematic. The thesis assumes that the close corporation is the "functional equivalent" of a partnership in every significant way but one.[271] That one exception is the illiquidity of the minority investment in a close corporation. In contrast, absent agreement otherwise, a disgruntled partner can dissolve a partnership at will.[272]

This thesis implies that the other traditional distinctions between the two forms of business organization, such as limited liability and transferability of interests, are insignificant. If this were true, the close corporation form, compared to the partnership,

264 Hetherington & Dooley, *supra* note 11, at 32-35.

265 *See* notes 201-18 *supra* and accompanying text. A "freeze-out" is not necessarily "oppressive conduct." The most obvious manifestation of oppressive conduct, however, is the freeze-out.

266 *See generally* Hetherington & Dooley, *supra* note 11.

267 *See id.* at 50.

268 *See id.* at 51-52.

269 *See generally* Israels, *supra* note 79.

270 *See, e.g., In re* Reading Co., 551 F. Supp. 1205, 1219 (E.D. Pa. 1982), *rev'd*, 711 F.2d 509 (3d Cir. 1983); Meiselman v. Meiselman, 309 N.C. 279, 287-90, 307 S.E.2d 551, 557-58 (1983); Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 72-75 (1982); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1550 n.99 (1982).

271 Hetherington & Dooley, *supra* note 11, at 2-3.

272 *Id.* "The position of the minority in the close corporation is as unique as it is precarious: no other form of business organization subjects an owner to the dual hazards of a complete loss of liquidity and an indefinite exclusion from sharing in the profitability of the firm." *Id.* at 6.

would represent only a trap for the unwary investor. In any event, the no-fault withdrawal proposal suffers from a more practical shortcoming: no state legislature has enacted such a statute. Thus, the proposal has yet to be tested.

3. Other Statutory Relief

The business judgment rule presumes that good-faith managerial decisions should be sheltered from liability. Would discarding this presumption require substituting statutory protection? Discarding this presumption may increase the risk of personal liability for officers and directors.

Insurance and indemnification, however, would still reassure management. Most state corporation codes expressly authorize the use of insurance and indemnity for officers and directors.[273] Although cost is a consideration, such arrangements are equally available to the managers of closely held corporations as well as publicly held organizations.[274]

B. *Shareholders' Agreements*

The shareholders' agreement is probably the most frequently mentioned "remedy" for aggrieved minority shareholders in the close corporation. Commentators and the courts have debated the utility and desirability of shareholders' agreements.[275] The idea is certainly appealing. This theoretical arms-length contract would specify the understanding and undertakings of the parties and would stipulate a dispute-resolution process. Such a contract may well provide faster and more certain relief than does protracted and expensive litigation. Indeed, a shareholders' agreement may give the minority shareholder in a close corporation a position preferable to that of his counterpart in the publicly held corporation.[276]

At best, however, a shareholders' agreement is preventive medicine. If an agreement does not exist at the time the dispute arises, this "remedy" will be useless. A shareholders' agreement would not be drafted in the midst of a dispute. Shareholders' agreements, however, are not routinely prepared when a close corporation is formed or reorganized.[277]

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273 *See* W. CARY & M. EISENBERG, *supra* note 1, at 960; H. HENN & J. ALEXANDER, *supra* note 1, at 1144.

274 *See* 1 F. O'NEAL, *supra* note 105, § 3.67.

275 *See* Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965); H. HENN & J. ALEXANDER, *supra* note 1, at 778-81; F. O'NEAL, *supra* note 60, §§ 2.17, 8.05.

276 Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1031 n.107 (1981).

277 *See In re* Topper, 107 Misc. 2d 25, 33, 433 N.Y.S.2d 359, 365 (Sup. Ct. 1980); Meiselman v. Meiselman, 309 N.C. 279, 290, 307 S.E.2d 551, 558 (1983); Hetherington, *Special*

Even when such agreements are prepared, minority interests often are not adequately protected. Minority interests, by definition, hold a weak bargaining position. Any agreement between the majority and the minority shareholders would reflect this imbalance. Typically, one attorney handles all the legal aspects of incorporation. Therefore, a shareholders' agreement, if drafted, may not greatly protect the minority interests.[278]

In addition, such an agreement may well be inartfully drafted or incomplete because a well-written shareholders' agreement requires considerable time and effort. Indeed, a comprehensive agreement may not be a realistic objective considering the myriad disagreements that may arise.[279] Furthermore, not every situation is conducive to the preparation of a shareholders' agreement. Rarely would a minority shareholder demand, much less receive, a shareholders' agreement if the shares were acquired by inheritance or gift or an employer's offer.[280]

In light of these considerations, a minority shareholder cannot be said to assume the risk of oppression by not initially insisting on a shareholders' agreement. In fact, the people who need shareholders' agreements the most may actually benefit from them the least.[281]

This discussion implicitly suggests the principal reasons why a shareholders' agreement is not an adequate "remedy." Individuals acquire minority interests in many ways, and expectations may change. This combination makes anticipating and providing for future problems particularly difficult, even for the most conscientious drafter.[282] Moreover, because the success of the close corporation depends so heavily on the continued good will and close cooperation of the parties, a shareholders' agreement is of limited value.[283] In short, the usefulness of a shareholders' agreement, either as a

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Characteristics, Problems and Needs of the Close Corporation, U. ILL. L.F. 1, 17-18 (1969). *See also* Hetherington & Dooley, *supra* note 11, at 38 n.121; O'Neal, *supra* note 80, at 881.

278 Hetherington, *supra* note 277, at 17-19.

279 *See* Hetherington & Dooley, *supra* note 11, at 37-38; O'Neal, *supra* note 80, at 881; *Stockholder's Duty*, *supra* note 176, at 425-26 n.26.

280 *See Meiselman*, 309 N.C. at 291, 307 S.E.2d at 558-59; Hetherington, *supra* note 277, at 17-18.

281 *See, e.g.*, *Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983); Hetherington & Dooley, *supra* note 11, at 36; Hetherington, *supra* note 277, at 16-19; O'Neal, *supra* note 80, at 881.

282 Professors Hetherington and Dooley state:

> Such comprehensive private arrangements call for legal services of an extent and kind not likely to be available to small businessmen. Even if such services were available, something is fundamentally wrong with a system that requires sophisticated, complex, and costly organizational arrangements for what are usually the least sophisticated business ventures.

Hetherington & Dooley, *supra* note 11, at 38.

283 *Id.* at 2.

preventive measure or as a remedy, should not be overemphasized.

C. *Judicial Substitutes for the Business Judgment Rule*

The business judgment rule presently forms the basis for judicial analysis of corporate litigation. The rationale of numerous cases begins with this principle. If the rule were discarded, another judicial doctrine would have to provide this analytical "starting point." No statutory or contractual substitute appears acceptable.

1. The "Intrinsic Fairness" Inquiry

Traditional corporate law theory holds that the business judgment rule does not apply if "interest" on the part of officers and directors is shown.[284] The existence of conflicting loyalties may have undermined the ability of the accused officers and directors to reach an independent decision. The inquiry therefore focuses on the "intrinsic fairness" of the challenged transaction.[285]

If the business judgment rule were discarded in cases involving close corporations, an obvious substitute would be the intrinsic fairness test. As true independence rarely, if ever, exists in the close corporation,[286] such a substitution would not be implausible or fortuitous. In fact, the norm in close corporations may be conflicting interests, whether obvious or subtle.

Would automatic application of the intrinsic fairness standard result in an analysis different from that under the business judgment rule? One commentator has suggested that the two analyses do not differ significantly.[287] In theory, however, if not in practice, the operation of the two tests differs. The business judgment rule establishes a presumption in favor of management decisions

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284 *See* notes 38-39 *supra* and accompanying text.

285 As the Delaware Chancery court explains:

> [W]hen the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present. Intrinsic fairness, tested by all relevant standards, is then the criterion.

David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968). *See also* Polin v. Conductron Corp., 552 F.2d 797 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960); Arsht, *supra* note 6, at 115-16.

The business judgment rule can be avoided by a showing other than "interest." Lack of good faith or an inability to establish a rational basis for the challenged decision, for example, will also render the rule inapplicable. *See* notes 38-39 *supra* and accompanying text. Regardless of the means employed, the common result is loss of the presumption in favor of the managerial decision and also a shift in the burden of proof.

286 *See* notes 239-44 *supra* and accompanying text.

287 Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 318 n.49 (1974).

reached in good faith.[288] Once the defendants have made a minimal showing, the burden of proof rests squarely on those challenging such decisions.[289] In contrast, the intrinsic fairness test, in effect, shifts the burden of proof to the defendants.[290] The difference in burden of proof often has practical significance.[291]

Substituting the intrinsic fairness standard would complement the skeptical attitude, expressed in cases such as *Zapata Corp. v. Maldonado*,[292] about the use of the business judgment rule and special litigation committees. In *Zapata*, the Delaware Supreme Court concluded that such a committee must initially prove its independence, its good faith, and its performance of a reasonable investigation before the court will entertain a motion to dismiss a shareholder derivative suit.[293] To reach that conclusion, the court analogized "demand-excused" derivative suits to "interested director" transactions where the defendant-directors must prove the intrinsic fairness of the transaction.[294] The common thread is the existence of reasonable doubts about the independence of management. If independence cannot be presumed, an intrinsic fairness inquiry is appropriate.[295]

The advantages of this substitute test are easily identifiable. First, the test represents a refinement of a familiar type of review. Second, the use of such a test should strengthen an aggrieved shareholder's bargaining position by making the threat of litigation more serious.

This substitution, however, would have disadvantages. First, increasing the seriousness of the threat of a derivative suit is both an advantage and a disadvantage. Second, the types of behavior that trigger the intrinsic fairness standard have been narrowly defined. The conflicting interests ordinarily need to be egregious.[296] Third, the term "fairness" is no more specific than "good faith" or "fiduciary duty." Like so many terms in this area, "fairness" defies precise definition.[297]

Moreover, to whom must a challenged transaction or decision

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288 *See* note 21 *supra* and accompanying text.

289 *See* notes 21-36 *supra* and accompanying text.

290 *See* note 285 *supra*.

291 Polin v. Conductron Corp., 552 F.2d 797, 809 n.42 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977).

292 430 A.2d 779 (Del. 1981).

293 *Id.* at 788.

294 *Id.* at 788 n.17.

295 The lack of disinterested, independent judgment is the critical fact. The key effect of the "intrinsic fairness" test is to shift the burden of proof from the plaintiffs to the defendants.

296 *Stockholders' Duty*, *supra* note 176, at 426 n.27.

297 *See* D. VAGTS, BASIC CORPORATION LAW 272-73 (1979). *See also* H. HENN & J. ALEXANDER, *supra* note 1, at 639.

be "intrinsically fair"? To the corporation? To minority shareholders? To all shareholders? Or to both the corporation and its shareholders? The case law is surprisingly ambiguous on this point.[298] When a court invokes the intrinsic fairness standard, it typically does not identify the object of "fairness." The omission may not be accidental. The answer to this question, however, alters the effectiveness of the result. A "fairness" review only to the corporate level in a close corporation will often be meaningless. The most effective techniques of oppression typically are facially neutral and would not adversely affect the corporation.[299]

Instead, the inquiry would have to extend to the individual shareholders. Such an extension would not be unprecedented. Courts have occasionally assessed a particular transaction's fairness to various groups of shareholders, without regard to the effect on the corporation.[300] This approach, however, is usually employed when an aggrieved shareholder may assert a direct cause of action, apart from any derivative claims. Distinguishing between derivative and direct claims in the close corporation is often difficult.[301] The benefits of making the distinction are equally difficult to identify.[302] The requirement of a direct action, however, would not present an obstacle if the aggrieved close corporation shareholder could use the duty of the majority to the minority shareholder to maintain a

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298 *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952). *See also* H. HENN & J. ALEXANDER, *supra* note 1, at 639; Arsht, *supra* note 6, at 115-16. Statutes directed at interested director problems, however, are not as ambiguous. For example, § 144 of the Delaware Corporation Code requires the contract or transaction to be "fair as to the corporation." DEL. CODE ANN. tit. 8, § 144(a)(3) (1983). Section 41(c) of the Model Business Corporation Act requires the contract or transaction to be "fair and reasonable to the corporation." MODEL BUSINESS CORP. ACT § 41(c) (1979).

299 It is difficult, for example, to show that a nonpublic corporation is injured because earnings are distributed in the form of salary rather than in the form of dividends. The situation is much the same with partial or selective repurchase of stock. Unless the corporation's liquidity or solvency is threatened, a repurchase should be a matter of indifference to the corporation. Zidell v. Zidell, Inc., 277 Or. 423, 427-28, 560 P.2d 1091, 1093 (1977).

300 *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 105-08, 460 P.2d 464, 470-71, 81 Cal. Rptr. 592, 597-99 (1969); Donahue v. Rodd Electrotype Co., 367 Mass. 578, 588-94, 328 N.E.2d 505, 512-16 (1975). The Delaware courts took an analogous approach to review of cash-out mergers, where a corporation decides to acquire all the outstanding shares of a subsidiary it does not then own. The "fairness" issue arises when officers or directors of the parent also sit on the board of the subsidiary and vote for the proposal. When "fairness" is at issue, the Delaware Supreme Court has indicated that "fairness" means fairness to the subsidiary's minority shareholders whose shares are being "cashed out." Weinberger v. UOP, Inc., 457 A.2d 701, 711-14 (Del. 1983).

301 For example, there is no general agreement as to whether an action to compel declaration of dividends—a common close corporation issue—is direct or derivative. H. HENN & J. ALEXANDER, *supra* note 1, at 1051. *See also* W. CARY & M. EISENBERG, *supra* note 1, at 896-99; H. HENN & J. ALEXANDER, *supra* note 1, at 1044-53.

302 *See* notes 210-12 *supra* and accompanying text.

direct cause of action.[303]

Extending the "fairness" inquiry to individual shareholders raises new questions. How broad should the inquiry be? Is past conduct relevant? Should the expectations of the parties be considered? These questions indicate the necessary prerequisites to the use of such a standard—a consensus on what is "fair" in the close corporation and on the proper scope of a "fairness" inquiry. That consensus does not now exist.[304] The business judgment rule analysis is faulted for reviewing isolated incidents and ignoring an overall pattern of oppression.[305] Unless a consensus is achieved, the intrinisic fairness test could foster the same problem.

2. The Duty of the Majority to the Minority

The idea that majority shareholders owe a fiduciary duty to the minority shareholders has taken hold.[306] Judge Traynor strongly stated this duty in *Jones v. H.F. Ahmanson & Co.*: "The comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state."[307] While not confined to the close corporation,[308] the majority shareholders' duty would probably arise in this context. A close corporation would be more likely to have a majority shareholder or shareholders than would a publicly held corporation.

The duty of the majority theoretically provides an attractive way to surmount the usual obstacles to relief, such as the business judgment rule. For all its apparent appeal, however, the principle actually has dubious value. The business judgment rule should arise in cases where management decisions are challenged directly. In contrast, the duty of the majority would be invoked when, for whatever reason, a direct challenge to a management decision is either unavailable or undesirable.[309] Thus, the duty of the majority

303 *See* note 147 *supra* and notes 306-13 *infra* and accompanying text.

304 For instance, there is still considerable support for the notion that a minority shareholder in a close corporation, because of his status, assumes the risk of a freeze-out. As expressed by the Oregon Supreme Court: "[I]t is common knowledge that, as a practical matter, the stock acquired by one who purchases a 49% interest in a 'close' family corporation, as in this case, is worth considerably less than 49% of the book value of such stock." Baker v. Commercial Body Builders, Inc., 264 Or. 614, 637, 507 P.2d 387, 398 (1973).

305 *See* notes 202-18 *supra* and accompanying text.

306 2 F. O'NEAL, *supra* note 105, § 8.07 (cases collected therein).

307 1 Cal. 3d 93, 112, 460 P.2d 464, 474, 81 Cal. Rptr. 592, 602 (1969).

308 H. HENN & J. ALEXANDER, *supra* note 1, at 653-60. For example, in *Ahmanson*, Judge Traynor did not limit the application of the principle to closely held corporations. *See* note 307 *supra* and accompanying text.

309 A facially valid decision of the board of directors to increase employee compensation, for example, or to repurchase stock held by a shareholder, absent clear evidence of self-dealing, will have little chance of surviving the business judgment rule's counterattack.

would seem to avoid the presumption of business judgment rule.

In practice, however, no such distinction has emerged. Courts have instead simultaneously applied the business judgment rule and the duty of the majority. For example, in *Masinter v. WEBCO Co.*,[310] the West Virginia Supreme Court recognized that the majority shareholders owe a basic duty of good faith. The court then promptly noted that the existence of such a duty "does not mean that the officers and directors are not accorded a rather broad latitude in the conduct of corporate affairs."[311]

Thus, the duty of the majority has not developed as a substitute for the business judgment rule. The duty remains an alternative for a court of equity to use in reaching a result seemingly inconsistent with the business judgment rule. In any event, the duty of the majority would not be a significant improvement over the business judgment rule. The duty of the majority could only partially replace the business judgment rule. The duty of the majority would be irrelevant to allegations of ordinary neglience. Furthermore, the rule's replacement would only be a loosely defined duty of good faith and fair dealing. Such a duty, as developed by the courts, would not be more exacting than the fiduciary duty owed by officers and directors to the corporation.[312]

3. The Analogy to a Partnership

A close corporation and a partnership have several similar characteristics.[313] The close relationship between ownership and control and the great importance of cooperation and mutual trust are the key similarities.[314] These similarities prompted the Supreme Judicial Court of Massachusetts in *Donahue v. Rodd Electrotype Co.*[315] to impose on close corporation shareholders a duty

Likewise, since the recovery in a successfully prosecuted derivative lawsuit ordinarily belongs to the corporation, and not the complaining shareholder, this device will often be unattractive. The recovery inures primarily to the benefit of the wrongdoers. *See* notes 211-12 *supra* and accompanying text.

310 262 S.E.2d 433 (W. Va. 1980).

311 *Id.* at 438. *See also* Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 276, 278 (Alaska 1980); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 850-51, 353 N.E.2d 657, 663 (1976); Zidell v. Zidell, Inc., 277 Or. 413, 418-19, 560 P.2d 1086, 1089 (1977).

312 *But see* Donahue v. Rodd Electrotype Co., 367 Mass. 578, 593-94, 328 N.E.2d 505, 515-16 (1975).

313 *See* Galbreath v. Scott, 433 So. 2d 454, 457 (Ala. 1983); Meiselman v. Meiselman, 309 N.C. 279, 289, 307 S.E.2d 551, 557 (1983); W. CARY & M. EISENBERG, *supra* note 1, at 18-19, 366; F. O'NEAL, *supra* note 105, § 9.02; Hetherington & Dooley, *supra* note 11, at 1-2; Hillman, *supra* note 270, at 65. *Contra* Baker v. Commercial Body Builders, Inc., 264 Or. 614, 507 P.2d 387 (1973).

314 Meiselman v. Meiselman, 309 N.C. 279, 288-89, 307 S.E.2d 551, 557 (1983). *See* F. O'NEAL, *supra* note 105, § 9.02; Hetherington & Dooley, *supra* note 11, at 2; Hillman, *supra* note 270, at 65.

315 367 Mass. 578, 328 N.E.2d 505 (1975).

corresponding to that owed among partners.

The *Donahue* court adopted the premise that the duty one partner owes to another is more rigorous than the duty directors owe to shareholders and shareholders owe to each other. The court contrasted the "utmost good faith and loyalty required of partners" with the "somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere."[316]

Transferring the duty of partners to the shareholders of a close corportion, the *Donahue* court allowed the minority shareholders to resell stock to the corporation on terms equivalent with those accorded to the defendant, the majority shareholder. The court reasoned that the defendant's use of "control" to obtain "special advantages and disproportionate benefit" violated the duty owed by the shareholders to one another as quasi-partners.[317]

Although widely noted,[318] the *Donahue* approach offers little improvement over the status quo. The fundamental problems of defining the duty of partners and distinguishing that duty from the existing duty in the corporate model remain. The *Donahue* opinion did not resolve these problems. Discovering a solution is indeed a difficult task. Partnership law in general and partners' duties have not attracted much attention.[319] Furthermore, articulating the difference between duty at the corporate level and duty at the partnership level proves particularly frustrating.[320]

The partnership and the close corporation share many similarities. However, as the concurring opinion to *Donahue* noted,[321] the two forms are not identical. The traditional distinctions between the two business forms include the limited liability of shareholders, the perpetual legal existence of the corporation, the transferability of shares, and the tax "entity" status of the corporation.[322] In practice, these distinctions may be more theoretical than real.[323] Yet in certain situations, these distinctions may have practical significance.

Either transplanting the duty of partners to the close corporation or expanding the duty of the majority to the minority would

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316 *Id.* at 593-94, 328 N.E.2d at 515-16.

317 *Id.* at 598-99, 328 N.E.2d at 518.

318 *See generally* Gillerman, *The Corporate Fiduciary in Massachusetts*, 65 MASS. L. REV. 113 (1980); Note, *The Strict Good Faith Standard—Fiduciary Duties To Minority Shareholders in Close Corporations*, 33 MERCER L. REV. 595 (1982); *Stockholders' Duty, supra* note 176; Comment, 61 CORNELL L. REV. 986 (1976); Comment, 61 IOWA L. REV. 876 (1976); Comment, 21 VILL. L. REV. 307 (1975).

319 Hillman, *supra* note 270, at 1.

320 *Stockholders' Duty, supra* note 176, at 428.

321 367 Mass. at 604, 328 N.E.2d at 521 (Wilkins, J., concurring).

322 R. HAMILTON, *supra* note 1, at 9-20.

323 *Id.*

shift attention from the board of directors to the true focus: the interaction between the principals. But analogizing the close corporation to a partnership, like expanding the duty of the majority, would simply replace one inexact and ambiguous set of principles with another. The partnership analogy thus would not provide a better method to analyze close corporation litigation.

4. The "Less Harmful Means" Analysis

One year after *Donahue*, the Supreme Judicial Court of Massachusetts modified its approach to reviewing management conduct in the close corporation. In *Wilkes v. Springside Nursing Home, Inc.*,[324] the court adopted a two step analysis for cases of alleged breach of duty by majority shareholders. First, the majority must demonstrate a legitimate business purpose for the offending action.[325] If the majority shareholder advances either no purpose or an unsatisfactory purpose, the complaining shareholders are entitled to relief.[326] If a legitimate business purpose is advanced, the complaining shareholders may demonstrate that the legitimate business purpose "could have been achieved through an alternative course of action less harmful to the minority's interest."[327] The court must then "weigh the legitimate business purpose, if any, against the practicability of the less harmful alternative."[328]

The *Wilkes* court characterized its approach as a modest retreat from *Donahue's* broadly phrased standards.[329] The court was concerned that "untempered application" of the *Donahue* standard might "unduly hamper" the efficient management of the close corporation.[330] Thus, the *Wilkes* court reiterated that courts should give substantial latitude to management decisions in areas such as dividends, compensation, and personnel matters.[331]

The first prong of the *Wilkes* test tracks the traditional business judgment rule analysis. Requiring the defendant to initially articulate a legitimate business purpose essentially forces the defendant to demonstrate a rational basis for the challenged action. The defendant would make such a demonstration to invoke the business judgment rule in any event.[332] Thus, requiring the defendant to

324 370 Mass. 842, 353 N.E.2d 657 (1976).
325 *Id.* at 851-52, 353 N.E.2d at 663.
326 *Id.*
327 *Id.*
328 *Id.*
329 *Id.*
330 *Id.*
331 *Id.*
332 *See* Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). These cases suggest that a showing of a rational basis for the challenged business decision, in the ab-

articulate a legitimate business purpose for a challenged corporate action offers little protection for minority interests.

At best, the legitimate business purpose requirement would only control the outcome of egregious cases of oppression, such as in *Wilkes*.[333] In most cases, a plausible business purpose would not be difficult to show.[334] The experience of the Delaware courts, culminating in the exasperated abolition of the requirement, is instructive.[335] The rise and fall of the business purpose requirement in cash merger litigation underscores the inadequacy of this approach as protection for minority shareholders.

In spite of the court's effort to reaffirm the business judgment rule, the *Wilkes* approach actually represents a significant departure from the rule. The opportunity to show a less harmful means to the legitimate business objective adds a new level of inquiry. Also, a plaintiff's showing of a less harmful means triggers closer judicial scrutiny. The court must substantively compare the alternative means. Such comparisons are unnecessary when the business judgment rule is invoked. Under the business judgment rule, if a rational basis for the decison exists, the court presumes that the

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sence of evidence of bad faith or "interest," will be sufficient to invoke the business judgment rule. *See also* PRINCIPLES OF GOVERNANCE, *supra* note 4, comment to § 4.01(d) at 62-63.

333 Plaintiff Wilkes, along with the three individual defendants, operated a nursing home. Each of the four shareholders owned 25% of the stock, and each performed services for the corporation for which compensation was paid. No dividends were paid. In time, Wilkes and one of the other shareholders had a falling-out. When Wilkes attempted to sell his shares at appraised value, the other shareholders, acting as directors, cut off Wilkes' salary. Wilkes was subsequently not re-elected as either an officer or director of the corporation. 370 Mass. at 844-47, 353 N.E.2d at 659-61.

334 *See* F. O'NEAL, *supra* note 60, § 3.05; Note, *supra* note 102, at 1638.

335 In Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), the majority shareholder engineered a merger solely to eliminate the minority shareholders. The Delaware Supreme Court held that the merger violated the fiduciary duty owed by the majority to the minority. If challenged, the majority would thus be required to show a legitimate business purpose for the merger. Shortly thereafter, in Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977), the court held that a merger made primarily to advance the business purpose of the majority shareholder satisfied the "business purpose" test of *Singer*. Then, in Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979) the court reiterated the continuing vitality of the business purpose requirement. *Singer*, *Tanzer*, and *Roland* became known as the *Singer* trilogy. The *Singer* trilogy's business purpose test was widely criticized. *See, e.g.*, Fischel, *supra* note 11; Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 671 n.300 (1981); Comment, *Delaware Reevaluates State-Law Limitations on Take-Out Mergers*, 62 N.C.L. REV. 812 (1984). Finally, in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the Delaware Supreme Court threw in the towel. The court discarded the business purpose requirement, noting that "we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement [of the *Singer* trilogy]." *Id.* at 715.

There is at least a theoretical link between the cash merger litigation described above and the *Wilkes* approach. A merger which lacks a valid business purpose is a sophisticated freeze-out technique, since it uses control to eliminate minority shareholders. Gabhart v. Gabhart, 267 Ind. 370, 383, 370 N.E.2d 345, 353 (1977).

course chosen is acceptable.[336] In effect, under the rule, substantive review stops if the defendant shows a rational basis for the decision.

Application of the *Wilkes* approach appears deceptively simple. The *Wilkes* court, however, did not have to demonstrate the operation of the less harmful means approach. Instead, the court simply acknowledged, without elaboration, that comparisons will be necessary.[337] In *Wilkes*, the plaintiff prevailed because the defendant did not advance a legitimate business purpose for the plaintiff's termination as an employee.[338]

Drawing the comparisons necessary under the *Wilkes* test could be a formidable task. If, for example, the defendant, the majority shareholder, advances a legitimate business purpose, and the plaintiff demonstrates an alternative that is much less harmful but slightly more expensive, should the plaintiff prevail? Consider the typical situation where a non-employee shareholder sues to have dividends declared. The defendant majority shareholder asserts the need to accumulate funds to finance a planned expansion of the business. The plaintiff minority shareholder replies that such expansion could be financed through bank loans. Who should prevail? The tone of the *Wilkes* opinion suggests that a court comparing alternative means should respect the decisions of those in control. The *Wilkes* court deemed a "large measure of discretion" appropriate.[339] This "large measure of discretion" seems the same as the business judgment rule's presumption.

The less harmful means approach, however, would offer an aggrieved shareholder more opportunity to demonstrate his plight than would the usual operation of the business judgment rule. This approach would induce a court to consider alternate means to the corporate objective and thus would result in closer scrutiny of board actions.

The *Wilkes* reformulation of the *Donahue* partnership analogy has not been tested outside of Massachusetts.[340] In a Montana

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336 *See* notes 20-34, 332 *supra* and accompanying text.

337 370 Mass. at 852, 353 N.E.2d at 663.

338 *Id.*

339 *Id.*

340 Subsequent discussion of *Wilkes* by Massachusetts courts provides little guidance as to the mechanics of the test envisioned in *Wilkes*. For example, in Hallahan v. Haltom Corp., 7 Mass. App. 68, 385 N.E.2d 1033 (1979), the defendants failed to demonstrate any legitimate business purpose for discharging the plaintiff minority shareholders from employment. No comparison of alternatives was necessary. In Drury v. Abdallah, 9 Mass. App. 865, 866, 401 N.E.2d 154, 156 (1980), the court reiterated the observation made in *Wilkes* that those in control of the corporation are entitled to a "large range of discretion" in managing the corporation. The *Drury* court also implied that the business judgment rule has done no serious damage in Massachusetts.

case, *Ski Roundtop, Inc. v. Hall*,[341] the dissent employed an approach similar to that used in *Wilkes*. The dissent, however, did not refer to *Wilkes* and offered its approach in response to the majority's conclusion that alternate means need not be considered once a legitimate business purpose is established.[342]

5. The "Reasonable Expectations" Approach

Involuntary dissolution statutes provide the principal form of statutory relief for aggrieved shareholders.[343] The weaknesses of such statutes have been widely noted.[344] Such statutes typically empower a court to order relief upon a finding of oppressive conduct.[345] Predictably, a reliable definition of "oppression" has proved elusive.[346] A growing number of courts have defined oppression in terms of the reasonable expectations of the parties: frustration of a party's reasonable expectations results in "oppression."[347]

This emphasis on reasonable expectations, long championed by Professor O'Neal,[348] represents a willingness to treat the close corporation as a legal entity fundamentally different from the publicly held corporation. The essential difference is that close corporations "are companies based on personal relationships."[349] In that context, the reasonable expectations of the various parties assume great significance. The reasonable expectations represent the understanding and assumptions that initially induced the parties to combine efforts.

In a sense, "reasonable expectations" describes all the conditions and premises a highly comprehensive shareholders' agreement might contain. The parties' reasonable expectations could be described as an implied multilateral contract among the shareholders.[350] Reasonable expectations typically include assurance of em-

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341 Ski Roundtop, Inc. v. Hall, 658 P.2d 1071 (Mont. 1983).

342 *Id.* at 1083.

343 *See* notes 255-58 *supra* and accompanying text.

344 *See* notes 255-64 *supra* and accompanying text; *see also* F. O'NEAL, *supra* note 60, § 9.09.

345 *See* note 260 *supra* and accompanying text.

346 *See* notes 260-61 *supra* and accompanying text.

347 *See, e.g.*, O'Donnel v. Marine Repair Serv., 530 F. Supp. 1199, 1207 (S.D.N.Y. 1982); Capital Toyota v. Gerwin, 381 So. 2d 1038, 1039 (Miss. 1980); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 154-55, 400 A.2d 554, 561 (Law. Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); *In re* Taines, 111 Misc. 2d 559, 564-65, 444 N.Y.S.2d 540, 543 (Sup. Ct. 1981); *In re* Topper, 107 Misc. 2d 25, 34-35, 433 N.Y.S.2d 359, 365 (Sup. Ct. 1980); Hillman, *supra* note 270, at 38.

348 F. O'NEAL, *supra* note 60, §§ 1.01 n.1, 7.15.

349 F. O'NEAL, *supra* note 60, § 7.15. *See* notes 125, 314 *supra*.

350 *See, e.g.*, *In re* Topper, 107 Misc. 2d at 33-34, 433 N.Y.S.2d at 365: "These reasonable expectations constitute the bargain of the parties in light of which subsequent conduct must be appraised."

ployment and participation in management. The expectations are seldom limited to a right to vote for directors and to participate in dividend distributions.[351]

Courts applying the reasonable expectations analysis have concluded that this analysis prevails over the business judgment rule if a conflict arises.[352] Thus, in *Exadaktilos v. Cinnaminson Realty Co.*[353] and in *Meiselman v. Meiselman,*[354] the courts severely criticized the oppressive potential of the business judgment rule and then discussed the virtues of the reasonable expectations analysis. Similarly, in *O'Donnel v. Marine Repair Service,*[355] the court concluded that a thirty-five percent shareholder could, under the circumstances, reasonably anticipate equal participation in management and compensation. Furthermore, in *In re Topper,*[356] the court noted that even discharge of a shareholder-employee for cause could disrupt the shareholder's reasonable expectation of continued employment. The court observed: "Whether the controlling shareholders discharged petitioner for cause or in their good business judgment is irrelevant."[357] Thus, the reasonable expectations analysis could displace the business judgment rule as the method to review facially neutral corporate transactions.[358]

Existing case law suggests several generalizations about the reasonable expectations approach. First, the expectations of all the principals are relevant, not just the plaintiff's.[359] Second, a party's expectation will be honored only if it was disclosed to the other parties. Secret expectations are unenforceable,[360] although the expectations need not be in writing.[361] Third, courts have not limited expectations in a close corporation to voting for directors and participating in dividends. Assurance of employment, for example, and participation in management are often part of the reasonable

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351 *See* Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 153-54, 400 A.2d 554, 560-61 (Law. Div. 1979), *aff'd,* 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); Meiselman v. Meiselman, 309 N.C. 279, 302-03, 307 S.E.2d 551, 565 (1983).

352 Conflicts are, of course, not inevitable. An aggrieved shareholder's petition for relief triggers a "reasonable expectations" inquiry. Such a petition typically takes the form of a request for involuntary dissolution of the corporation, as authorized by applicable law. But otherwise, the business judgment rule operates freely.

353 167 N.J. Super. 141, 154-55, 400 A.2d 554, 561 (Law Div. 1979), *aff'd,* 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980).

354 309 N.C. 279, 292, 307 S.E.2d 551, 559 (1983).

355 530 F. Supp. 1199 (S.D.N.Y 1982).

356 107 Misc. 2d 25, 433 N.Y.S.2d 359 (Sup. Ct. 1980).

357 *Id.* at 28, 433 N.Y.S.2d at 362.

358 *Cf.* F. O'NEAL, *supra* note 60, § 7.15.

359 *See Exadaktilos,* 167 N.J. Super. at 154-56, 400 A.2d at 561-62; *Topper,* 107 Misc. 2d at 33, 35, 433 N.Y.S.2d at 365, 366; *Meiselman,* 309 N.C. at 314, 307 S.E.2d at 571 (Martin, J., concurring).

360 *See Meiselman,* 309 N.C. at 298, 307 S.E.2d at 563; Hillman, *supra* note 270, at 77-81.

361 *See Topper,* 107 Misc. 2d at 33, 433 N.Y.S.2d at 365; Note, *supra* note 86, at 1143.

expectations of one or more of the parties.[362] Fourth, expectations may change over time.[363] And finally, expectations may vary from shareholder to shareholder.[364]

Reasonable expectations may vary not only from shareholder to shareholder, but from corporation to corporation. The reasonable expectations for a specific set of shareholders depends upon the circumstances surrounding the creation and evolution of that particular corporation.[365] Thus, conduct which is oppressive in one corporation might be unobjectionable in another.

These generalizations suggest the difficulty of identifying a shareholder's reasonable expectations. This analysis assumes that "in a close corporation the bargain of the participants is often not reflected in the corporation's charter, by-laws nor even in separate signed agreements."[366] Problems of proof will be inevitable. Oral testimony about past conduct and past conversations contradicting the corporate documents will be necessary. In short, parol evidence will not only be unavoidable, but essential. Conceptually, this analysis would force a court to discover and to reconstruct an implied contract that the parties theoretically agreed upon at the corporation's formation and amended over time. This reconstruction must occur without the benefit of a single writing.

Nonetheless, the reasonable expectations analysis has considerable advantages. First, unlike the business judgment rule, this doctrine is based on and tailored to the attributes of the close corporation.[367] Second, this approach focuses attention on the relationship of the parties as joint investors in the close corporation and not on the ritualistic mechanics of board decisions. Third, the analysis encourages comprehensive review of behavior patterns over time, rather than cursory inspection of isolated events.

In combination, these benefits lessen the potential for oppression in the close corporation. Thus, the discharge of a one-third owner in *Topper* and a forty-six percent owner in *Meiselman* were actionable under the expanded review of the reasonable expectations analysis. The review included the role that soured personal relationships played in the attempted freeze-out of the minority shareholders. In both cases, the courts recognized the roadblock the business judgment rule would have posed to the desired result.[368]

362 *In re* Taines, 111 Misc. 2d 559, 565, 444 N.Y.S.2d 540, 544 (Sup. Ct. 1981); *Topper*, 107 Misc. 2d at 33, 433 N.Y.S.2d at 365.

363 *Meiselman*, 309 N.C. at 298, 307 S.E.2d at 563.

364 *Id.*

365 *See Topper*, 107 Misc. 2d at 33-34, 433 N.Y.S.2d at 365; O'Neal, *supra* note 80, at 886.

366 *Topper*, 107 Misc. 2d at 33, 433 N.Y.S.2d at 365.

367 F. O'NEAL, *supra* note 60, § 7.15. All the reported "reasonable expectations" cases involve closely held corporations.

368 *See* notes 354, 356 *supra*.

Moreover, the reasonable expectations analysis may promote use of shareholder agreements reflecting the true "bargain" among the parties. A prospective majority shareholder, for example, may prefer a detailed statement of the parties' understanding and objectives, prepared at the outset, to the expectations a court might later reconstruct.

The most unique feature of the reasonable expectations analysis is the lack of a bad faith requirement. At most, the plaintiff is required to show that he or she was not at fault, not that the defendant acted in bad faith.[369] An objective inquiry determines whether the shareholder's expectations were reasonable and were frustrated.[370] Channeling the inquiry away from assessing fault or detecting oppressive intent simplifies the court's task. Shifting the focus from a fault standard also has practical implications. Examining the facts of cases such as *Gay*, *Miller*, and *Zidell* indicates that detecting fault in this context often proves frustrating and fruitless.

The absence of any bad faith or fault requirement suggests that the reasonable expectations analysis should prevail over the business judgment rule. If a shareholder's reasonable expectations have been frustrated, the shareholder has lost the benefit of the original bargain.[371] If the decision to join the enterprise forms part of the original bargain, the situation resembles that arising from a change in corporate structure, such as a merger, a consolidation or a sale of substantially all the corporate assets.[372] In the latter situations, dissatisfied shareholders typically may liquidate their investment under an appraisal statute. The dissenting shareholder's statutory right to a "cash out" originates from the altered nature of the enterprise.[373] The right does not arise from the business judgment rule. Similarly, the business judgment rule should not affect a court-ordered dissolution or buy-out[374] based on a finding that a shareholder's reasonable expectations have been frustrated.

The courts in *Topper*, *Exadaktilos*, and *Meiselman* all used an involuntary dissolution statute to reach the reasonable expectations

369 *Exadaktilos*, 167 N.J. Super. at 155-56, 400 A.2d at 561-62; *Meiselman*, 309 N.C. at 301, 307 S.E.2d at 564.

370 *Meiselman*, 309 N.C. at 301, 307 S.E.2d at 564. *See* F. O'NEAL, *supra* note 60, § 7.15.

371 The analogy to an implied contract is a favorite one of the courts in this area. *See* note 350 *supra*.

372 Such would not necessarily be the case, however, in situations where the plaintiff did not voluntarily join the enterprise.

373 M. EISENBERG, THE STRUCTURE OF THE CORPORATION 77-79 (1976). *See* H. HENN & J. ALEXANDER, *supra* note 1, at 997-1010.

374 Under the North Carolina statute, the court is empowered to order a buy-out as an alternative to dissolution. N.C. GEN. STAT. § 55-125.1(a)(4) (1982). *See* note 377 *infra*. Under the New York statute, other shareholders or the corporation itself may elect to purchase the petitioners' shares at fair value, as an alternative to dissolution. N.Y. BUS. CORP. LAW § 1118(a)(b) (McKinney Supp. 1984).

standard. In *Topper* and *Exadaktilos*, the courts linked the statute and the standard through the term "oppressive," as used in the New York[375] and New Jersey[376] statutes. In *Meiselman*, a construction of the phrase "reasonably necessary for the protection of the rights and interests of the complaining shareholders"[377] provided the link.

No court has yet adopted the reasonable expectations test without the assistance of a statute. The test, however, does not require such a restriction. In addition, the involuntary dissolution statutes in virtually every state allow a court to order dissolution or other relief in its discretion. The connection between the language of the New York and North Carolina statutes and the concept of reasonable expectations is not unique. Furthermore, even without a statute, a disgruntled shareholder may petition for relief other

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375 The relevant portion of the New York statute provides:

> (a) The holders of twenty percent or more of all outstanding shares of a corporation, other than a corporation registered as an investment company under an act of congress entitled "Investment Company Act of 1940," no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or an affiliated securities association, who are entitled to vote in an election of directors may present a petition of dissolution on one or more of the following grounds: (1) The directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders . . . .

N.Y. BUS. CORP. LAW § 1104-a (McKinney Supp. 1984).

376 The relevant portion of the New Jersey statute provides:

> 1. The Superior Court, in an action brought under this section, may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock as provided below, or enter a judgment dissolving the corporation, upon proof that
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> . . . .
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> (c) In the case of a corporation having 25 or less shareholders, the directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees.

N.J. REV. STAT. § 14A:12-7(1)(c) (Supp. 1984).

377 The relevant portions of the North Carolina statute provide:

> The superior court shall have power to liquidate the assets and business of a corporation in an action by a shareholder when it is established that:
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> . . . .
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> (4) Liquidation is reasonably necessary for the protection of rights or interests of the complaining shareholder.

N.C. GEN. STAT. § 55-125(a)(4) (1982).

> In any action filed by a shareholder to dissolve the corporation under G.S. 55-125(a), the court may make such order or grant such relief, other than dissolution, as in its discretion it deems appropriate, including, without limitation, an order:
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> . . . .
>
> (4) Providing for the purchase at their fair value of shares of any shareholder, either by the corporation or by other shareholders, such fair value to be determined in accordance with such procedures as the court may provide.

N.C. GEN. STAT. § 55-125.1(a)(4) (1982).

than dissolution.[378]

The reasonable expectations approach could not completely replace the business judgment rule. Traditional corporate governance principles operate until a shareholder petitions for some form of relief, such as a buy-out or an involuntary dissolution. Such a petition would then trigger the reasonable expectations analysis. The reasonable expectations analysis thus would essentially function as a check on managerial discretion. The analysis focuses on the effect of management decisions, rather than on the mechanics of the decision-making process. This analysis would temper the application of the business judgment rule in the close corporation.

The reasonable expectations analysis offers a flexible approach to the widely varying fact patterns in this area. Each case presents a different set of shareholder expectations.[379] Such a flexible approach makes predicting the outcome of litigation impracticable. This uncertainty is the greatest drawback to the analysis. If the focus is the minority shareholder's plight, however, and not the effect upon corporate governance, then uncertainty may be advantageous.

6. Fixed-Term Charters

Perhaps the strongest argument for continued use of the business judgment rule in the close corporation is the lack of any clearly preferable alternative. Protection of minority shareholders through greater use of shareholders' agreements is unrealistic.[380] Statutory relief on any broad scale is unlikely. The substitution of ambiguous and comprehensive principles such as the majority's duty to the minority[381] or the duty of partners to one another[382] offers little improvement over the use of the business judgment rule.

Introducing an intrinsic fairness test would create definitional and evidentiary issues.[383] How is "fairness" defined and in what context should "fairness" be assessed? The less harmful means ap-

378 The general availability of involuntary dissolution statutes has retarded the development of a substantial amount of case law on the subject, particularly in recent years. A modest body of case law supports, on equitable principles, an aggrieved shareholder's right to dissolution in appropriate circumstances. Miner v. Belle Isle Ice Co., 93 Mich. 97, 53 N.W. 218 (1892), is probably the most frequently cited authority for the principle that courts of equity have inherent power to order dissolution. *See also* Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 274 (Alaska 1980); Hetherington & Dooley, *supra* note 11, at 7-8; Note, *supra* note 86, at 1125-26. This inherent equitable power also enables the court to order relief less drastic than dissolution when appropriate. Masinter v. WEBCO Co., 262 S.E.2d 433, 439 (W. Va. 1980).

379 *See* notes 364-65 *supra* and accompanying text.

380 *See* notes 277, 283 *supra* and accompanying text.

381 *See* notes 309-12 *supra* and accompanying text.

382 *See* notes 318-23 *supra* and accompanying text.

383 *See* notes 296-305 *supra* and accompanying text.

proach deftly shifts the burden of proof back and forth among litigants. Questions remain, however, about the guidelines for the court's balancing of the interests of the shareholder and the corporation.[384] The balance requires a tradeoff between economic benefit to the corporation and protection of minority interests.

The reasonable expectations analysis offers limited relief in specific situations. It would not alter the basic governance structure of the closely held corporation, but would present challenging, if not severe, evidentiary problems.[385] Yet one other alternative to the business judgment rule remains: the fixed-term charter. The charter would bypass the courts and the legislature and would require relatively little effort to effectuate, even in the preparation of the incorporation papers.

The strongest argument against the continued use of the business judgment rule is that it facilitates oppression of minority interests.[386] A great potential for oppression exists in the close corporation because of the illiquidity of the minority interest.[387] The majority thus has no incentive to bargain with the minority after the original investment.[388] The standard practice of endowing a corporation with perpetual existence[389] makes an accounting in the future or any other outlet for the minority interest unlikely.

Statutes, however, do not require perpetual life for a corporation. Strictly speaking, perpetual existence is an option which is invariably chosen. Giving the corporation a fixed-life would provide a minority interest with bargaining power, particularly a minority with a substantial investment. A fixed-life provision in effect would force the majority to periodically "campaign" in an election where every vote is significant.

This periodic "election" would create an incentive to bargain with the minority. A single shareholder could refuse to agree to renew the corporate status when the term expired and thus could force a dissolution. This possibility would encourage the majority shareholders to compromise—and perhaps to select fellow shareholders more carefully at the outset. Thus, the use of limited-life charters could eliminate some of the problems illiquidity causes for shareholders in the closely held corporation.

The fixed-term charter could result in dissolution and immediate reincorporation. But this action would pose a less serious

384 *See* notes 336-42 *supra* and accompanying text.
385 *See* notes 365-66 *supra* and accompanying text.
386 *See* notes 202-18 *supra* and accompanying text.
387 *See* notes 252-54 *supra* and accompanying text.
388 *See* note 253 *supra* and accompanying text.
389 *See, e.g.*, W. CARY & M. EISENBERG, *supra* note 1, at 21-22; R. HAMILTON, *supra* note 1, at 18; H. HENN & J. ALEXANDER, *supra* note 1, at 132.

threat to a minority shareholder than a potential freeze-out. Dissolution followed by reincorporation would at least allow a newly excluded shareholder to litigate the fair value of the interest, without the confusion of a debate about the existence of a legitimate business purpose. Furthermore, electing a limited-life charter would be consistent with the view expressed by a number of commentators that a legal judgment is never as efficient as an economic remedy.[390] The courts would become involved only if the parties disagreed over fair value.[391]

Commentators have proposed and criticized the use of limited-life charters. Professor Hetherington, for example, argued that a limited-life charter would not prevent short-term exploitation of the minority interest.[392] The risk of exploitation obviously increases with the length of the term. Thus, prospective minority shareholders should actively negotiate at the pre-incorporation stage for a relatively short term. If the majority interest desires a longer initial period, then the minority should demand concessions to minimize the increased risk.

Furthermore, existing legislation provides a right to petition for involuntary dissolution at any time.[393] Such legislation offers a remedy for shareholders "oppressed" in mid-term. Thus, limited-life charters would simply complement the current principal means of protection—shareholders' agreements and involuntary dissolution statutes.[394]

IV. Conclusion

In many ways, the close corporation is a hybrid of a publicly held corporation and a partnership. But neither corporate nor partnership law provides a completely acceptable alternative to the business judgment rule as applied to close corporations. Traditional corporate law principles, usually designed for publicly held corporations, inadequately address the issues that arise in close corporations. And the inherent differences between a partnership and a close corporation should be recognized when a managerial liability is assessed in a shareholder derivative suit.

This article has discussed several alternatives to applying the

390 *See, e.g.*, Fischel, *supra* note 11, at 937-38; Hetherington & Dooley, *supra* note 11, at 39.

391 Most dissolutions ordered by courts actually result in buyouts. Hetherington & Dooley, *supra* note 11, at 30-31, 33.

392 *Id.* at 45.

393 *See* notes 255-60 *supra* and accompanying text.

394 Perhaps the most basic problem with limited-life charters is a practical one. Who, in the incorporation process, will propose such an arrangement? It seems unrealistic to believe that minority investors are typically represented by their own attorneys. Perhaps the attorney who prepares the incorporation papers should recommend this arrangement.

business judgment rule to close corporations. These alternatives include statutory "no fault" withdrawal, shareholders' agreements, the "intrinsic fairness" inquiry, and the majority duty to the minority. Other suggested alternatives are the analogy to a partnership, the "less harmful means" analysis, the "reasonable expectations" approach, and the fixed-term charter. Although none is a wholly satisfactory substitute, the reasonable expectations analysis provides the flexibility necessary to address the special problems of the close corporation. The analysis acknowledges the importance of personal relationships in close corporations and provides a suitable framework in which to determine managerial liability. Although evidentiary problems may arise, the reasonable expectations test avoids the difficult task of proving bad faith. Among the present alternatives to the business judgment rule, the reasonable expectations analysis offers the most protection for minority shareholders in close corporations.