Oklahoma Law Review

Volume 49 | Number 1

1-1-1996

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David C. Crago

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David C. Crago, *Fiduciary Duties and Reasonable Expectations: Cash-Out Mergers in Close Corporations*, 49 OKLA. L. REV. 1 (1996),
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FIDUCIARY DUTIES AND REASONABLE EXPECTATIONS: CASH-OUT MERGERS IN CLOSE CORPORATIONS

DAVID C. CRAGO*

For at least the past seventy years, courts and commentators have recognized that closely held corporations did not fit easily into general corporation statutes designed for more widely held firms. The resulting statutory and common law "trend toward . . . treatment of the close corporation as *sui generis*"[1] has been both applauded and well chronicled. The development of a recognized body of close corporation law has been driven primarily by the desire to protect minority shareholders from "oppression."[2] These goals have manifested themselves in a variety of legislative enactments and judicial opinions recognizing the validity of shareholder agreements, voting arrangements, management structures, and minority rights to exit the corporation.

Elimination of minority shareholders from close corporations[3] by majority action, however, has taken a different path. By focusing on supposed expectations and heightened fiduciary duties, the courts have sought to "protect" minority shareholders from freeze-outs. Although early decisions consistently held that shareholders in close corporations "cannot be partners *inter sese* and a corporation as to the rest of the world,"[4] most modern courts and commentators have concluded that in "important operational aspects, the close corporation is the functional equivalent of the partnership."[5] This conclusion has led to the nearly

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* Associate Professor of Law, Ohio Northern University. A.B., 1974, Duke University; J.D., 1977, University of Michigan. I want to acknowledge my research assistants for 1995-1996, Kristine Hanratty and Susan Wetzel, for their diligent help in preparing this article.

1. Galler v. Galler, 203 N.E.2d 577, 584 (Ill. 1964).

2. One authority on close corporations has claimed that "[u]nfair treatment of . . . minority interests in . . . closely held corporations by persons in control . . . is so widespread that it is a national business scandal." F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1986-1987) [hereinafter O'Neal, *Oppression*]. In the words of other observers, "The question is not simply one of good or bad conduct; it is question of how much exploitation will occur." J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 35 (1977).

3. Recently some scholars have observed that a simple dichotomy between close and public corporations distorts reality. Rather, they describe a "continuum" of jointly owned firms. *See* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992). These observations have obvious validity, but do not impact the analysis here. For the definition of close corporation adopted for purposes of this article, *see infra* notes 12-21 and accompanying text.

4. Jackson v. Hooper, 75 A. 568, 571 (N.J. 1910).

5. Hetherington & Dooley, *supra* note 2, at 2; *see also* Carlos D. Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948) ("The objective of the participants in a close corporation is to equate the scheme of governance of their enterprise to that of a partnership."). The analogy to

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universally accepted notion that shareholders in close corporations owe fiduciary duties[6] to each other similar to the duties partners owe other partners.[7] With little analysis of partnership standards and eerie echoes of the "vested rights" language,[8] those duties have frequently been found to limit the ability of majority shareholders to convert the minority's equity position to cash. In short, while current law increasingly gives minority stockholders the right to cash in their investment and exit the enterprise,[9] the development of special fiduciary duties for the majority gives the same minority shareholders the right to stay. The effect has been to give the minority the ability to compel "a continuation of the association by legal constraint — what was once called 'togetherness by injunction' — a prospect which scarcely seems a desirable policy goal."[10] The reasoning that leads to a recognition of the necessity of a minority right of exit, however, dictates acceptance of the majority's right to buy out the minority without regard to the majority's purpose or motivation.[11]

I. Attributes of Close Corporations

Traditional corporate law notions are oriented toward a presumption that shareholders served a separate and independent function from corporate officers

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partnerships also forms the predicate for Professor Eisenberg's study of corporate decision making. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 9-17 (1976). This conclusion, however, is not without contemporary dissent. Judge Easterbrook, writing for the court in *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 384 (7th Cir. 1990) asserted: "Corporations are *not* partnerships. . . . Commercial rules should be predictable; this objective is best served by treating corporations as what they are . . . ."

6. J.A.C. Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 28-29; Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630, 1636-37 (1961).

7. *See, e.g.*, Wilkes v. Springside Nursing Home, 353 N.E.2d 657 (Mass. 1976); Fought v. Morris, 543 So. 2d 167 (Miss 1989). In many respects, however, this analysis has become circular. For example, Justice Traynor in considering the potential freeze-out of an at-will partner asserted that a partner's "fiduciary duties are at least as great as those of a shareholder of a corporation." Page v. Page, 359 P.2d 41, 44 (Cal. 1961).

8. *Compare* Lewis v. Clark, 911 F.2d 1558, 1560 (11th Cir. 1990) ("If minority stockholders . . . want stock in the merged corporation, they are entitled to even treatment with all other holders of the like stock.") *with* Outwater v Public Serv. Corp., 143 A. 729, 731-32 (N.J. Ch. 1928) ("Continued membership, until dissolution, is an inherent property right in corporate existence . . . [o]therwise, a merger would be a simple medium for a compulsory sale, and that is not permissible.").

9. *See, e.g.*, REV. MODEL BUS. CODE ANN., CLOSE CORP. SUPP. § 43; CAL. CORP. CODE § 1800(b)(5) (West 1990).

10. Hetherington, *supra* note 6, at 29.

11. Both the analogy to partnerships and the right to dissolution on demand have been criticized. Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25, 87 n.289 (1987). Acceptance of the criticism, however, would not diminish the merits of allowing the majority to exercise its statutory right to a cash-out merger. The notion that the participants made a reasoned choice to incorporate and not to include a dissolution right in their charter may limit the application of the partnership analogy. The argument, however, validates the use of corporate statutory transactions from which the participants chose not to opt out.

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and directors.[12] The function of the former is to provide capital while the function of the latter is primarily management of the corporation.[13] This dual system does not accurately reflect the typical close corporation in which there is generally an intimate group of participants who contribute to both the financial investment in the corporation and the management of the corporation.[14] Generally, the shareholders "expect employment and a meaningful role in management, as well as a return on the money paid for the shares. Further, their expectations are often complicated by family or other personal relationships within the corporation."[15] Essential to the success of the enterprise is the "ability [of the shareholders] to sustain a close, harmonious relationship over time."[16]

Fifty years ago, Professor Israels lamented that "no satisfactory all-purpose definition of a close corporation appears ever to have been worked out."[17] In the time following, a consensus of the characteristics, if not a definition, of what constitutes a close corporation has developed. In a widely cited opinion, the Massachusetts Court of Appeals defined a close corporation as one "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."[18] The leading text in the area of close corporations limits its definition of the close corporation to those corporations whose "shares are not generally traded in the securities markets."[19] The Supreme Court of Ohio also has defined a close corporation as a "corporation with a few shareholders and whose corporate shares are not generally traded on a securities market."[20] In short, close working relationships between owners who are actively involved in the enterprise coupled with the lack of a ready market and the corresponding illiquidity of the shareholders' investment are fundamental characteristics which distinguish close corporations from public corporations.[21]

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12. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7.02 (2d ed. 1985).

13. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 260-61 (1967).

14. *Id.* at 278-79; Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 702-03 (1993) [hereinafter Thompson, *Shareholder's Cause*]; Symposium, 52 NW. U. L. REV., 345, 346 (1957).

15. Thompson, *Shareholder's Cause*, *supra* note 14, at 702.

16. Hetherington & Dooley, *supra* note 2, at 2.

17. Israels, *supra* note 5, at 491. Although concluding that "[t]he closely held . . . corporation 'problem' will not be resolved partnerships," one recent commentator was "forced to conclude, after studying virtually any legislative or judicial formulation adopted to define a closely held corporation, that we are attempting to define a business organization which has already been well defined — that of a partnership." David E. Roseberry, *Traditional Corporate Concepts in Light of Demands for Elastic Norms for the Family or Closely Held Corporations*, 5 J. CORP. L. 455, 478-79 (1980).

18. Donahue v. Rodd Electrotype Co., 328 N.W.2d 505, 511 (Mass. 1975).

19. O'NEAL & THOMPSON, *supra* note 12, § 1.01.

20. Crosby v. Beam, 548 N.E.2d 217, 220 (Ohio 1989).

21. Hetherington & Dooley, *supra* note 2, at 2-6; Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 215-16 (1988) [hereinafter Thompson, *Corporate Dissolution*]; Henry F. Johnson, *Strict Fiduciary Duty in Close Corporations: A Concept in*

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II. Cash-Out Mergers

A cash-out merger[22] is a merger which forces the minority shareholders to relinquish their equity in the corporation in exchange for cash or debt securities while allowing the majority shareholder to retain his equity.[23] Such transactions, by definition, "are coercive: Minority stockholders are bound by majority rule to accept cash or debt in exchange for their common shares . . . . But this alone does not render freeze outs objectionable."[24] The objection to cash-outs in closely held corporations lies deeper in the mists of corporate history.

At common law, unanimous shareholder approval was required to approve any merger.[25] As a result, cash-out mergers were not only impossible, but a single shareholder could block a transaction desired by the vast majority of stockholders.[26] In order to allow corporations to act in ways beneficial to the majority, the merger statutes were amended and appraisal rights granted to dissenting shareholders.[27] In the context of closely held corporations, however, use of statutorily granted merger powers to cash out the minority interest continued to be described as "devastating" or as a method to "victimize minority interests."[28]

As a result, "[e]ven if the flexibility accorded to majority shareholders to run larger corporations permits them to change the enterprise and cash out minority shareholders, that flexibility has not been extended to close corporations . . . ."[29] Indeed, despite the seemingly obvious conclusion that in the face of deadlock or dissention, there is "reason to facilitate or encourage the departure of one group or the other from the enterprise,"[30] several "[c]ourts have held that merger transactions that are formally authorized by the [applicable statutory] procedures . . .

Search of Adoption, 18 CAL. W. L. REV. 1, 1-2 (1982); *see also* Galler v. Galler, 203 N.E.2d 577, 583-84 (Ill. 1964).

22. This article uses the term "cash-out merger" to describe these transactions. Most often these transactions are referred to pejoratively as "freeze-outs" or "squeeze-outs." The implication from these terms is highly negative and reflects the notion that minority shareholders are somehow mistreated in these transactions. As the following discussion demonstrates, however, use of statutorily provided mechanisms to provide liquidity for minority shareholders' investments have come to be the preferred means of addressing dissension within closely held corporations. Within this context, mergers designed to eliminate the minority interest at a fair price are not oppressive.

23. Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 24 n.2 (N.Y. 1984).

24. Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978).

25. Voeller v. Neilston Warehouse Co., 311 U.S. 531, 535 n.6 (1941); William J. Carney, *Fundamental Corporate Changes, Minority Shareholders and Business Purposes*, 1980 AM. B. FOUND RES. J. 69, 78-79.

26. Elliot J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 626-31 (1981).

27. Armstrong v. Marathon Oil Co., 513 N.E.2d 776, 782 (Ohio 1987).

28. F. HODGE O'NEAL & JORDAN DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATIONS 69, 71 (1961).

29. Thompson, *Shareholder's Cause*, *supra* note 14, at 744; *see, e.g.*, Lewis v. Clark, 911 F.2d 1558, 1560 (11th Cir. 1990).

30. Brudney & Chirelstein, *supra* note 24, at 1356 n.9.

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constitute a breach of [fiduciary] duty to minority shareholders where the effect of the transaction is to eliminate them from further equity participation in the enterprise."[31]

In publicly traded companies, this type of merger has generally come to be known as a "going private" transaction.[32] Both the volume and magnitude of these transactions have focused the business and legal communities' attention on the implications for the minority shareholders in these corporations.[33] With some hesitations,[34] the courts and legislatures have abandoned the common law notion of a shareholder's "vested right" to be an owner of a particular corporation and replaced it with an understanding of the shareholder's position as being simply an economic one.[35] Thus, the debate over cash-out mergers in public corporations has centered generally on fairness issues surrounding disclosure and its effect on valuation and price.[36]

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31. 3 MODEL BUS. CORP. ACT ANN. § 11.01 cmt. 1 (1994). Presumably the majority (if it is a large enough majority) does retain the ability to voluntarily dissolve the corporation, although the *Donahue/Wilkes* standard discussed *infra* notes 57-65, may bring that into question. *See* Thompson, *Corporate Dissolution*, *supra* note 21, at 200 n.30. Dissolution, however, is rarely in any shareholder's best interest; valuation as a going concern is almost always higher than liquidation value. Moreover, corporate statutes are generally construed to give the majority the power to engage in cash-out mergers subject to the minority's appraisal rights. Therefore, proponents of preventing minority oppression must have some rationale, other than the availability of voluntary dissolution, for limiting cash-out mergers. As will be seen *infra*, the justifications for protecting minority shareholders also support majority use of cash-out mergers in closely held corporations.

32. Brudney & Chirelstein, *supra* note 24, at 1365.

33. *See, e.g.*, Brudney & Chirelstein, *supra* note 24, at 1355-56; Kent T. van den Berg, Note, *Approval of Take-out Mergers by Minority Shareholders: From Substantive to Procedural Fairness*, 93 YALE L.J. 1113 (1984).

34. *See, e.g.*, Coyne v. Park & Tilford Distillers Corp., 154 A.2d 893 (Del. 1959); Note, *Elimination of Minority Share Interest by Merger: A Dissent*, 54 NW. U. L. REV. 629, 635 (1959) (The "more flagrant injury inflicted . . . is the forced extinguishment of the share interest itself. As the shareholder is the owner of a unit of interest in the corporation, he possesses the right of ownership . . . .").

35. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); *see* Coleman v. Taub, 638 F.2d 628, 634 (3d Cir. 1981) (referring to the doctrine as "the discredited notion that shareholders have a vested right in corporate participation"). Weiss, *supra* note 26, at 626-53, traces these developments chronologically.

36. Even though the Delaware test of "entire fairness" for determining the propriety of these transactions is becoming more widely accepted, *see infra* note 125 and accompanying text, the courts have failed to clearly define the term "entire fairness." The concept of "entire fairness" encompasses two aspects. The substantive sense of entire fairness is fair price and the procedural aspect is fair dealing. According to the court in *Weinberger*, the analysis of fair dealing and fair price are not separate tests, but must be analyzed as a whole. *Weinberger* clearly states that appraisal is not necessarily a minority shareholder's sole remedy in Delaware. 457 A.2d at 713. In *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099, 1106 (Del. 1985), the court held that an unfair dealing claim, which is based upon breaches by the majority shareholder of the duties of loyally and care, raise issues which an appraisal remedy simply cannot address. Therefore, the Delaware Supreme Court held that if a minority shareholder makes specific allegations of "procedural unfairness" and "unfair dealing" in a freeze-out merger, these challenging the "entire fairness" of the merger. *Id.* at 1104-05. According to *Weinberger*, fair dealing is meant to be characterize the fiduciary duty owed by the majority shareholders to the minority shareholders. Note, *supra* note 33, at 1115.

"Fair dealing" also embraces the duty of the majority shareholder to use complete candor throughout the transaction. Persinger v. Carmazzi, Sales One, Inc., 441 S.E.2d 646, 652 (W. Va. 1994). The burden

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III. Cash-Out Mergers in Closely Held Corporations

At the same time the law has been providing increased flexibility to the elimination of minority equity interests in public corporations, the law has been imposing ever more rigid rules regarding close corporations. Having seized the analogy to partnerships, the courts have discovered onerous fiduciary duties that frequently prevent cash-out mergers. Not only is the analogy based on a seriously flawed understanding of partnership law but also these decisions have radically altered the nature of the relationship between shareholders in close corporations.[37] All of this has occurred contemporaneously with the adoption of corporate codes designed to allow the members of close corporations wide latitude in structuring these relationships.[38]

These limitations on majority rule have resulted from judicial concern for the perceived plight of minority shareholders. The existence of a relatively small number of shareholders restricts the transfer or alienation of shares and produces an unavailability of a ready market in which to offer their stock for sale.[39] The lack of a ready means of withdrawal from the business by disenchanted shareholders has been thought to make "the problem of exploitation . . . uniquely related to illiquidity."[40] Because he cannot use a market to exit the enterprise and recover his capital, the minority is vulnerable to a variety of devices that allow the majority to benefit from the minority's investment without compensating him

rests upon the majority shareholder to show that minority shareholder's decision whether to accept the merger consideration or to opt for a appraisal. Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 846 (Del. 1987).

37. Hetherington, *supra* note 6, at 22-23; Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 428-29 (1990).

38. 2 JAMES D. COX ET AL., CORPORATIONS § 14.16 (1995).

39. This concern for the illiquidity of the minority's investment lies at the root of much of the commentary and proposed reform. *See* Hetherington, *supra* note 6, at 21-23. Shareholders in closed corporations, unlike investors in publicly traded corporations, become participants in a particular enterprise, not mere investors seeking the highest return on their investment. *See* REV. MODEL BUS. CORP. ACT, CLOSE CORP. SUPP. § 11 official cmt. (1993). This participation in management involves working relationships with other shareholders which parallel the relationships found in partnerships. Because of the nature of this participation, the transfer of the minority's interest is extremely difficult. Addressing this concern, however, by limiting the majority's ability to remover the minority, even at a fair price, is neither wise nor justifiable by any reference to "partnership duties."

40. *See* Hetherington & Dooley, *supra* note 2, at 6; *see also* Thompson, *Shareholder's Cause*, *supra* note 14, at 699. Not all authors are convinced. At least some commentators assert that liquidity is not the issue and that the risk in closely held businesses is no more, or less, than in public. Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 272 (1986). This argument, however, fails to give full effect to the vulnerability of the minority's positioning a close corporation. *See* Zenichi Shishido, *The Fair Value of Minority Stock in Closely Held Corporations*, 62 FORDHAM L. REV. 65, 67, 94-96 (1993).

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for it.[41] "It is this lack of a market that enables those in control to 'freeze-out' the minority."[42]

An Ohio Court of Appeals has described these "freeze-out" or "squeeze-out" devices as the "manipulative use of corporate control to eliminate minority shareholders, or to reduce their share of voting power or percentage of ownership of assets, or otherwise unfairly deprive them of advantages or opportunities to which they are entitled."[43] Professor O'Neal defined "squeeze-out" as "the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique to eliminate from the enterprise one or more of its owners or participants."[44] The vulnerability of the investment of minority shareholders to majority action caused courts to develop doctrines limiting the ability of the majority to act.

IV. Shareholder Fiduciary Duties and Expectations in Close Corporations

A. Partnership Duties and Shareholder Protection

As a general rule, majority shareholders have long been understood to owe a fiduciary duty to minority shareholders.[45] In the case of a close corporation, however, "numerous courts have 'borrowed' a rule from partnership law, and have held that majority shareholders have a heightened fiduciary duty, one of the utmost good faith and loyalty, to the minority shareholders."[46] The duty owed by a majority shareholder to a minority shareholder in a close corporation is similar to the duty owed by partners in a partnership to one another because "[a] close corporation is functionally similar to a partnership because of its relatively informal management structure and the personal relationships that exist between participants."[47]

The analogy to partnerships has been used by courts concerned about the plight of minority shareholders in closely held corporations to transform traditional corporate norms for majority rule. Relying on this analogy, courts have concluded

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41. WP v. Bikon Corp., 669 A.2d 1382, 1385-86 (N.J. 1996); Thompson, *Shareholder's Cause*, *supra* note 14, at 703. The traditional notions of majority abuse share this theme. *See* O'Neal, *Oppression*, *supra* note 2, at 125-34. Although Professor O'Neal also included cash-out mergers as one of these vehicles for oppression, *id.* at 125, he recognized that appraisal rights, at least, "supposedly mitigate" the danger to the minority, *id.* at 138. Indeed, appraisal rights operate in much the same fashion as court-supervised buy-outs in minority suits for dissolution.

42. Murdock, *supra* note 37, at 437.

43. Estate of Schroer v. Stamco Supply, Inc., 482 N.E.2d 975, 979 (Ohio Ct. App. 1984).

44. O'NEAL & THOMPSON, *supra* note 12, § 1.01.

45. Pepper v. Litton, 308 U.S. 295, 306-07 (1939); Southern Pac. Co. v. Bogert, 250 U.S. 483, 492 (1919).

46. Gigax v. Repka, 615 N.E.2d 644, 648 (Ohio Ct. App. 1992); *see also* Frank Lerner & Assoc., Inc. v. Vassy, 599 N.E.2d 734, 738 (Ohio Ct. App. 1991); Estate of Schroer v. Stamco Supply, Inc., 482 N.E.2d 975, 981 (Ohio Ct. App. 1984).

47. Gary C. Ivey, Note, *Standards of Management Conduct in Close Corporations: A Transactional Approach*, 33 STAN. L. REV. 1141, 1149 (1981).

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that these entities are merely "incorporated partnerships"[48] and purported to apply the fiduciary principles applicable to partners as a shield to protect minority shareholders. Two decisions of the Massachusetts Supreme Court have provided the point of departure for these developments.[49]

In *Donahue v. Rodd Electrotype Co.*,[50] the defendants caused the corporation to repurchase the shares of a former controlling shareholder. The defendants, however, refused to make the same offer to minority shareholders, including the plaintiff. Noting that the "close corporation bears striking resemblance to a partnership,"[51] the court described what it was as "the true plight of the minority shareholder."[52] In the court's view, "the minority stockholders may be trapped in a disadvantageous situation [because] [n]o outsider would knowingly assume [his] position."[53] As a result, the minority "cannot easily reclaim his capital."[54] The solution, as the court reasoned, was to "hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another."[55] The court described this duty as one of "utmost good faith and loyalty"[56] and concluded that it required all stockholders be given the same opportunity to sell their shares that had been given to the controlling shareholder.[57]

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48. *See, e.g.*, 68th St. Apts., Inv. v. Lauricella, 362 A.2d 78, 84-86 (N.J. Super. Ct. Law Div. 1976); COX ET AL., *supra* note 38, § 14.16; Kelvin H. Dickinson, *Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership*, 33 AM. U. L. REV. 559 (1984); *Principles of Corporate Governance: Analysis and Recommendations*, 2 A.L.I., § 7.01, cmt. e (1994). The analogy to partnerships and term "incorporated partnership," however, is not a particularly recent development. *See* Cuppy v. Ward, 176 N.Y.S. 233, 243-45 (1919) (Shearn, J., dissenting).

49. Earlier courts and commentators had drawn analogies to partnerships. *See, e.g.*, Helms v. Duckworth, 249 F.2d 482, 486-87 (D.C. Cir. 1957); Israels, *supra* note 5. However, *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975), and *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976), have come to be recognized as the leading cases, Murdock, *supra* note 37, at 436, although not without criticism, *see* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 245-47 (1991). For other earlier cases, see Larry D. Soderquist, *Reconciling Shareholders' Rights and Corporate Responsibility: Close and Small Public Corporations*, 33 VAND. L. REV. 1387, 1403 (1980).

50. 328 N.E.2d 505 (Mass. 1975).

51. *Id.* at 512.

52. *Id.* at 514.

53. *Id.* at 515.

54. *Id.* at 514.

55. *Id.* at 515. The apparent appropriateness of this application of partnership fiduciary duties to the participants in close corporations had been previously noted by many prominent commentators. *See, e.g.*, Manne, *supra* note 13, at 282 ("There is also a strong fiduciary duty owed one partner by another. These are essentially the elements desired or needed for close corporations, but none of them is a part of traditional corporation law.").

56. *Donahue*, 328 N.E.2d at 515. Remarkably, although the Uniform Partnership Act (UPA) was enacted in Massachusetts in 1922 (*see* MASS. ANN. LAWS ch. 108A, § 1 (Law. Co-op. 1995)), the court never cited or discussed its provisions in reaching its conclusion. The new Revised Uniform Partnership Act (RUPA) § 404(a) and (d) is consistent with the court's formulation. The RUPA, however, clearly allows freeze-outs by termination of the partnership.

57. *Donahue*, 328 N.E.2d at 518.

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The *Donahue* standard was modified a year later in *Wilkes v. Springside Nursing Home, Inc.*[58] In *Wilkes*, the majority removed the plaintiff as an officer and director, and the plaintiff claimed that this conduct breached their fiduciary duty to him.[59] The court asserted that *Donahue* and *Wilkes* involved "freeze-outs"[60] of minority shareholders and that "the distinction between the majority action in *Donahue* and the majority action in this case is more one of form than of substance."[61] The court then went on to note that, because "the majority, concededly, have certain rights,"[62] the court must determine "whether the controlling group can demonstrate a legitimate business purpose for its action."[63] If there was such a purpose, the court would determine "the practicability of a less harmful alternative"[64] to the minority's interest.

The *Donahue/Wilkes* formulation[65] of duty in close corporations has come to be widely accepted.[66] For example, in a context similar to *Donahue*, the Ohio Supreme Court[67] recently held that "controlling shareholders . . . breach their

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58. 353 N.E.2d 657 (Mass. 1976).

59. *Id.* at 661-62.

60. *Id.* at 662.

61. *Id.* at 663.

62. *Id.*

63. *Id.* Some earlier writers had described the absence of a business purpose as a prerequisite of a freeze-out: "The term has come to imply a *purpose* to force a liquidation or sale of the stockholder's shares, not incident to some other wholesome business goal." James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1192-93 (1964).

64. *Wilkes*, 353 N.E.2d at 663; *see also* Zimmerman v. Bogoff, 524 N.E.2d 849, 853 (Mass. 1988).

65. The approach taken in these cases was anticipated and advocated in a student note several years earlier. *See* Note, *supra* note 6, at 1645-47. *Donahue* and *Wilkes*, however, are generally viewed as the source of this enhanced fiduciary duty standard.

66. As one commentator has noted, "Differences as to the scope and meaning of the fiduciary duties under a *Donahue* standard do not detract from its widespread acceptance." Thompson, *Shareholder's Cause*, *supra* note 14, at 729; *see also* Wulf v. Mackey, 899 P.2d 755, 757 (Or. Ct. App. 1995) (quoting Noakes v. Schoenborn, 841 P.2d 682, 687 (Or. Ct. App. 1992)) ("When the majority shareholders of a closely held corporation use their control over the corporation to their own advantage and exclude the minority from the benefits of participating in the corporation, absent a legitimate business purpose, the actions constitute a breach of their fiduciary duties . . . ."); Masinter v. Webco Co., 262 S.E.2d 433, 440-41 (W. Va. 1980) ("[T]he particular type of oppressive conduct . . . is the attempt to 'freeze or squeeze out' a minority shareholder by depriving him, without any legitimate business purpose, of any benefit from his ownership . . . ."); Russell v. First York Savings Co., 352 N.W.2d 871, 874 (Neb. 1984) *overruled on other grounds*, 364 N.W.2d 14 (Neb. 1985) ("Shareholders in a close corporation owe one another the same fiduciary duty as that owed by one partner to another in a partnership."); Schwartz v. Marien, 335 N.E.2d 334, 338 (N.Y. 1975) ("[N]ot only must it be shown that it was sought to achieve a bona fide independent business objective, but as well that such objective could not have been accomplished substantially as effectively by other means . . . .").

67. Crosby v. Beam, 548 N.E.2d 217 (Ohio 1989). One consequence of those direct duties to minority shareholders is to eliminate the need to bring these claims derivatively. In *Crosby*, the majority shareholders argued that minority shareholders could only bring a derivative cation and that the named plaintiffs had no standing to do so based on the factual circumstances of the case. At the trial level, the action was dismissed and the court rejected plaintiffs' argument that as to the allegation of breach of fiduciary duty, plaintiffs should have a direct action against the controlling shareholders. On appeal the supreme court held that "claims of a breach of fiduciary duty alleged by minority shareholders against

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heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit."[68] The articulated rationale for this holding was acceptance of the "striking resemblance"[69] of close corporations to partnerships and the supposed inability of the minority shareholder to escape from his "disadvantageous situation."[70]

The effect of this heightened fiduciary duty has been to act as a brake on majority action. This has been particularly appropriate where the actions have taken advantage of the unmarketable nature of a minority interest in the enterprise.[71] By the time the majority has embarked upon this type of conduct, however, relations between the participants have broken down severely. As a result, the minority often prefer to withdraw their investment rather than compel payment of dividends or return to work in a hostile environment.[72]

> Recognition of this essential character of the relationship should be the beginning point of close corporation cases. This view immediately suggests the difficulty, if not impossibility, of regulating or measuring the conduct of associates toward each other by objective criteria and the inherent unfairness of denying relief to those who are dissatisfied with the relationship in the absence of 'unlawful' conduct. Personal relations may become so unsatisfactory that no amount of commercial success is adequate recompense. Only the participants can judge when continuation of an association becomes intolerable.[73]

The application of partnership fiduciary duties to close corporations has allowed courts to require the majority to buy out the minority interest — provide the

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shareholders who control a majority of shares in a close corporation, and use their control to deprive minority shareholders of the benefits of their investment, may be brought as individual or direct actions." *Crosby*, 548 N.E.2d at 221. The court reasoned that limiting recovery to a derivative remedy in the case of a freeze-out type of situation would not be an effective remedy because it would allow the wrongdoers to benefit from their wrongs. *Id.*; *see also* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, 2 A.L.I. § 7.01(d) (1994).

68. *Crosby*, 548 N.E.2d at 221; *see also* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) ("Majority shareholders may not use their power to control corporate activities to benefit themselves alone . . . . Any use to which they put . . . their power to control the corporation must benefit all shareholders proportionately.").

69. *Crosby*, 548 N.E.2d at 220.

70. *Id.*

71. The development of Donahue/Wilkes fiduciary duty standard has significantly changed the minority's vulnerability to exploitation by loss of use or income from its investments which troubled Hetherington & Dooley, *supra* note 2, at 43. *See* Murdock, *supra* note 37, at 484-85.

72. Murdock, *supra* note 37, at 427. The breakdown in the participants' relationship has many causes. Although description of the problem as "oppression of minority shareholders" tends to focus attention on the "greed and desire of majority shareholders for absolute power," even the foremost advocate of minority rights recognizes that this deterioration can also be caused by minority behavior. O'Neal, *Oppression*, *supra* note 2, at 122-23.

73. Hetherington, *supra* note 6, at 29.

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missing liquidity — at a court-determined fair price. In *Orchard v. Corvelli*,[74] the plaintiff had been a minority shareholder in a group of McDonald's restaurant franchises. Through a series of transactions the defendant majority shareholder was able to acquire the renewal of these franchises individually and exclude the plaintiff.[75] Beginning with the proposition that "vulnerability of minority shareholders in the closely held corporation is well recognized,"[76] the court, following Donahue,[77] concluded that "the law imposes a fiduciary duty upon the majority requiring it to act with the utmost good faith and loyalty in transacting corporate affairs . . . . [A]ny attempt to 'squeeze out' a minority shareholder must be viewed as a breach of this fiduciary duty."[78] Based upon this breach, the court ordered the majority to buy out the plaintiff's position.

B. Expectations and the Right To Exit the Enterprise

If the shareholders, either through agreement or charter provision, structure their relationship to provide for a falling out, the minority could use those provisions to exit.[79] Failure to negotiate these terms, however, leaves the minority's investment in the enterprise at risk of being retained while the shareholder receives no return. To address this dilemma, legislatures have amended their corporation codes to liberalize the grounds for dissolution at the request of the minority.[80]

The remedy of dissolution has generally been perceived as extraordinarily harsh.[81] Courts have been reluctant to impose dissolution, even with the more liberal prerequisites for its use. Instead, alternative remedies for dissolution claims based on "oppression" have developed.[82] Although the statutes provide a variety of possibilities, the preferred remedy has been a court-supervised buy-out of the minority interests.[83] "The increased use of buyouts as a remedy for deadlock or dissension is the most dramatic recent change in legislative and judicial thinking on close corporations problems."[84]

74. 590 F. Supp. 1548 (W.D. Pa. 1984), *aff'd*, 802 F.2d 448 (3d Cir. 1987).

75. *Id.* at 1551-53.

76. *Id.* at 1557.

77. *Id.* at 1559.

78. *Id.* at 1557.

79. For example, many close corporation statutes now allow for the articles of incorporation to provide for dissolution at the request of any shareholder. *See, e.g.*, DEL. CODE ANN. tit. 8, § 355 (1991); 805 ILL. COMP. STAT. ANN. 5/2A.50 (West 1993); 15 PA. CONS. STAT. ANN. § 2337 (West 1995).

80. F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 881-82 (1978) [hereinafter O'Neal, *Close Corporations*]. Today at least 37 states allow dissolution at the request of the minority on the ground of "oppression." Thompson, *Shareholder's Cause*, *supra* note 14, at 709.

81. Haynsworth, *supra* note 11, at 31.

82. Thompson, *Corporate Dissolution*, *supra* note 21, at 228-36.

83. Haynsworth, *supra* note 11, at 53; Murdock, *supra* note 37, at 470.

84. Thompson, *Corporate Dissolution*, *supra* note 21, at 231.

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These claims began as a response to "oppression" of minority shareholders.[85] Recently, however, the necessity of establishing fault on the part of the majority has been greatly diminished, if not eliminated. "[I]n protecting expectations, the courts are focusing on the impact on shareholders of acts by those in control of the corporation, rather than using the traditional approach of searching for misconduct by those in control."[86] The expectations have been described as "the most reliable guide to a just solution of a dispute among shareholders . . . in the typical close corporation."[87] Frustration of those expectations, regardless of the "fault" of the majority, has become grounds for minority exit at a judicially imposed fair price.[88]

This concept is also derived from the perceived similarity of closely held entities to partnerships[89] and concern for the liquidity of the minority's investment.[90] In a leading case[91] to adopt the reasonable expectation theory, the court confronted a statute that permitted dissolution when "'reasonably necessary for the protection of the rights or interests' of the [complaining] shareholders."[92] The court concluded that these rights include the minority shareholder's "'reasonable expectations' . . . in the corporation."[93] Although the court purported to recognize that "[o]nly expectations embodied in understandings, express or implied, among the participants should be recognized by the court,"[94] these expectations are very fluid: the determination "will include the 'reasonable expectations' created at the inception of the participants' relationship; those . . . 'expectations' as altered over time; and the . . . 'expectations' which develop as the participants engage in a course of dealing in conducting the affairs of the corporation."[95]

The New York cases serve to illustrate how the "expectations" of minority shareholders can be used to enhance the liquidity of those interests.[96] In *In re Topper*,[97] the petitioner was a shareholder in two closely held corporations. He had left a position he had held for twenty-five years and relocated from Florida

85. Murdock, *supra* note 37, at 461.

86. O'Neal, *Oppression*, *supra* note 2, at 142.

87. O'Neal, *Close Corporations*, *supra* note 80, at 886.

88. Indeed, frustration of minority expectations has become a vehicle for the minority to force the majority to sell to the minority. Muellenberg v. Bikon Corp., 669 A.2d 1382, 1389 (N.J. 1996).

89. *See* Symposium, *supra* note 14, at 386; Haynsworth, *supra* note 11, at 87 n.289 (Breach of the enhanced fiduciary duty derived from partnership analogy can also serve as the basis for these oppression claims.); Thompson, *Shareholder's Cause*, *supra* note 14, at 712.

90. Muellenberg v. Bikon Corp., 669 A.2d 1382, 1386 (N.J. 1996).

91. Meiselman v. Meiselman, 307 S.E.2d 551, 557-58 (N.C. 1983).

92. *Id.* at 561; *see* N.C. GEN. STAT. § 55-14-30 (1995).

93. *Meiselman*, 307 S.E.2d at 563.

94. *Id.*

95. *Id.* at 563.

96. The concern for liquidity of investment lies at the basis of the reasonable expectation just as much as it underpins the *Donahue/Wilkes* fiduciary duty approach. *See* Thompson, *Corporate Dissolution*, *supra* note 21, at 197-99.

97. 433 N.Y.S.2d 359 (Sup. Ct. 1980).

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to New York to become a shareholder. After a short period of employment with the corporation, the plaintiff was discharged. He then brought suit for dissolution of the corporation on grounds of "oppression." Noting that "the relationship between the stockholders in a close corporation vis-á-vis each other in practice closely approximates the relationship between partners,"[98] the court turned to a consideration of the parties "expectations" to determine whether the majority's actions had been oppressive.[99] Deciding that "oppressive conduct is distinct from illegal or fraudulent,"[100] the court held that "[w]hether the controlling shareholders discharged petitioner for cause . . . is irrelevant."[101] Instead, the court concluded "that the respondents' actions have severely damaged petitioner's reasonable expectations . . . ; consequently, they are deemed to be 'oppressive.'"[102] As a result, the court was entitled to order a buy-out of the plaintiff's interest at a price determined by the court.

This approach was endorsed by the New York Court of Appeals in *In re Kemp & Beatley, Inc.*[103] The petitioners, two shareholders, had resigned from their long-term employment with the corporation. In response, the majority shareholders modified the company's dividend policy in a manner that eliminated any dividends on the petitioners' stock.[104] Reasoning from the premise that "the majority shareholders[] [owe a] fiduciary obligation to treat all shareholders fairly and equally,"[105] the court (after reviewing the extensive commentary on the issue) concluded that "utilizing a complaining shareholder's 'reasonable expectations' as a means of identifying and measuring conduct alleged to be oppressive is appropriate."[106]

The court reached this conclusion despite the availability of shareholder agreements that could have addressed this issue[107] and the recognition that absent "such an agreement, however, ultimate decision-making power respecting corporate policy will be reposed in the holders of a majority interest in the corporation."[108] Nonetheless, apparently because the exercise of majority power could both "destroy a stockholder's vital interests and expectations"[109] and because the stockholder had no "reasonable means of withdrawing his or her

98. *Id.* at 364 (quoting Weiss v. Gordon, 301 N.Y.S.2d 839 (App. Div. 1969)).

99. *Id.* at 365.

100. *Id.*

101. *Id.* at 362. Under a *Donahue/Wilkes* analysis, however. this issue would be critical. Because the focus in the fiduciary duty claim is on the "fault" of the majority, good cause for termination would be an acceptable business purpose. Thus, the plaintiffs would lose. *See, e.g.*, Priebe v. O'Malley, 623 N.E.2d 573 (Ohio Ct. App. 1993); Reynolds v. Wingers, Inc., 621 N.E.2d 1239 (Ohio Ct. App. 1993).

102. *Topper*, 433 N.Y.S.2d at 362.

103. 473 N.E.2d 1173 (N.Y. 1984).

104. *Id.* at 1176.

105. *Id.* at 1177.

106. *Id.* at 1179.

107. *Id.* at 1178.

108. *Id.* at 1179.

109. *Id.*

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investment,"[110] the court affirmed an order granting dissolution of the corporation unless the respondents bought out the minority's interest.[111]

In sum, "legislatures and judges today recognize that the structure of the intimate, illiquid close corporation requires some modification to enable an investment in such a corporation to be less permanent."[112] The development not only of statutory means to define shareholder rights by agreement but also the widespread acceptance of statutory rights of minority shareholders to cash out their position[113] has not been accompanied, however, by a corresponding acceptance of the majority's ability to compel a sale by a minority.[114]

C. Cash-Out Mergers

The concern for the minority's inability to escape from the corporation forms the basis for the *Donahue/Wilkes* theory of duty and the developing tort of oppression.[115] Without any discussion of the applicability of the liquidity rationale underlying *Donahue* and *Wilkes*, several courts and commentators have applied a "partnership" fiduciary standard to limit the majority's ability to engage in corporate transactions which provide for the minority's investment to exit the corporation at a fair price.[116] These decisions demonstrate not only a fundamentally flawed understanding of partnership law but also a total absence of any recognition of the difference between majority conduct which retains the minority's investment and a transaction which results in payment of a fair price for that investment.[117]

Remarkably, the reluctance to allow the use of mergers to cash out minority interests in close corporations has persisted despite the development of corporate codes that allow the minority to force a buy-out[118] and recognition that, even when the majority has been guilty of a breach of duty,[119] the minority shareholder's interests "are fully protected by liquidating only his interest and

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110. *Id.*

111. Hetherington & Dooley argue that these decisions or statutes granting buy-out rights make the minority worse off than simply allowing dissolution. The position is predicated on the notion that dissolution is so extreme that the majority will pay a premium to avoid it. Hetherington & Dooley, *supra* note 2, at 22-23. Neither the authors, nor logic, justify giving the minority a premium.

112. Thompson, *Shareholder's Cause*, *supra* note 14, at 705.

113. Thompson, *Corporate Dissolution*, *supra* note 21, at 231.

114. Murdock, *supra* note 37, at 440. Recognizing that "[o]bjectively, it may be better that the parties live apart." The issue is then phrased as "may the minority shareholder retrieve the value of her investment in the corporation?" Professor Murdock is persuasive in advocating continued expansion of mandatory buy-out remedies, but he appears almost oblivious to the limits the expanded fiduciary duty puts on the majority's ability to compel a sale.

115. Haynsworth, *supra* note 11, at 36-37; Thompson, *Shareholder's Cause*, *supra* note 14, at 739.

116. Johnson, *supra* note 21, at 21-25.

117. Gabhart v. Gabhart, 370 N.E.2d 345, 353 (Ind. 1977).

118. Murdock, *supra* note 37, at 433-36; *see, e.g.*, CAL. CORP. CODE § 2000 (West 1990); N.Y. BUS. CORP. LAW § 1118 (McKinney 1986).

119. The use of the reasonable expectations standard has allowed courts to mandate buy-outs even when the complaining minority is guilty of criminal conduct resulting in his discharge. *See* Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1021-22 (Sup. Ct. 1984).

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paying the fair value of his shares while permitting the remaining shareholders to continue the business."[120] Commentators have continued to urge liberalization of these statutes to provide buy-outs "not merely where minority shareholders are the victims of the unfairly prejudicial misuse of control power by majority shareholders, but also in any circumstances where the minority shareholders are found to be in deeply embittered or grievously disappointing circumstances."[121] Indeed, the initial impetus for the partnership analogy in close corporations was to justify the use of mechanisms to allow minority withdrawal from the enterprise and to enhance the liquidity of close corporation investments.[122] By use of "a jurisprudence of analogy rather than principle,"[123] courts have used the analogy to find a fiduciary duty on the part of the majority not to cash out the minority.

Application of this fiduciary duty/business purpose test to cash-out mergers was made in *Coggins v. New England Patriots Football Club*.[124] The court concluded that this standard "is not limited to close corporations[125] but applies to judicial

120. 3 MODEL BUS. CORP. ACT ANN. § 14.34, cmt. (1994). A "court supervised buy out has become the predominant form of relief" in involuntary dissolution cases predicated on majority oppression or other misconduct. Haynsworth, *supra* note 11, at 53. For an analysis of the valuation of these interests, see Murdock, *supra* note 37, at 471.

121. Edwin J. Bradley, *An Analysis of the Model Close Corporation Act and Proposed Legislative Strategy*, 10 J. CORP. L. 817, 837 (1985).

122. The law of close corporations is moving to this position with the judicial trend toward ordering mandatory buy-outs favoring minority shareholder dissolution petitions. The use of this remedy without any showing of fault by the minority has moved the law much closer to the partnership paradigm. *See* WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 542-43 (7th ed. 1995).

123. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879. Even the critics of the partnership analogy recognize its value within limits. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 49, at 249. Acceptance of the criticism, however, would result in the application of corporation statutes as the "contract" between the participants. *Id.* at 236-38; *see also* O'Kelley, *supra* note 3, at 216 n.2. The statutory "contract" clearly permits the use of mergers to cash out minority interests.

124. 492 N.E.2d 1112 (Mass. 1986).

125. Delaware flirted with the legitimate business purpose test for freeze-out mergers in publicly traded corporations in *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977). This test requires that the merger promotes a legitimate business purpose separate from the purpose of eliminating the minority shareholders. Delaware quickly rejected the legitimate business purpose rule in determining the validity of going private mergers. In *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983) a cash-out merger between UOP, Inc. and its majority owner, the Signal Companies, Inc., eliminated the minority shareholders of UOP, Inc. The minority shareholders argued that there was no legitimate business purpose for the merger as required under *Singer*. However, the Delaware Supreme Court abolished the need for a legitimate business purpose and they made the analysis an entire fairness analysis, which requires the evaluation of the merger on the basis of fair dealing and fair price. *Id.* at 711. Presumably, this standard would apply to cash-out mergers in closely held corporations. *See* Nixon v. Blackwell 727 A.2d 1366 (Del. 1993).

Some states have gone even further. For example, Minnesota had modified the test by eliminating the "entire fairness" analysis altogether. In *Sifferle v. Micom Corp.*, 384 N.W.2d 503 (Minn. Ct. App. 1986), the directors of Micom Holding Company merged the subsidiary Micom into the parent (Micom Holding Company) and eliminated the minority shareholders of Micom. The minority shareholders challenged the "entire fairness" of the transaction. According to the Minnesota Court of Appeals, section 302A.471, subdivision 4 of the Minnesota Statutes does not allow for minority shareholders to challenge

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review of [all] cash freeze-out mergers."[126] Believing that "the danger of abuse of fiduciary duty is especially great in a freeze-out merger, the court must be satisfied that the freeze-out was for the advancement of a legitimate corporate purpose."[127] Because the merger did not serve "any valid corporate objective unrelated to the personal interests of the majority shareholders," the defendants breached their fiduciary duty.[128]

The combined fiduciary duty/business purpose test can lead courts to conclude that cash-out mergers are simply not available.[129] By definition, "in a freeze-out merger the minority shareholders are being treated in a different manner: the majority is permitted continued participation in the equity of the surviving corporation while the minority has no choice but to surrender their shares for cash."[130] The result of this reasoning is that a transaction designed merely to cash out the minority is a breach of duty.[131]

In *Gabhart v. Gabhart*,[132] the court confronted the majority's use of a merger to eliminate the plaintiff from his equity position in a closely held corporation.[133]

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the "entire fairness" of the merger, as is permitted under Delaware law. *Id.* at 507. Minnesota also does not allow for a legitimate business purpose analysis, therefore the only remedy that a minority shareholder in Minnesota can seek is appraisal. *See also* Persinger v. Carmazzi, 441 S.E.2d 646, 654 (W. Va. 1994).

126. Coggins, 492 N.E.2d at 1117. A few other states also retain a "business purpose" standard for mergers of publicly held companies. *See* Dower v. Mosser Indus., 648 F.2d 183 (3d Cir. 1981) (applying Pennsylvania law); Valley Nat'l Bank of Arizona v. Trustee for Westgate-California Corp., 609 F.2d 1274 (9th Cir. 1979) (applying California law); Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974); Klurfeld v. Equity Enters., 436 N.Y.S.2d 303 (App. Div. 1981). Most states, however, seem to be following Delaware's lead in rejecting this standard. *See supra* note 125.

127. *Coggins*, 492 N.E.2d at 1118.

128. *Id.*

129. The effect of treating close corporations as possessing unique characteristics creating heightened fiduciary duties creates the specter of two standards for mergers under the same corporation code. For example, in Ohio the case of *Howing Co. v. Nationwide Corp.*, 927 F.2d 263, 268 (6th Cir. 1991), *vacated on other grounds*, 502 U.S. 801 (1991), involved a merger of Nationwide Corporation, a subsidiary, with its parent, Nationwide Mutual. This merger eliminated the minority public shareholders of the subsidiary. The Sixth Circuit held that as a general rule under Ohio law the majority shareholder may "cash out" the minority shareholders for any reason so long as the majority shareholders pay a "fair" price and fully disclose all relevant facts about the value of the corporation whose stock it is buying. Apparently, *Crosby's* duty of equal opportunity does not apply to public corporation transactions.

130. Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 28 (N.Y. 1984); *see also* Brudney & Chirelstein, *supra* note 24, at 1358.

131. *See* Twenty Seven Trust v. Realty Growth Investors, 533 F. Supp. 1028, 1039 (D. Md. 1982) ("Although the defendants . . . may ultimately show that the merger was for legitimate business purposes . . . whether such is the case cannot be resolved on motion to dismiss."); *see also* Umstead v. Durham Hosiery Mills, 578 F. Supp. 342, 345 (M.D.N.C. 1984) ("[P]laintiff's allegation, taken as true, that defendants intended to freezeout the minority shareholders adequately states a breach of fiduciary duty claim.").

132. 370 N.E.2d 345 (Ind. 1977). In response to the Indiana Supreme Court's decision in *Gabhart*, the Indiana legislature enacted section 23-1-44-8 of the Indiana Code. This new statute does not allow the type of minority shareholder challenge to corporate action permitted by *Gabhart*. *See* Fleming v. International Pizza Supply Corp., 640 N.E.2d 1077 (Ind. Ct. App. 1994).

133. *Gabhart*, 370 N.E.2d at 348.

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Although the transaction met all statutory requirements,[134] the court understood the issue to be "whether the majority may force a merger having no corporate purpose."[135] The transaction resulted from "the use of corporate control vested in the statutory majority . . . to eliminate minority shareholders from the enterprise . . . ."[136]

As its point of departure, the court noted, "[a]lthough the form of such freeze-out transaction may vary and is not confined to merger or consolidation, the policy considerations are generally the same."[137] These policies, however, appeared to the court to be in conflict.

> The case law concerning the validity of mergers effected for no corporate purpose is dominated by principles of contract and agency. Those jurisdictions which hold appraisal to be an exclusive remedy without regard for the underlying purpose of the corporate action tend to rely on contract principles, stating that the merger statute is part and parcel of the minority shareholder's contract, and the minority shareholder has thereby been put on notice that the majority may unilaterally alter the terms of the minority's investment.
>
> On the other hand, those cases which allow a minority shareholder to preserve his status, in the absence of a legitimate corporate reason for change, emphasize agency principles and the fiduciary duty owed by controlling shareholders and directors to the minority.
>
> Both positions have merit and respectable support, and it would be unwise to embrace one and to ignore the other.[138]

The court resolved this dilemma by concluding that cash-out mergers were impermissible, but that statutory dissolution was available.[139] According to the court, this result was preferable because it afforded greater protection to the minority than simply an appraisal action.[140]

In *Alpert v. 28 Williams St. Corp.*,[141] Madison Associates wanted to purchase Realty Corporation, whose sole asset was an office building.[142] Madison Associates formed a wholly owned subsidiary, 28 Williams Street Corporation, to act as the nominal purchaser of the majority shareholders' interests.[143] After completing the purchase, 28 Williams Street notified the minority shareholders of Realty

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134. *Id.* at 350.
135. *Id.* at 353.
136. *Id.* at 353.
137. *Id.*
138. *Id.* at 354-55 (citations omitted).
139. *Id.* at 355.
140. *Id.* This conclusion is highly questionable. Generally, valuation of the entity as a going concern will yield a higher price than the liquidation of the business. *See* Haynsworth, *supra* note 11, at 44; *see also* Murdock, *supra* note 37, at 441-43.
141. 473 N.E.2d 19 (N.Y. 1984).
142. *Id.* at 22.
143. *Id.*

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Corporation that their interests would be excluded through a cash-out merger.[144] Noting that "there exists a fiduciary duty to treat all shareholders equally,"[145] the court observed that "[o]n its face, the majority's conduct would appear to breach this fiduciary obligation."[146] Echoing *Donahue/Wilkes*, the New York Court of Appeals held that "[i]n the context of a freeze-out merger" the removal of minority shareholders is permissible only "when related to the advancement of a general corporate interest."[147] Absent such a purpose, a cash-out merger would not be allowed.

V. Cash-Out Mergers in Light of Fiduciary Duty and Participants' Expectations

The focus on fiduciary duties and minority expectations has made courts and commentators blind to the fact that "the danger in a freezeout is that a majority stockholder who is in fact an insider will force the minority to accept an unfair price for their interests."[148] Cash-out mergers in a closely held enterprise, however,

> generally arise in the context of a dispute over the disentanglement of what are essentially partnership arrangements . . . . The parties are visibly at loggerheads over division of the business's prosperity or over the conduct of its business; their disagreements are of a continuing kind, likely both not to be resolved until the business terminates and to plague the parties as they remain unable to disentangle satisfactorily.[149]

If the majority chooses to behave in an oppressive manner during this dispute, the minority can exit at a fair price.

Although a cash-out merger would give rise to a right to an appraisal (and thus a judicially monitored buy-out at fair value) in every state,[150] courts and commentators are still reluctant to endorse their use.[151] For example, the American Law Institute's effort at developing standards for cash-outs explicitly excludes application to closely held corporations purportedly because of their

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144. *Id.* at 22-23.

145. *Id.* at 27-28.

146. *Id.* at 28.

147. *Id.*

148. Brudney & Chirelstein, *supra* note 24, at 1364. Remarkably, these authors slip into the same vested rights fallacy in their desire to prohibit certain going private transactions. In their view, "the fiduciary principle suggests that . . . [courts should] interpret corporate statutes . . . as not permitting insiders to unilaterally condemn the stock of public investors when the effect is to leave the public with no chance to return to the enterprise." *Id.* at 1367.

149. *Id.* at 1356 n.9.

150. Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 831-33 (1984).

151. Even when courts allow cash-out mergers, they do so grudgingly. *See* REO Mechanical v. Barnes, 691 S.W.2d 224, 227 (Ky. Ct. App. 1985).

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similarity to partnerships.[152] The commentators simply cannot escape the notion that the law should "allow a shareholder to retain his status until something more than the majority's desire to be rid of him or to own his shares justifies his elimination."[153]

The right to an appraisal following a cash-out merger, however, provides protection analogous to buy-out remedies developed in oppression cases.[154] Recognition of an appraisal action's "proper function as providing a cash exit at fair value"[155] makes its use particularly appropriate to remedy liquidity problems in close corporations.[156] "Actually, appraisal remedies could work for the same purposes as buyout remedies . . . ."[157] The objection to this proposition is that although appraisal "may protect the value of the shareholder's investment, . . . it does not protect those shareholders who would prefer to retain their interest in the corporation."[158] Thus, at the root of the reluctance to approve cash-out mergers lingers the concept of a vested right to remain a shareholder, not the fiduciary duties of a partner nor the expectations of the parties.

A. Fiduciary Duties Owed by Partners

The foundation for the limitation on the majority's conduct in cash-outs is the analogy to the fiduciary duties owed by partners in a partnership setting.[159] Perhaps the most famous interaction of the fiduciary duties of partners was by Justice Cardozo: "Joint adventurers, like co-partners, owe to one another . . . the duty of the finest loyalty . . . . A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the

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152. *Principles of Corporate Governance: Analysis and Recommendations*, 2 A.L.I. § 7.25 cmt. a (1994) ("When a corporation's shares are closely held, shareholders often have relationships with each other similar to those of partners, and their fair expectation concerning continued participation . . . may be considerably different . . . . Accordingly, § 7.25 [on appraisal] does not address the rights of shareholders of closely held corporations, which may be more appropriately governed by principles comparable to partnership law."); *see also* Note, *supra* note 6, at 1641-42.

153. Vorenberg, *supra* note 63, at 1201. Professor Vorenberg believed that appraisal was an inefficient and ineffective remedy that could not reliably compensate shareholders. More importantly, in his view "only where there is a plausible business purpose of the corporation beyond the majority's desire to enlarge their own stockholdings or to eliminate a minority stockholder" should transactions with those effects be permitted. *Id.* at 1204.

154. John E. Davidian, *Corporation Dissolution in New York: Liberalizing the Rights of Minority Shareholders*, 56 ST. JOHN'S L. REV. 24, 46 (1981).

155. Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 121 (1995).

156. *Id.* at 120-24.

157. Shishido, *supra* note 40, at 103.

158. William J. Harmon, Note, *Corporation Freezeouts: A New Limitation Imposed by the "Entire Fairness Standard,"* 1978 U. ILL. L.F. 686, 696.

159. "If fiduciary relation means anything I cannot conceive a stronger case of fiduciary relation than that which exists between partners." Helmore v. Smith, 35 Ch. 436, 444 (1885); *see generally* Leona Beane, *The Fiduciary Relationship of a Partner*, 5 J. CORP. LAW 483 (1980); Note, *Fiduciary Duties of Partners*, 48 IOWA L. REV. 902 (1963).

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most sensitive is the standard of behavior."[160] In only slightly less encompassing terms, a leading treatise notes "the main elements of the partners' fiduciary duties are well recognized: utmost good faith, fairness, and loyalty."[161] When the focus is narrowed to the acquisition of another participant's interest in the partnership, however, the scope of these duties is well defined: "The partners' principal fiduciary duty in the buy-sell situation is that of full disclosure."[162]

The Uniform Partnership Act (UPA) contains provisions regarding fiduciary duties that require all partners to account to the partnership for any benefit received in connection with the partnership and to hold such benefits as trustee for the partnership.[163] Under the UPA, partners also have a duty to provide to other partners "true and full" information, upon demand, of "all things affecting the partnership."[164] Case law has summarized the nature of the fiduciary relationship among partners defined in the UPA to require each partner to act "in the utmost good faith" toward the other partner or partners.[165]

These duties, however, do not bar the majority (or even a single partner) from ending the partnership. Indeed, "[o]ne of the characteristics of a partnership is freedom of exit. The courts have considered it unwise to keep people in business together when they want to disassociate."[166] Any partner may cause the partnership to cease merely by withdrawing.[167] "[T]he consequences of such an action depend on whether the dissolution is 'wrongful,' a concept which the UPA treats as largely equivalent to 'in contravention of the partnership agreement.'"[168] In

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160. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

161. ALAN R. BROMBERG & LARRY E. RIBSTEIN, PARTNERSHIP 6:68 (1994 & Supp. 1995); *see also* Beane, *supra* note 159, at 497-501.

162. BROMBERG & RIBSTEIN, *supra* note 161, at 6:87. Without any partnership analogy, corporate law consistently required disclosure to minority shareholders in a close corporation of potential valuation factors prior to the purchase of the minority's stock by the corporation or majority shareholders. *See, e.g.*, Weatherby v. Weatherby Lumber Co., 492 P.2d 43 (Idaho 1972); Jacobson v. Yaschik, 155 S.E.2d 601 (S.C. 1967); Shermer v. Baker, 472 P.2d 589 (Wash. Ct. App. 1970).

163. UNIF. PARTNERSHIP ACT § 21(1), 6 U.L.A. 602 (1994).

164. *Id.* § 20, 6 U.L.A. 256.

165. Wilensky v. Blalock, 414 S.E.2d 1, 4 (Ga. 1992). This concept has been incorporated into section 404(d) of the RUPA as applying to partners' duty of care and loyalty. REV. UNIF. PARTNERSHIP ACT § 404(d) (1994). Neither "good faith" nor "fair dealing," however, prohibit self-interested transactions, *id.* § 404(e), or bar partners from purchasing at partnership dissolution sales and continuing the business, *id.* § 404(f) cmt. 6.

166. Charles B. Blackman, *Partnership Precedents in a Corporate Setting — Exit from the Close Corporation*, 7 J. CORP. L. 237, 238 (1982).

167. UNIF. PARTNERSHIP ACT § 31, 6 U.L.A. 771 (1994); *see* O'NEAL & THOMPSON, *supra* note 12, § 6.05 ("Since a partnership is primarily a consensual relationship and can be dissolved at any time by any partner . . . ease of dissolution avoids in partnerships those injustices caused by corporate squeeze-plays . . . [where the minority shareholder is forced] to leave his investment in the business."). The lack of such a right to a minority shareholder was thought to be "the decisive distinction between the close corporation and the partnership." Hetherington, *supra* note 6, at 11.

168. Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 11 (1982). Despite the protests of some corporate law observers, *see, e.g.*, EASTERBROOK & FISCHEL, *supra* note 49, at 249-50, "wrongful dissolution" rarely occurs absent a specific duration for the

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other words, the fiduciary duties of partners do not guarantee continued participation in the business by any member.[169] Unless the partnership is formed for a definite duration, "any partner may freely dissolve without breach of contract and without liability, whatever the motive and whatever the injurious consequences to co-partners . . . ."[170] In short, the "existence of the partnership does not create . . . an entitlement or interest in the indefinite or even limited continuation of the partnership."[171]

Under either the UPA or the Revised Uniform Partnership Act (RUPA), "a single partner can compel liquidation of the firm at any time."[172] The RUPA confirms both the right to withdraw at will and the absence of any right to continue in the enterprise. The termination of the partnership "is wrongful only if: (1) it is in breach of an express provision of the partnership agreement; or (2) in the case of a partnership for a definite term or particular undertaking, before expiration of the terms or completion of the undertaking."[173]

Section 404 of the RUPA describes the General Standards of Partner's Conduct.[174] Subsection (a) sets forth the only two fiduciary duties owed by a partner: the duty of loyalty and the duty of care.[175] These duties run to both the partnership and the other partners. Subsection (b) limits the partner's duty of loyalty: "(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner. . . . ; (2) to refrain from dealing with the partnership . . . as or on behalf of a party having an adverse interest. . . . ; and (3) to refrain from competing with the partnership . . . ."[176] As the comment to the section makes clear, "those rules are exclusive and encompass the entire duty of loyalty."[177] The Reporters for the RUPA have amplified this point: these provisions are "specific and exclusive."[178] In other words, courts are not to find new or different duties derived from the partnership relationship.

Under the RUPA there remains no duty to continue the partnership with all of its members nor any obligation to refrain from competing for the continuation of

partnership or conduct that would be unlawful even absent the dissolution.

169. This is not to say that a partner has no fiduciary responsibility in regard to the termination. "In short, having the right to terminate a relationship does not establish the absence of fiduciary constraints on transactions connected with the termination." DeMott, *supra* note 123, at 887. These obligations, however, do not mandate that former partners have a right to continued participation in the enterprise nor require that former partners be retained in any continued form of the venture.

170. ALAN R. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP 422 (1968).

171. Clapp v. LeBoeuf, Lamb, Leiby & McRae, 862 F. Supp. 1050, 1058 (S.D.N.Y. 1994); *see also* Hetherington & Dooley, *supra* note 2, at 41-42.

172. Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 62 (1993).

173. REV. UNIF. PARTNERSHIP ACT § 602(b).

174. *Id.* § 404.

175. *Id.* § 404(a).

176. *Id.* § 404(b).

177. *Id.* § 404(b) cmt. 2.

178. Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 23 (1993).

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the business of the partnership.[179] The RUPA specifically states that conduct which furthers a partner's own interest does not, by itself, result in a violation of the RUPA or the partnership agreement.[180] A partner or group of partners is permitted to purchase all of the dissolved partnership's assets.[181]

Characterization of the dissolution as simply a forced sale of the minority's interest does not restrict a partner's ability to eliminate the minority. In *Prentiss v. Sheffe*,[182] the Court of Appeals of Arizona adopted the trial court's finding of facts, which included a finding that there had been a freeze-out of the defendant from the management and affairs of the partnership.[183] The effect of this conduct by the majority was to dissolve the at-will partnership and cause the trial court to order a judicial sale.[184] The defendant requested the trial court to forbid the plaintiffs from entering a bid at the upcoming judicial sale of the partnership assets because of the fact that the defendant had been wrongfully excluded from the affairs of the partnership.[185] The trial court refused to do so, however, and the assets went to the plaintiffs because they were the highest bidders. On appeal, the defendant claimed that "the sale to the plaintiffs [was] a forced sale of his partnership interest."[186] The court of appeals affirmed, however, in spite of the freeze-out.[187] In short, there is "no obstacle against a partner purchasing the assets of a dissolved partnership and continuing the business."[188]

Applied to cash-out transactions in close corporations, "the business purpose requirement reflects a conceptual commitment to the notion that the minority has a right to continued participation."[189] Partnerships, however, are fluid, persona

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179. REV. UNIF. PARTNERSHIP ACT § 404(b)(3) cmt. 2; *see id.* §§ 602-603, 801(1). At least one commentator has found the retention of this right problematic. There is, however, no question about the RUPA's authorization of dissolution at will. BROMBERG & RIBSTEIN, *supra* note 161, § 7.01, at 7:14 (Supp. 1995).

180. REV. UNIF. PARTNERSHIP ACT § 404(e).

181. *Id.* § 404(f) cmt. 6. This technique has long been recognized as a standard cash-out maneuver in partnerships: "The partner forcing the dissolution buys up the firm's assets on its liquidation . . . and continues the business without the undesired party, probably at the same location . . . . This procedure is frequently used. In many instances, it proves to be unimpeachable." O'NEAL & THOMPSON, *supra* note 12, § 6.04.

182. 513 P.2d 949 (Ariz. Ct. App. 1973).

183. *Id.* at 951.

184. *Id.*

185. *Id.*

186. *Id.* at 952.

187. *Id.*; *see also* Mandell v. Centrum Frontier Corp., 407 N.E.2d 821, 831-32 (Ill. Ct. App. 1980). Defendants' former partners had purchased the partnership assets, but the court concluded, "Defendants here were not excluded from their interest in the partnership. Defendants are entitled to their proportionate share of the proceeds of the sale." *Id.*

188. HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, HANDBOOK ON THE LAWS OF AGENCY AND PARTNERSHIP 344 (1979). Of course, section 404(f) of the RUPA now specifically authorizes this action.

189. Dierdre A. Burgman & Paul N. Cox, *Reappraising the Role of the Shareholder in the Modern Public Corporation: Weinberger's Procedural Approach to Fairness in Freezeouts*, 1984 WIS. L. REV. 593, 632 (1984). In certain situations of highly profitable businesses, the minority may have more than a "vested rights" reason for wanting to remain. *See* Murdock, *supra* note 37, at 447-51. As Professor

relationships that, absent express agreement, carry with them no duty to remain in the business. There is, therefore, no right to continued participation in the partnership. As a result, application of partnership duties by analogy to close corporation shareholders should not guarantee a continued equity interest in the enterprise nor require that the majority have a business purpose beyond eliminating the minority before such transactions are appropriate.

B. Reasonable Expectations and the Right To Remain a Shareholder

To the extent that the participants' reasonable expectations are to be owners of an enterprise to which partnership norms apply, they can have no expectation of a right to continue as an owner. The very norms used to provide liquidity for the minority's investment compel recognition of the majority's right to cash out the minority's ownership interest. Moreover, participants in business ventures select the type of organization they believe best suits their needs.[190] By opting to incorporate, the parties have presumptively made decisions reflecting their expectations.[191] "Minority shareholders in close corporations are not necessarily dependent upon the legislatures and the courts for protection against freezeouts."[192] Given the increased flexibility to negotiate protections for the expectations of minority shareholders under most modern corporation codes,[193] the necessity of imposing limitations on the majority in cash-out transactions (other than fair compensation for the value of the minority's equity position) is unnecessary.[194]

Murdock points out, however, valuation of these businesses on some going concern basis adequately compensates the minority.

190. O'Kelley, *supra* note 3, at 245-46.

191. EASTERBROOK & FISCHEL, *supra* note 49, at 250. This has become even more obvious with the development of Limited Liability Companies and limited liability partnerships. The availability of alternative business forms to provide investors with limited liability or preferable tax treatment without incorporating, argues even more strongly for applying corporate norms to the parties enterprise absent an explicit agreement to the contrary. *See* O'Kelley, *supra* note 3, at 246. These newly recognized entities, of course, present their own set of concerns surrounding majority rights and minority duties. *See* Franklin A. Gevurtz, *Squeeze-outs and Freeze-outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497 (1995).

192. Note, *supra* note 6, at 1642. Perhaps the simplest way to prevent cash-out mergers (should the participants wish to do so) is to establish super-majority voting provisions at levels that would prevent fundamental change absent minority consensus. Modern corporate codes generally allow for such provisions. *See* 4 MODEL BUS. CORP. ACT ANN., CLOSE CORP. SUPP. § 20 (3d ed. 1996); *see also* DEL. CODE ANN. tit. 8, § 350 (1995); GA. CODE ANN. § 14-2-920 (1990); MONT. CODE ANN. § 35-9-301 (1995); N.C. GEN. STAT. § 55-7-31 (1995); TEX. BUS. CORP. ACT. ANN. art. 12.32 (West 1996); WYO. STAT. § 17-17-120 (1996).

217. *See* CAL. CORP. CODE § 710 (West 1990); GA. CODE ANN. § 14-2-727 (1996); MISS. CODE ANN. § 79-4-10.21 (1996); N.C. GEN. STAT. § 55-10-22 (1995); S.C. CODE ANN. § 33-7-270 (Law. Co-op. 1995).

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The perceived restrictive nature of general corporate law made it "apparent how inappropriate traditional corporate norms were"[195] in dealing with the structure of close corporations.[196] Although initially corporate codes made "no distinction between the close corporation and the publicly-held corporation,"[197] the inconsistency of closely held corporation common law has led to the development of a separate body of legislation designed to address problems unique to the close corporation.[198] These problems have been identified as related to the management and operation of these entities and the relationship of the participants in these entities to each other.[199] The legislative effort has been to allow more flexibility in management and more protection from majority "oppression."[200]

Close corporation legislation has proven to be extremely popular.[201] Generally, those statutes provide a legislative definition of these entities.[202] By choosing to incorporate as a close corporation in those states which have adopted close corporation legislation, participants may structure their relationships to provide greater protection for minority shareholders and avoid the more restrictive general

195. Manne, *supra* note 13, at 282.

196. The degree to which this assumption underlying modern corporate codes is valid in regard to one particular close corporation turns on how nearly that entity approximates the archetypical close corporation. O'Kelley, *supra* note 3, at 242. This insight, however, does not change the analysis here. To the extent that the entity would be most benefitted by adopting the flexible options created by the codes, the failure of the parties to elect these provisions still reflects preemptively rational choice. Moreover, if these norms are essentially partnership norms, freedom of exit implies no fiduciary duty as other limitation based on motivation for the majority cash-out merger. To the extent that the close corporation is more suitably governed by traditional corporate norms, the principle of majority value is firmly established and the availability of cash-out mergers to the majority, regardless of motive, should not be in doubt.

197. Symposium, *Actions Prejudicial to Minority Shareholders*, 52 NW. U. L. REV. 345, 385 (1957).

198. The merit of this approach is not without critics. *See, e.g.*, Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L.J. 663 (1989).

199. *Id.* at 672-77.

200. Thompson, *Shareholder's Cause*, *supra* note 14, at 707; Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 427 (1990).

201. The development of special close corporation statutes has been extensive. O'Neal, *Close Corporations*, *supra* note 80, at 873-79. At least eighteen states have adopted specific integrated close corporation statutes. *See* 4 MODEL BUS. CORP. ACT, CLOSE CORP. SUPP. § 55, at CC-71. One commentator, however, has claimed "the effect of most modern amendment programs dealing with basic provisions of the corporation acts has been to modify them in the interest of the close corporation. Our general corporation laws seem to be in the process of becoming general close corporation laws . . . ." Manne, *supra* note 13, at 284. To date, only a small percentage of close corporations have taken advantage of those acts. *See* Thompson, *Corporate Dissolution*, *supra* note 21, at 226.

202. Delaware's approach is typical. Title 8, section 342 of the Delaware Code Annotated provides that a close corporation is one in which, in addition to being organized under the aforementioned statute, complies with all of the following: "1. No more than thirty (30) persons shall hold all of the corporation's issued stock; 2. the issued stock must be subject to at least one restriction on transfer; and 3. the corporation shall not engage in any public offering of its stock." DEL. CODE ANN., tit. 8, § 342(a)(1), (2), (3) (1995).

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corporation laws by ordering affairs under the more flexible close corporation laws.[203]

The premise of those statutes is acceptance of the partnership model of allowing the participants to structure their relationship as they see fit. The statutes recognize that "where a private transaction imposes no substantial cost on society or third parties, the parties to it should be allowed . . . to 'make their own deal.' Government intervention should be limited to the enforcement of private bargains and . . . reducing the costs of bargaining."[204] In such a system, the statutes function only as default rules.[205]

Beyond adoption of integrated close corporation provisions, modern corporate codes contain general provisions that have been modified to facilitate the use of shareholder agreements in ways particularly appropriate to close corporations. For example, section 7.32 of the Revised Model Business Corporate Act (RMBCA) validates a variety of shareholder agreements which offend traditional norms of corporate governance.[206] Although located in the general corporation provisions of the RMBCA, this section focuses on close corporations.[207] In addition to the states which have adopted the RMBCA,[208] many other states have provisions which are similar.[209] As a result of this greater flexibility, shareholders who enter into a minority position in the corporation are able to bargain for their rights in the event that the relationship deteriorates in the future.[210]

Absent such agreements, the general corporate law norms should apply.[211] Although commentators advocating an expectation approach assert that "minority shareholders should not be understood as having agreed that the venture is to be

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203. Hetherington, *supra* note 6, at 5-10.

204. Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 253 (1977). Although courts "once viewed unusual contractual mechanisms in close corporations with suspicion, . . . [they now] enforce whatever the participants invent." EASTERBROOK & FISCHEL, *supra* note 49, at 234.

205. Although some proponents of minority "protection" recognize that the provisions of a state's corporation act function as "default rules," they reference general (not special close corporation) statutes to argue for the propriety of an enhanced fiduciary duty. *See* Thompson, *Shareholder's Cause*, *supra* note 14, at 729.

206. 2 MODEL BUS. CORP. ACT ANN. § 7.32 & cmts. (3d ed. 1996). According to the official comment to section 7.32,

> Section 7.32 also recognizes that many of the corporate norms contained the Model Act, as well as the corporation statutes of most states, were designed with an eye towards public companies . . . [and therefore] section 7.32 validates for nonpublic corporations various types of agreements among shareholders even when the agreements are inconsistent with the statutory norms contained in the Act.

Id. § 7.32 official cmt.

207. *Id.* § 7.32 & cmts.

208. *See, e.g.*, ALA. CODE § 10-2B-7.32 (1996); N.H. REV. STAT. ANN. § 293-A:7.32 (1995).

209. *See, e.g.*, MICH. COMP. LAWS ANN. § 450.1463 (West 1990); N.Y. BUS. CORP. LAW § 620(b)-(g) (McKinney 1986).

210. O'Neal, *Oppression*, *supra* note 2, at 144-46.

211. Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993); Blount v. Taft, 246 S.E.2d 763, 772 (N.C. 1978).

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operated strictly as a majority-rule entity,"[212] these same commentators assert that this failure to take advantage of these close corporation statutes has more to do with naivety and trust than intention.[213] Explanations for this failure to contract range from lack of "foresight or . . . power"[214] to negotiate effectively to lawyer conflict of interest.[215] In the words of the leading proponent of the expectation standard, "when courts apply the principle of majority rule in close corporations, they often disappoint the reasonable expectations of the minority participants."[216]

To the extent that the reasonable expectation standard seeks to enforce nonwritten shareholder agreements, it is in fundamental conflict with the statutes making only such agreements in writing enforceable.[217] Moreover, the search for *ex ante* expectations in terms of the outcome of specific issues in individual cases ignores the "signalling effect provided by initial form selection."[218] By deciding to incorporate and to not adopt statutorily permissible means of limiting majority control, a closely held business investor's expectation is that general corporate norms would govern.[219] In short, "[r]ational investors understand, in general, the adaptive characteristics and opportunistic risks that normally attend corporate, partnership, and sole proprietorship form. They adopt a particular form in the expectation that . . . will provide outcomes that are consistent with the investors' *ex ante* governance expectations."[220]

Indeed, "the primary utility of corporation law lies in providing a set of standard, implied contract terms, . . . so that business firms do not have to stipulate these terms anew every time they transact . . . ."[221] The use of

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212. Bradley, *supra* note 121, at 840.

213. *Id.*

214. Brenner v. Berkowitz, 634 A.2d 1019, 1026 (N.J. 1993); *see also* Thompson, *Corporate Dissolution*, *supra* note 21, at 224.

215. Bradley, *supra* note 121, at 840; *see also* Hetherington & Dooley, *supra* note 2, at 37-38. The explanations appear to be rationalizations designed to justify judicial intervention. EASTERBROOK & FISCHEL, *supra* note 49, at 237, 240-41.

216. O'Neal, *Close Corporations*, *supra* note 80, at 884. To the extent that this simply means the participants think of themselves as "partners," O'NEAL & THOMPSON, *supra* note 12, § 2.10, it does not provide any basis for limiting the cash-out merger rights of the majority.

217. *See* CAL. CORP. CODE § 710 (West 1990); GA. CODE ANN. § 14-2-727 (1996); MISS. CODE ANN. § 79-4-10.21 (1996); N.C. GEN. STAT. § 55-10-22 (1995); S.C. CODE ANN. § 33-7-270 (Law. Co-op. 1995).

218. O'Kelley, *supra* note 3, at 252.

219. *See* Shishido, *supra* note 40, at 95.

> If the shareholders made no contract because either they failed to anticipate future squeeze-outs or they had no incentive to bargain, then they had no idea of what they would have wanted. When the parties intended nothing and it is impossible to find what they would have wanted, it is reasonable to come back to the off-the-rack standard, in our case, corporate law. If the shareholders made no contract because they intentionally considered that no contract is better than an incomplete contract, they might have wanted to leave the future open, and expected to rely on corporate law as a standard contract in cases of dispute.

Id.

220. O'Kelley, *supra* note 3, at 252.

221. Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499,

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"reasonable expectations" to limit statutorily authorized majority action that provides fair value to minority shareholders defeats this function of corporation statutes.[222] Although persons may "enter closely-held businesses in the same manner as they enter marriage: optimistically and ill-prepared,"[223] the fact that the minority either did not or could not bargain successfully for the protection of these "expectations"[224] but yet chose to participate in the corporation belies any notion that in preventing cash-out mergers the court is enforcing anything remotely related to "express or implied understanding"[225] regarding the minority's right to a continued ownership interest in the corporation.

VI. Conclusion

The result of the legislative and judicial developments of the past two decades is

> that minority shareholders are no longer helpless . . . . The development of the concept of fiduciary duties running from those in control to minority shareholders, the restatement of oppression in terms of reasonable expectations of minority shareholders, and the development of a buy-out remedy converges into a vastly changed posture for minority shareholders.[226]

Lost in the urge to protect minority owners in those enterprises, however, has been the majority's right to cash out the minority's interest. Recognition of the minority's expectations and the majority's fiduciary duties does not justify this result. At bottom, nothing supports these decisions but the discredited notion of vested rights of ownership in the corporation. This doctrine was discarded long ago in public corporations; its abandonment is long overdue in closely held companies.

506 (1976); *see also* Winter, *supra* note 203, at 259 ("[A] prime function of state corporation codes is to supply standard terms which reduce transaction costs . . . by eliminating costly bargaining . . . ."); EASTERBROOK & FISCHEL, *supra* note 49, at 236-37.

222. O'Kelley, *supra* note 3, at 247.

223. Murdock, *supra* note 37, at 426.

224. *See* Meiselman v. Meiselman, 307 S.E.2d 551, 558-59 (N.C. 1985).

225. *Meiselman*, 307 S.E.2d at 563.

226. *Id.* at 484-85. This represents a significant change since Hetherington & Dooley wrote a decade and a half ago. *See* Hetherington & Dooley, *supra* note 2, at 19.

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