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"Reasonable Expectations" Define Board Power to Liquidate a Solvent Close Corporation in Bankruptcy

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“REASONABLE EXPECTATIONS” DEFINE BOARD POWER TO LIQUIDATE A SOLVENT CLOSE CORPORATION IN BANKRUPTCY

*Shelby D. Green**

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I. INTRODUCTION

Business associates in a small closely held corporation fear estrangement. Typically, associates have not anticipated such a change in relations. One shareholder might consider withdrawal and attempt to sell his interest in the enterprise, but a market may not exist. The shareholder might propose a buyout, but the other shareholder’s interest may not be liquid. The shareholder might plan an ouster of another shareholder, but his ownership interests may be evenly divided.

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In *In re Quarter Moon Livestock Co.*,¹ one faction in a dispute chose the final solution—liquidation in bankruptcy.² The bankruptcy solution was particularly remarkable because the corporation was not insolvent.³ Despite the apparent economic health of the corporation and the objection of shareholders owning half the company's stock, the bankruptcy court let the liquidation proceed.⁴

Apart from the seemingly radical nature of the solution to the intra-corporate dispute, the case is important because it presents a significant question in corporate law: may a board of directors, without shareholder assent, liquidate a solvent close corporation in bankruptcy? State corporation statutes contain express provisions for terminating the corporate existence through dissolution, sale of all or substantially all of the corporation's assets, or merger.⁵ With a minor exception in the case of merger,⁶ these acts must be approved by the shareholders.⁷ Remarkably, state corporation statutes are silent regarding voluntary bankruptcy of a solvent business as a form of corporate death.⁸ This silence cannot be explained on grounds of federal preemption because the question of whether a party filing a petition in bankruptcy has authority to act is determined by reference to state law.⁹ An ideal of our judicial system is that "judges should apply to their cases existing law and not make new law . . . even when the text of particular constitutional provisions, statutes, or available precedents appears to offer no determinate guide."¹⁰ Unfortunately, as the English jurist H.L.A. Hart has noted, "what

1. *In re Quarter Moon Livestock Co.*, 116 B.R. 775 (Bankr. D. Idaho 1990).

2. *Id.* at 777. The board filed a Chapter 7 petition under the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2604 (current version at 11 U.S.C. §§ 701-66 (1989)).

3. *In re Quarter Moon Livestock Co.*, 116 B.R. at 780.

4. *Id.*

5. *See, e.g.*, IDAHO CODE §§ 30-1-1 to -83 (Supp. 1992).

6. *See infra* text accompanying note 63.

7. *See, e.g.*, IDAHO CODE § 30-1-79 (Supp. 1992).

8. *See infra* text accompanying notes 73-99.

9. *See infra* text accompanying notes 59-73.

10. H.L.A. Hart, *American Jurisprudence Through English Eyes: The Nightmare and the Noble Dream*, 11 GA. L. REV. 969, 978 (1977). Hart described the two predominant views in the debate over the proper role of judges in adjudicating cases as the "Dream" and the "Nightmare." *Id.* at 973. The "Nightmare" is that "[despite] pretensions to the contrary, judges make the law which they apply to litigants and are not impartial, objective declarers of existing law." *Id.*

Hart comments on views by scholars of the American Legal Realist Movement. He quotes Justice Oliver Wendell Holmes as saying that "[t]he prophecies of what the courts will do in fact and nothing more pretentious, are what I mean by the law," *id.* at 974 (quoting OLIVER W. HOLMES, *The Path of the Law*, in COLLECTED LEGAL PAPERS 167, 173 (1920)), and Karl Llewellyn as saying that "[w]hat [judges] do about disputes is . . . the law itself," *id.*, (quoting KARL LLEWELLYN, *THE BRAMBLE BUSH* 3 (1930)), and he cites Jerome Franks for the proposition that "the belief that there could be legal rules binding on judges and applied by them, not made by them, in concrete cases is stigmatized as an immature form of fetishism or father fixation calling for psychoanalytical therapy." *Id.* (citing JEROME FRANKS, *LAW AND THE MODERN MIND* 175, 178, 193, 203, 244, 264 (1930)). Hart then summarized the central themes of the legal jurisprudential movements that account for the two images. *Id.* at 974-76. Legal

the existing law *is* need not be and very often is not obvious, and the trained expertise of the lawyer may be needed to extract it from the appropriate sources."¹¹ But what are the relevant and permissible sources from which the court must extract the law?

In *Quarter Moon*, the court considered the state corporation statute and the bankruptcy code, as well as the company's articles of incorporation and bylaws.¹² The court found no answer to the question of whether shareholder approval of the Chapter 7 petition was required.¹³ It also considered the Supreme Court's 1933 decision in *Royal Indemnity Co. v. American Bond &*

realism denounced a "purely backward-looking style of adjudication according to which particular decision in particular cases owed their legal justification exclusively to their relation to the predetermined meaning of existing legal rules" and "urged upon judges a forward-looking form of adjudication according to which legal rules are treated as displaceable presumptions or working hypotheses, to be modified or rejected if the predictable consequences of their application in a shifting social context proved unsatisfactory." *Id.* at 976. Hart pondered the affect of the Realism Movement:

Seen from afar it appears . . . not to have advanced legal theory far or to have added much to the stock of valuable jurisprudential ideas. But the virtues and beneficent influence of the realist movement lay elsewhere. [I]ts main effect was to convince many judges and lawyers, practical and academic, of two things: first, that they should always suspect, although *not* always in the end reject, any claim that existing legal rules or precedents were constraints strong and complete enough to determine what a court's decision should be without other extra-legal considerations; secondly, that judges should not seek to bootleg silently into law their own conceptions of the law's aims or justice or social policy or other extra-legal elements required for decision, but should openly identify and discuss them.

Id. at 977-78.

According to Hart, Llewellyn rejected the assumption that a particular legal rule proves indeterminate in a given case so that the court is unable to justify its decision as the strict deductive conclusion of a syllogism in which it appears as a major premise, then the decision which the court gives *can* only be the judge's legally uncontrolled choice.

Id. at 979, 981. Instead, judges remain constrained by role, process, and method. *See generally* KARL LLEWELLYN, *THE CASE LAW SYSTEM IN AMERICA* (1989). Hart states that Pound speaks of constraints found in "received values or ideals of the system." Hart, *supra*, at 981. Hart also considered the writings of Ronald Dworkin, who according to Hart maintains that a judge is never free "to determine what the law *shall* be; he is confined to saying what he believes *is* the law before his decision, though of course he may be mistaken." Hart, *supra*, at 983; *see also* Ronald Dworkin, *Hard Cases*, 88 HARV. L. REV. 1057 (1975), *reprinted in* RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 81 (1977).

Professor Dworkin recognizes that at any level of enquiry into the system and the general principles which may be said to be immanent in the existing law there may be unresolved questions of this sort. To deal with them the judge must, ideally at any rate, open up much wider ranging questions of justice and political morality.

Hart, *supra*, at 984; *see also* DWORKIN, *supra*, at 107.

11. Hart, *supra* note 10, at 972.

12. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 778-82 (Bankr. D. Idaho 1990).

13. *Id.* at 782.

*Mortgage Co.*¹⁴ In *Royal Indemnity*, the Court rejected a challenge to a bankruptcy petition on the ground it lacked shareholder approval.¹⁵ The bankruptcy court relied heavily on *Royal Indemnity* to deny the motion in *Quarter Moon*.¹⁶ As this Article will demonstrate, the bankruptcy court inappropriately relied on the Supreme Court case, which could not serve as legal precedent for its subsequent holding in *Quarter Moon*.

Although the court found no determinate answer to the question of the appropriateness of liquidating a solvent business through bankruptcy, it was not free to "push aside the law books and proceed to legislate."¹⁷ Nor would it have been sound for the court simply to limit its consideration to points found in the language of existing rules and traditional doctrine, denying relief when these sources are silent. Rather, a resolution of the question requires an appreciation of the nature and ideology of the close corporation and a specially tailored doctrine. Investment expectations that extend beyond the receipt of dividends, but contemplate control and economic benefits deriving from employment in the enterprise, distinguish this entity from the public corporation, for which the traditional doctrine is appropriate.

This Article will argue that, in the absence of contrary provisions in the articles of incorporation, the power of the board of directors of a solvent close corporation to file a voluntary petition for liquidation in bankruptcy must be determined by the theory of "reasonable expectations." This doctrine not only addresses wrongdoing by those in control, but also defines the power and rights of close corporation participants. Part II briefly considers the uses of bankruptcy in recent years and comments on the peculiar occasion of a solvent corporation deciding to liquidate in bankruptcy. Part III summarizes the facts and identifies the two grounds on which the bankruptcy petition in *Quarter Moon* should have been dismissed. Parts IV and V explain how the case should have been resolved under the corporation and bankruptcy doctrines. Finally, Part VI concludes with suggestions.

14. *Id.* at 780-81 (citing *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. 165 (1933)). The *Royal Indemnity* case concerned a group of creditors who sought standing to petition the court to vacate a judgment based on a petition authorized by the directors of a bankrupt corporation. *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. at 166. State law specifically forbade transfer of the company's assets without shareholder approval unless done in the usual course of business. *Id.*

15. *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. at 170-71.

16. *In re Quarter Moon Livestock Co.*, 116 B.R. at 780-81.

17. Hart, *supra* note 10, at 981.

II. THE BANKRUPTCY SOLUTION AND THE SOLVENT LIQUIDATING DEBTOR

In recent years, large corporations have filed petitions in bankruptcy almost as a matter of course.¹⁸ The circumstances and motivations for this historically ignominious course are quite varied:¹⁹ as an act of desperation when facing financial disaster, as in the cases of Federated and Allied Stores;²⁰ as a tactical maneuver to foil a labor union, as in the cases of Continental Airlines, Eastern Airlines, and Greyhound Bus Lines;²¹ as an attempt to defeat tort victims, as was done by Texaco because of the Pennzoil litigation;²² and perhaps out of a desire to curtail losses to constituents.²³ In each of these cases, the board of directors was responsible for unilaterally imposing this course on the corporation.²⁴ Shareholders found their already marginalized role in the corporate decision-making process wholly preempted.

Significantly, each of these debtors is a large publicly held corporation with widely dispersed stock ownership. Among the shareholders of such corporations, there is a prevailing attitude of rational apathy. Any involvement in corporate affairs beyond the simple execution of a proxy in favor of management for the annual meeting is not an economical or efficient expenditure of time and resources for most shareholders. These corporations were also insolvent or experiencing cash management problems, and in most cases, the corporations sought to reorganize rather than to liquidate.²⁵

18. See Louis Uchitelle, *Business Scene: How Bankruptcy Can Feed Doubt*, N.Y. TIMES, Dec. 17, 1990, at D2. The pace of these filings is unprecedented. *Id.* Between August and December 1990, more than 1300 companies filed for bankruptcy weekly according to the Dun & Bradstreet Corporation, which tracks such data nationwide. *Id.* The 55,000 companies that declared bankruptcy from January through November 1990 listed \$64.1 billion in debts, a sum equal to 1.1 % of the gross national product. *Id.* "Not since the Depression has the level even approached [one] percent." *Id.*

19. See Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U.L. REV. 919, 920 (1991); see generally Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 776 (1987).

20. See Isadore Barash, *Campeau Invokes Bankruptcy Code for its Big Stores*, N.Y. TIMES, Jan. 16, 1990, at A1.

21. Ponoroff & Knippenberg, *supra* note 19, at 933-37.

22. Ponoroff & Knippenberg, *supra* note 19, at 938-39.

23. Ponoroff & Knippenberg, *supra* note 19, at 938-39.

24. See Barash, *supra* note 20, at A1; Thomas C. Hayes, *Bankruptcy, Like the Strike, May Be Rough at Greyhound*, N.Y. TIMES, June 6, 1990, at D1; Thomas C. Hayes, *Bankruptcy Filing by Greyhound*, N.Y. TIMES, June 5, 1990, at D1; Steve Coll, *Texaco, Inc., Files for Bankruptcy; Oil Giant Seeks Protection After Pennzoil Talks Fail*, WASH. POST, April 13, 1987, at A1.

25. A Chapter 11 reorganization petition is an alternative to liquidation bankruptcy. See 11 U.S.C. § 109 (1988). The Supreme Court has observed that "[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984). "By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners Congress

In *Quarter Moon*, the company was solvent when it filed for bankruptcy; there was no question the corporation could pay its debts as they came due.²⁶ Perhaps the peculiar occasion of a *solvent* debtor deciding to liquidate in bankruptcy was not contemplated by the corporation statutes, because the term "bankrupt" (a term found in earlier, but not the current version of the code)²⁷ suggests one be "depleted" or "unable to pay his creditors in full."²⁸ This level of financial distress is not, however, a prerequisite for filing a petition under Chapter 7.²⁹ As the court in *Quarter Moon* noted, "a Chapter 7 'debtor' need not be insolvent to be eligible for Chapter 7 relief. Nor does the standard established for those persons who 'may be' debtors under Chapter 7 contain any specific or implied requirement that such persons be heavily burdened by debts."³⁰ Collier explains further:

Under this subdivision any person not within the excluded class who owes debts in any amount, no matter how small, may file a petition for liquidation. It is interesting to note that various legislative attempts to establish a minimum amount of debts owed as a criterion for eligibility for relief have never succeeded, as such minimum requirements have been seen as being an unnecessary hardship which should not be inflicted upon small but certainly hard-pressed debtors. A debtor under [C]hapter 7 may be solvent or insolvent, and his or her motive is generally considered to be immaterial, except that the debtor may not file a petition for the purpose of perpetrating a fraud. Thus, there is no reason why, if a solvent person cares to have its property distributed among its creditors through bankruptcy liquidation, it should not be allowed to do so [T]he Code structure in no way requires a debtor to allege insolvency in its petition, nor to prove it, to procure relief³¹

presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.' United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983); see also H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977).

26. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 781 (Bankr. D. Idaho 1990). The court noted, however, that the "evidence suggests a real difficulty in accomplishing payment given the dispute among management." *Id.*

27. The use of the term "debtor" "is a change in terminology from [the previous act], which identifie[d] the person by or against whom a petition is filed in a straight bankruptcy liquidation case as a 'bankrupt'" S.R. 95-989, 95th Cong., 2d Sess. 5, reprinted in 1978 U.S.C.C.A.N. 2549, 5809.

28. See BLACK'S LAW DICTIONARY 147 (6th ed. 1990); AMERICAN HERITAGE DICTIONARY 172 (3d ed. 1987).

29. The "insolvency" requirement appears under other sections of the Code, but not under the section applicable to debtors like *Quarter Moon*. The legislative history makes clear that "[§ 707] does not contemplate . . . that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal." See H.R. REP. No. 598, 95th Cong., 1st Sess. 380 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6336.

30. *In re Quarter Moon Livestock*, 116 B.R. at 781, n.4 (quoting 2 COLLIER ON BANKRUPTCY ¶¶ 109.02, 109-12 (15th ed. 1988)).

31. 2 COLLIER ON BANKRUPTCY ¶ 109.02 (citations omitted).

Although personal or corporate insolvency is not a prerequisite to filing a voluntary petition in bankruptcy,³² the question of solvency is "extremely important in ascertaining whether the benefits of the Bankruptcy Act are being used in bad faith or fraudulently . . . [because] no one would contend that the bankruptcy court exists for any purpose other than to aid financially embarrassed debtors in adjusting their affairs with their creditors."³³

III. QUARTER MOON LIVESTOCK CO.: FACTS AND GROUNDS FOR DISMISSAL

Two families, the Gilberts and the Addlemans, formed Quarter Moon Livestock Company.³⁴ Each family was to have equal ownership and management interests in the corporation.³⁵ Although the parties' children owned the stock, the parents acted as custodians.³⁶ The children of each family held eight shares of the sixteen total shares.³⁷ The parents served as the outstanding directors of the corporation.³⁸ The corporation leased pasture from the Gilberts, who were also paid wages to operate the business.³⁹ The Addlemans supplied the accounting and bookkeeping services.⁴⁰

32. See *Coastal Cable T.V. v. Coastal Cable T.V.*, 709 F.2d 762, 764 (1st Cir. 1983) (stating that "a person in bankruptcy, while not necessarily insolvent . . . must at least owe debts (even though the statute is mysteriously silent on the question)"); *Porterfield v. Gerstel*, 222 F.2d 137, 140 (5th Cir. 1955) (holding that a corporation was insolvent in the equity sense, *i.e.*, unable to meet its obligations as they matured, but not in the bankruptcy sense, because its assets exceeded its liabilities by approximately \$80,000); *In re Donaldson Ford, Inc.*, 19 B.R. 425, 431 (Bankr. N.D. Ohio 1982) (stating that voluntary petitioner may be solvent or insolvent); *In re Yarborough*, 18 F. Supp. 359, 360 (M.D. Ga. 1937) (stating that "[a] solvent person who owes debts may file a voluntary petition in bankruptcy"); *In re Fox West Coast Theatres*, 25 F. Supp. 250, 261-62 (S.D. Cal. 1936), *aff'd sub nom. Talley v. Fox Film Corp.*, 88 F.2d 212 (9th Cir.), *and cert. denied*, 301 U.S. 710 (1937) (stating that when a corporation seeks voluntary bankruptcy, only stockholders or those with a financial interest may contest an adjudication on the ground of absence of volition); *In re People's Warehouse Co.*, 273 F. 611, 612 (S.D. Miss. 1921) (holding that court had jurisdiction to act where attorney for corporation voluntarily filed for bankruptcy and action was ratified by majority of stockholders).

33. *Porterfield v. Gerstel*, 222 F.2d at 142. The origins of a bankruptcy proceeding can be traced back to the days of Roman law: "[I]ts name is derived from statutes of Italian city-states, where it was called *banca rupta* after a medieval custom of breaking the bench of a banker or tradesman who absconded with property of his creditors." THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW 1* (1986) (citing Israel Treiman, *Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law*, 52 HARV. L. REV. 189 (1938)).

34. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 777 (Bankr. D. Idaho 1990).

35. *Id.* at 777.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

Until John Gilbert's death in August 1989, the company prospered.⁴¹ During the following eight months, however, the parties' relationship was damaged beyond repair.⁴² The parties unsuccessfully negotiated for a buy-out of the Addlemans' stock.⁴³ However, communications broke down, the parties argued heatedly, and the company could no longer be managed.⁴⁴

The vacancy on the board of directors caused by John Gilbert's death was filled by the Addlemans' election of their attorney, Mr. Anderson.⁴⁵ Mrs. Gilbert was not present at the special meeting held on March 31, 1990.⁴⁶ The Gilberts filed suit on April 20, 1990 in Idaho state court for "judicial dissolution of the corporation and appointment of a receiver."⁴⁷

A shareholders' meeting held April 21 adjourned without action because there was no quorum.⁴⁸ The Addleman/Anderson board then ordered the company's dissolution by bankruptcy.⁴⁹ On April 25, the corporation filed its Chapter 7 petition.⁵⁰ The Gilberts moved to dismiss the bankruptcy petition on two grounds.⁵¹ First, they argued the petition was not the "voluntary act" of the entity because the decision was not the product of a properly called meeting of the duly elected directors, at which a quorum was present.⁵² They unsuccessfully attempted to show that under Idaho law, the board was illegally constituted and thus lacked authority to act without shareholder approval.⁵³

41. *Id.*

42. *Id.*

43. *Id.* The Gilberts argued that Lance, John Gilbert's son, was elected in a negotiation meeting in December, 1989, to the board pursuant to an agreement under which the Gilberts would also buy the Addlemans' shares. *Id.* at 779. Later that month, Mr. Addleman "sent an annual corporate registration form to the Idaho Secretary of State's office showing Lance Gilbert as the fourth director" (although the registration form was rejected by the Secretary of State based on the corporation's prior failure to file annual reports or pay fees). *Id.* In any event, Mrs. Gilbert later repudiated the terms of the stock purchase arrangement, "contending that it had been 'tentative' and that she felt it was unfair to her family." *Id.* "Mr. Addleman testified that Lance had been listed on the corporate form as a director solely in consideration of the anticipated stock purchase [but] that when no agreement was consummated, he considered Lance's election to be ineffective." *Id.*

44. *Id.* at 777.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* The Gilberts sought dismissal under 11 U.S.C. § 707(a), which authorizes a bankruptcy court to dismiss a case "only after notice and a hearing and only for cause." *Id.* (citing 11 U.S.C. § 707(a) (1988)).

52. *In re Quarter Moon Livestock Co.*, 116 B.R. at 777-81.

53. *Id.* at 778. The Gilberts also contended that under the corporation's bylaws, "the directors were elected to hold illegal staggered terms." *Id.* The bylaws, "adopted in 1984, provided for staggered terms for each of the initial four directors, with annual elections, so that at least one-fourth of the directorship [would] stand for election at each annual meeting." *Id.*

Alternatively, the Gilberts argued the petition constituted a "sale or disposition of all or substantially all of the company's assets other than in the ordinary course of its business."⁵⁴ Under Idaho law, such a final act must have been authorized by the shareholders.⁵⁵ Although there was no dispute about the interpretation of the asserted statute, the Gilberts could cite no cases from Idaho courts supporting the argument that liquidation in bankruptcy is tantamount to a sale of all or substantially all of the corporation's assets, and thus should be governed by corporate rules.⁵⁶

The bankruptcy court appears to have rejected the Gilberts' arguments largely because of the absence of any clear Idaho law. If the analysis is extended, however, beyond the fixed texts of the corporate statutes to questions about the ideology of the close corporation and the purposes of the bankruptcy process, the absence of an express provision on the issue is no more significant than the absence of a provision on the authority of the board to adopt defensive measures to a hostile takeover.

The relevant laws and policies require that a Chapter 7 petition filed under the circumstances in *Quarter Moon* be dismissed for two reasons. First, a Chapter 7 petition by a solvent close corporation that lacks the assent of the shareholders is not a "voluntary act" as required under the Bankruptcy Code because it is not an "act" of the corporation. Second, a Chapter 7 petition whose object is to avoid substantive state law restrictions lacks the good faith required of all petitioners in bankruptcy.

IV. "VOLUNTARY ACT" UNDER CORPORATION DOCTRINE

Under section 301 of the Bankruptcy Code, a Chapter 7 petition must be a "voluntary act."⁵⁷ Courts have interpreted this language to mean the

The Idaho statute "limit[ed] classification of directors . . . to those corporations where there are nine or more directors, and only then if authorized by the articles of incorporation, not the bylaws of the company. *Id.* The Gilberts pointed out that "[n]o annual meetings [had] been held by Quarter Moon since 1986," but the initial directors continued to serve until 1989. *Id.* Although the court recognized Quarter Moon's documents failed to meet the statutory requirements, such noncompliance, "[did] not compel a holding that all actions taken by the board were void, or even voidable, including the election of Mr. Anderson and the decision to seek bankruptcy liquidation under these facts." *Id.* The court held the directors elected under Quarter Moon's bylaws "were at least *de facto* in status." *Id.* The court stated that since Mrs. Gilbert was one of those illegal directors, "equitable considerations . . . suggest she should not now be heard to complain." *Id.*

There were other instances of disregard of corporate formalities, such as the failure to hold annual meetings for several years. *Id.* The court suggested that "the most appropriate remedy would be an order compelling the corporation to bring its documents into compliance." *Id.* But "[a]s against third parties, such as corporate creditors (or their trustees), the corporation's actions should not be upset." *Id.*

54. *Id.* at 779-80.

55. *Id.* at 780 (citing IDAHO CODE § 30-1-79 (1980)).

56. *Id.*

57. 11 U.S.C. § 301 (1988).

petition must be filed by someone in the corporate enterprise with authority to act, as determined under state law.⁵⁸

A. Termination of the Corporate Existence

Under traditional corporation doctrine, the board of directors has the authority to act on behalf of and manage the corporation.⁵⁹ In the exercise of its corporate powers, the board of directors decides how the corporation's assets should be applied.⁶⁰ This power is limited, however, to matters occurring in the ordinary course of business.⁶¹ As an extraordinary act, voluntary dissolution of the corporation can be accomplished only with shareholder approval.⁶² Other acts or dispositions that result in fundamental or organic changes to the corporation or to shareholder rights, such as a merger or the sale of all or substantially all of the corporation's assets, also require shareholder assent.⁶³ Whether there has been a sale of all or substantially all

58. See *Price v. Gurney*, 324 U.S. 100, 106 (1945); *In re Giggles Restaurant*, 103 B.R. 549, 553 (Bankr. D. N.J. 1989); *In re The Hawaii Times, Ltd.*, 53 B.R. 560, 561 (Bankr. D. Haw. 1985); *In re Greater Atlanta Apartment Hunter's Guide*, 40 B.R. 29, 32 (Bankr. N.D. Ga. 1984); *In re Crescent Beach Inn*, 22 B.R. 155, 157-58 (Bankr. D. Me. 1982) (upholding unanimous decision by two-member board to file Chapter 11 petition); *In re Autumn Press*, 20 B.R. 60, 62 (Bankr. D. Mass. 1982) (dismissing Chapter 11 petition when signed by the sole director and the state statute required all corporations to have a minimum of three directors); *In re American Int'l Indus.*, 10 B.R. 695, 696 (Bankr. S.D. Fla. 1981); *Prosser v. Betty Brooks, Inc.*, No. 7938, 1985 WL 11577, at *2 (Del. Ch. 1985).

In *Prosser*, the plaintiff's motion for a preliminary injunction to restrain the consideration of the possible filing of a bankruptcy petition was denied, because if the filing were carried out in a manner in contravention of a shareholder's agreement, plaintiff had a remedy at law, *i.e.*, a motion directed to the bankruptcy court to dismiss the petition. *Prosser v. Betty Brooks, Inc.*, 1985 WL at *2. This was so because a bankruptcy court must determine "whether a voluntary petition for bankruptcy has been properly filed on behalf of the corporation by those empowered to take such action." *Id.* The bankruptcy court

undoubtedly could grant a request by plaintiff to dismiss the bankruptcy petition if it found that the action had not been properly authorized on behalf of the corporation because the directors failed to abstain from consideration of the matter if they were required to do so by the [shareholders'] [a]greement.

Id.

59. See, *e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991).

60. See, *e.g.*, *id.*

61. See, *e.g.*, *id.* ("the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"); see also MODEL BUSINESS CORP. ACT § 8.01(b) (1992) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors.").

62. See, *e.g.*, DEL. CODE ANN. tit. 8, § 275 (1991); see also MODEL BUSINESS CORP. ACT ANN. § 14.02 (1992).

63. See, *e.g.*, DEL. CODE ANN. tit. 8, § 251 (1991); see also MODEL BUSINESS CORP. ACT ANN. §§ 11.01, 12.02 (1992).

Under the short form merger doctrine, a corporation owning at least 90% of the outstanding shares of each class of another corporation may merge such other corporation into itself without

of the assets is not always obvious and must be determined by considering the relevant facts and circumstances of each case. The nature of the transaction and whether it furthers the express objectives of the corporation's existence is also relevant.⁶⁴ If the sale is the type of transaction for which the corporation was organized,⁶⁵ and the "effect does not work a practical dissolution of the corporate business,"⁶⁶ the transaction may be found to be in the regular course of business, thus eliminating the requirement of shareholder assent. These factors should not end the inquiry, however, because the quantity of the assets sold should also be considered. If the assets are quantitatively vital to the operation of the corporation and substantially affect the existence and purpose of the corporation, the transaction may be considered extraordinary.⁶⁷ The sale or transfer of major assets causing a

the approval of the shareholders of either corporation. See DEL. CODE ANN. tit. 8, § 253 (1991); N.Y. BUSINESS CORP. LAW § 905 (McKinney 1986).

Statutory provisions governing the sale of assets by a corporation have been enacted in every jurisdiction. See generally 6A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2949.2 (1989). The majority of these statutes make a distinction between when all, or substantially all, of the corporate assets are sold in the regular course of business and otherwise. *Id.* Shareholder assent is not required in the first instance, but is in the second. *Id.* According to Fletcher, some states make no distinction between the two types of transactions, in which case shareholder assent is required for all transfers of all, or substantially all of the corporate assets. *Id.* (listing Delaware, Florida, Kansas, Massachusetts, Nevada, and Oklahoma). In other states, the statutes list the circumstances in which shareholder approval is not required. *Id.* (1989 & Supp. 1992) (listing Louisiana).

64. *Katz v. Bregman*, 431 A.2d 1274, 1275 (Del. Ch. 1981) (holding sale of subsidiary representing 51% of corporation's pretax income in one year and when the corporation proposed to embark on a new line of manufacture, was a radical departure from corporation's historically successful line of business); *Philadelphia Nat'l Bank v. B.S.F. Co.*, 199 A.2d 557, 561 (Del. Ch.), *rev'd on other grounds*, 204 A.2d 746 (Del. Ch. 1969); *In re Miglietta*, 39 N.E.2d 224, 228 (N.Y. 1942); *In re Timmis*, 93 N.E. 522, 523 (N.Y. 1910).

65. *Keck Enter. v. Braunschweiger*, 108 F. Supp. 925, 928 (S.D. Cal. 1952) (holding that when corporation was organized to manufacture and sell certain games, sale of most of the corporation's product was in furtherance of the corporation's regular course of business); *Brown v. Eastern States Corp.*, 86 F. Supp. 887, 891 (D. Md.), *aff'd*, 181 F.2d 26 (4th Cir. 1949), *cert. denied*, 340 U.S. 864 (1950); *Morris v. Washington Medical Ctr.*, 331 A.2d 132, 137 (D.C. 1975); *Fettig v. Heinz Mfg.*, 270 N.E.2d 335, 336 (Ind. Ct. App. 1971); *In re Miglietta*, 39 N.E.2d at 226.

66. *In re United Gas Corp.*, 58 F. Supp. 501, 513 (D. Del. 1944), *aff'd*, 162 F.2d 409 (3d Cir. 1947); see also *Dukas v. Davis Aircraft Prods. Co.*, 516 N.Y.S.2d 781, 782 (N.Y. App. Div. 1987). In *Dukas*, the corporation was "engaged in the business of designing, manufacturing and selling restraints used in aircraft." *Dukas v. Davis Aircraft Prods. Co.*, 516 N.Y.S.2d at 782. The board contracted to exchange a building used for its operations for another. *Id.* The court held that because the corporation continued in the same business and operations, the transaction did not result in a liquidation of the business and shareholder approval was unnecessary. *Id.*

67. See *Vig v. Deka Realty Corp.*, 531 N.Y.S.2d 633, 634 (N.Y. App. Div. 1988). In *Vig*, the corporation was incorporated to "do everything suitable, proper and conducive to the successful conduct of a real estate business,' including the buying and selling of real property." *Id.* at 634. The corporation was largely dormant during its first two years. *Id.* Thereafter, it acquired the property at issue, which became the only significant asset of the corporation. *Id.* The corporation operated and managed the building located on the property for two years, but had no other business. *Id.* A shareholder challenged the sale on the ground it lacked shareholder

change in the nature of the corporate business or purpose is unusual and irregular.⁶⁸

There appears to be an exception to these general rules when the corporation is insolvent or in failing condition. A number of courts have held the board of directors alone may dispose of the entire assets to pay debts and avoid the execution of judgments by sale and their attendant losses.⁶⁹ The logic of this rule is that the shareholders' power to determine the course of the corporation is compromised because a third party, such as a creditor, can force a liquidation.⁷⁰

assent. *Id.* The court found the corporation's regular business was managing this one piece of property. *Id.* Thus, the sale constituted a sale of the corporation's sole asset and was not made in the usual course of business. *Id.* Consequently, shareholder assent was required. *Id.*

On the other hand, in *Gimbel v. Signal Cos.*, the court held the corporation's sale of all of its stock in a wholly-owned subsidiary was a transaction in the ordinary course of business. *Gimbel v. Signal Cos.*, 316 A.2d 599, 607-08 (Del. Ch.), *aff'd on other grounds*, 316 A.2d 619 (Del. 1974). The sale represented about 26% of the total assets of the corporation, 41% of the corporation's net worth, and 15% of the corporation's revenues and earnings. *Id.* at 607. The court held that "from a straight quantitative approach . . . the sale . . . does not constitute a sale of 'all or substantially all' of Signal's assets." *Id.* The court further held that the nature of the corporation's business contemplated the acquisition and disposal of independent branches of its corporate business. *Id.* at 607-08; *see also Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982) (holding sale of an asset representing at least 26% and possibly as much as 50% of a corporation's total assets is not a sale of substantially all of the assets).

68. *See Campbell v. Vose*, 515 F.2d 256, 259-60 (10th Cir. 1975) (holding transfer of all operating assets of a corporation to a wholly owned subsidiary required stockholder approval); *Katz v. Bregman*, 431 A.2d 1274, 1275-76 (Del. Ch. 1981) (holding proposed sale of substantially all assets of corporations required stockholder approval); *Gimbel v. Signal Cos.*, 316 A.2d at 606-08 (holding transactions in ordinary course of business do not require shareholder approval); *Schwadel v. Uchitel*, 455 So. 2d 401, 403 (Fla. Dist. Ct. App. 1984) (holding restaurant was sole asset of the corporation organized to engage in the restaurant business, therefore sale amounted to substantially all of the corporation's assets); *Stiles v. Aluminum Prods. Co.*, 86 N.E.2d 887, 888 (Ill. App. Ct. 1949) (holding manufacturing corporation's sale of all plants, tools, machinery, office equipment and furniture, trucks, inventory, goodwill and patents, but retention of the corporation's stock in a subsidiary, money in a bank, accounts receivable and securities, and an automobile was sale of "substantially all of the assets," other than in the regular course of business, which required shareholder assent); *see also Prince George's Country Club, Inc. v. Edward R. Carr, Inc.*, 202 A.2d 354, 351-60 (Md. 1964); *In re Timmis*, 93 N.E. 522 (N.Y. 1942). *But see Air Line Pilots Ass'n, Int'l v. Eastern Airlines*, 701 F. Supp. 865, 878-79 (D.D.C. 1988), *aff'd without opinion*, 889 F.2d 291 (D.C. Cir. 1989), *cert. dismissed*, 112 S. Ct. 37 (1991) (holding sale of shuttle operations representing only 2.9% of the corporation's total assets at net book value, 1.5% of its total operations and 4.3% of its total operating revenue was not a sale of substantially all assets).

69. *See FLETCHER*, *supra* note 63, § 2949.5; *see also Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 596-97 (1921); *McDaniel v. Frisco Employees' Hosp. Ass'n*, 510 S.W.2d 752, 753-58 (Mo. Ct. App. 1974); *Rocket Mining Corp. v. Gill*, 483 P.2d 897, 900-01 (Utah 1971).

Some state statutes authorize this act when the corporation is in a failing condition. *See, e.g., LA. REV. STAT. ANN. § 12:121* (West 1969 & Supp. 1992). *But see Michigan Wolverine Student Coop. v. Goodyear & Co.*, 22 N.W.2d 884, 888 (Mich. 1946).

70. Under the Bankruptcy Code, creditors can force a debtor into bankruptcy. The Code provides in pertinent part:

In a Chapter 7 proceeding the debtor's assets are determined, liquidated, and distributed to claimants and shareholders in order of priority.⁷¹ The *Quarter Moon* court did not find that the similar consequences of the two kinds of liquidation controlled its interpretation of the state law.⁷² The absence of a provision in the state statute requiring shareholder authorization for bankruptcy meant there was a difference between a sale of all assets under corporation doctrine and a liquidation in bankruptcy; thus, a decision to liquidate through a bankruptcy petition need not be approved by the shareholders.⁷³ The silence of state statutes, however, cannot be interpreted as a positive rule that the decision to pursue liquidation in bankruptcy is no different in kind and consequence than the decision to pursue, for example, business in corn farming in addition to cattle ranching.⁷⁴ Nevertheless, under the general principle that management of the corporation rests with the board of directors, shareholder assent would not be required.⁷⁵ Moreover, it is difficult to conceive of a Chapter 7 liquidation of assets representing 100% of a corporation's assets and 100% of its operations as anything but "a sale of all or substantially all of its assets," other than in the ordinary course of business.⁷⁶ The liquidation "work[s] a practical dissolution of the corporate business."⁷⁷

B. A Misreading of Precedent

In *Quarter Moon*, the Gilberts offered case law from other jurisdictions to support their argument that liquidation should be regarded as a sale of all or substantially all of the company's assets.⁷⁸ One case cited by the court, *In*

An involuntary case may be commenced only under Chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business or commercial corporation, that may be a debtor under the chapter under which such case is commenced.

11 U.S.C. § 303(a) (1991).

71. See *id.* §§ 501-520, 701-704, 726. In most Chapter 7 cases, a trustee is appointed, who is then authorized to gather the debtor's nonexempt property and convert it to cash. *Id.* §§ 701-704. The trustee then distributes the property according to a guideline provided by the Code. *Id.* § 701. Only an "individual" debtor is granted a full discharge. *Id.* § 727(a)(1). Corporations and partnerships may not be discharged with liquidation. *Id.* § 727(a).

72. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 779-80 (Bankr. D. Idaho 1990).

73. *Id.* at 779-80. The bankruptcy judge found it "curious why it is not mentioned expressly in either the provisions requiring shareholder approval, . . . or the provision providing for 'dissenters' rights." *Id.* at 780 n.3.

74. *Id.* at 780-81. The *Quarter Moon* court noted that dissenters' rights are not triggered under a court order. *Id.* at 780. Instead, the Bankruptcy Code provides the minority shareholders "with ample protection of their shareholder rights." *Id.*

75. *Id.*

76. *Id.* at 779-80.

77. *In re United Gas Corp.*, 58 F. Supp. 501, 513 (D. Del. 1944), *aff'd*, 162 F.2d 409 (3d Cir. 1947); see also *Dukas v. Davis Aircraft Prods. Co.*, 516 N.Y.S.2d 781, 782 (N.Y. App. Div. 1987).

78. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 780 (Bankr. D. Idaho 1990).

re Quartz Gold Mining Co.,⁷⁹ seemed on point. In *Quartz Gold*, creditors filed an involuntary petition against the corporation.⁸⁰ By a board resolution, the corporation admitted its inability to pay its debts and its willingness to be adjudged bankrupt.⁸¹ In an action challenging the board's power to take this action, the court stated:

It is not an ordinary power pertaining to the board to dissolve the corporation, or to wind out its business; and the [l]egislature of the state has declared that the stockholders may do these acts. So that, under the statute, the directors are without any power whatsoever in the premises. If they cannot authorize dissolution and a winding out of the business of the corporation, it would seem to logically follow that they could not, in behalf of and as the act of the corporation, commit an act of bankruptcy which entails an entire disposition of the assets of the concern and a full settlement of all its past business transactions, unless by some authority of the stockholders, through appropriate by-laws or specific resolutions empowering them so to act.⁸²

The *Quarter Moon* court rejected the case on this point without much explanation—it merely noted that it found other cases “which indicate that a bankruptcy filing may be authorized by the board alone.”⁸³ The court nonetheless adopted the *Quartz Gold* court's logic on the significance of corporate charter provisions.⁸⁴ The court proceeded from the presumption that the board held the sole power to liquidate the corporation in bankruptcy unless qualified either by the statute or the corporation's charter.⁸⁵ Finding no specific reference in the statute and no such qualification in the corporation's organizational documents, the court denied the shareholders' motion to dismiss.⁸⁶ Consider, however, the last two lines of the above quoted text from *Quartz Gold*.⁸⁷ The theory expressed is precisely the opposite of that adopted in *Quarter Moon*.⁸⁸ As stated in *Quartz Gold*, the power to liquidate in bankruptcy is held *jointly* by both the board and shareholders unless this

79. *In re Quartz Gold Mining Co.*, 157 F. 243 (D. Or. 1907), *aff'd sub nom.* Vindicator Consol. Gold Mining Co. v. Frankfort Marine Accident & Plate Glass Ins. Co., 158 F. 1022 (8th Cir. 1908).

80. *Id.* at 244.

81. *Id.*

82. *Id.* at 246.

83. *In re Quarter Moon Livestock Co.*, 116 Bankr. at 780.

84. *See id.* at 778-79.

85. *Id.* at 779-80.

86. *Id.* at 782. The court explained that because the sale or disposition of assets in bankruptcy would be effected under court order, dissenters' rights are denied because the judicial supervision would protect minority shareholders to the same extent as under dissenters' rights. *Id.* at 780.

87. *See supra* text accompanying note 82.

88. *See In re Quarter Moon Livestock Co.*, 116 B.R. at 780-81.

power is *denied* to the shareholders in the corporation's organizational documents.⁸⁹

The *Quarter Moon* court appeared to place great significance on *Royal Indemnity Co. v. American Bond & Mortgage Co.*,⁹⁰ a 1933 Supreme Court case.⁹¹

We are told that this [Maine corporation] statute prohibits the filing of a voluntary petition in bankruptcy by authority of a resolution of the board of directors, and that a shareholders' vote is required to authorize such action. No case decided by the Maine courts is cited in support of this assertion. But it is said that the filing of such a petition is a conveyance of all of the corporate property, and so plainly within the statutory prohibition. We cannot agree. . . . [I]t seems too plain to need elaboration that the statute does not in terms affect the initiation of a bankruptcy proceeding, and was passed for a wholly different purpose.⁹²

The *Quarter Moon* court, however, misread *Royal Indemnity*. Two questions were posed to the Supreme Court in *Royal Indemnity*:

[1] Has the location where a corporation maintained its main office and transacted most of its business ceased to be the principal place of business for the purposes of jurisdiction in bankruptcy if, during the greater portion of six months preceding the filing of the petition, the company's assets and affairs were in the custody and control of equity receivers? [2] Have creditors standing to ask the vacation of an adjudication based on a petition filed by the directors of the bankrupt, where a statute of the state of incorporation forbids transfer, except in the usual course of business, of the franchises or assets of the company, without stockholder's assent?⁹³

The Court answered both questions in the negative. Answering the second question, the Court held that "the petition in a voluntary or involuntary proceeding is a pleading,"⁹⁴ and that "[t]he entry of an adjudication vests title in the trustee, and this transfer of title is the act of the court, not of the petitioner."⁹⁵ Moreover, the Court found it self-evident that the statute at

89. See *In re Quartz Gold Mining Co.*, 157 F. at 246.

90. *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. 165 (1933).

91. See *In re Quarter Moon Livestock Co.*, 116 B.R. at 780.

92. *Id.* (quoting *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. at 170-71).

In *Quarter Moon*, the bankruptcy court also cited *In re High-Low Tank Car Service Stations*, 254 F.2d 363 (7th Cir. 1958), and *In re Pneumatic Tube Steam Splicer Co.*, 60 F.2d 524 (D.C. Md. 1932).

93. *Royal Indem. Co. v. American Bond & Mortgage Co.*, 289 U.S. at 166.

94. *Id.* at 171.

95. *Id.*

issue was not intended to affect the initiation of a bankruptcy proceeding.⁹⁶ The Court further explained its decision:

We might rest our decision as to the second question upon this ground. But there is another equally persuasive. Statutes such as the one relied on are intended for the protection of stockholders and have nothing to do with the interests or rights of creditors. *Even if* action of directors authorizing the filing of a voluntary petition, or admitting inability of the corporation to pay its debts and its willingness on that ground to be adjudged a bankrupt, thus creating an act of bankruptcy . . . were in excess of the authority conferred, or otherwise invalid, creditors could not for that reason attack the consequent adjudication. The question is purely one of the internal management of the corporation.⁹⁷

The language of the decision seems too plain. The Supreme Court did not decide whether under state law, the board alone could authorize the filing of a bankruptcy petition to liquidate. It did nothing more than decide that “[c]reditors have no standing to plead statutory requirements not intended for their protection.”⁹⁸ Other cases cited in *Quarter Moon* relied upon *Royal Indemnity* as controlling and reflected the same misreading.⁹⁹ *In re Quartz* squarely addressed the issue in *Quarter Moon*, and should have informed the bankruptcy court. Moreover, even if it is accepted that the bankruptcy court could properly decline to follow *In re Quartz* because it was from another jurisdiction, application of other corporation principles requires the same result.

96. *Id.*

97. *Id.* (citations omitted) (emphasis added).

98. *Id.*

99. See *In re Joseph Feld & Co.*, 38 F. Supp. 506 (D.N.J. 1941). The *Feld* court ruled that “[i]t appears to be well established in the absence of any restrictions, either under the charter or statute, a board of directors, without the consent of the stockholders, may authorize the filing of a voluntary petition in bankruptcy” and that “the right of directors to authorize bankruptcy is not inconsistent with the right of shareholders to authorize dissolution.” *Id.* at 507. The court nonetheless declined jurisdiction of the voluntary petition in bankruptcy because the meeting of the board of directors authorizing the institution of the bankruptcy proceeding did not comport with local law. *Id.* New Jersey law required due notice to all directors of the time, place, and subject of a meeting, absent waiver. *Id.* One of the three directors of the corporation neither attended the meeting authorizing the petition nor was notified of it; thus, the resolution was invalid. *Id.*; see also *Boyce v. Chemical Plastics*, 175 F.2d 839 (8th Cir.), *cert. denied*, 338 U.S. 828 (1949) (corporation was at all times insolvent and, under statute giving board power to manage the corporation, it had power to authorize the filing of a petition in voluntary bankruptcy); *In re Crescent Beach Inn*, 22 B.R. 155 (Bankr. D. Me. 1982) (authority to file bankruptcy petition depends on governing instruments of corporation and on state law).

C. Board Power and Discretion Under Traditional Corporation Doctrine

Traditional corporation doctrine developed to govern the operation and to foster the growth of the large, publicly held entity. Shareholders were passive investors and the entity was run by directors and officers whose power and discretion were limited primarily by the fiduciary duties of care and loyalty.¹⁰⁰ Even these constraints were lessened by the business judgment rule, a doctrine requiring judicial deference to decision-making by corporate managers.¹⁰¹ When corporate actions affected minority shareholders in a negative, though not improper or illegal fashion, such shareholders had recourse in the market because shares were freely transferable. Under this conception of the entity, liquidation of the large publicly held corporation through bankruptcy, rather than under the corporation statutes, probably made little difference to the average shareholder, whose investment involved no more than the price of the stock.¹⁰² A public corporation's liquidation in bankruptcy by the sole act of the board, however, raises a question that is beyond the scope of this Article.

D. Board Power and Discretion Under Close Corporation Doctrine

Liquidation of an otherwise profitable close corporation could mean financial ruin for the shareholder whose livelihood depends on the corporation. No single, generally accepted definition exists for the close corporation. Some commentators define a close corporation as an "integration of ownership and management," in which the stockholders occupy most management positions.¹⁰³ Others focus on the number of stockholders and the nature of

100. The duty of care requires directors and officers to act in good faith by exercising the degree of care as an ordinarily prudent person in like position under similar circumstances and in a manner he reasonably believes to be in the best interests of the corporation. See MODEL BUSINESS CORP. ACT ANN. §§ 8.30(a), 8.42(a) (1991). In its most rudimentary sense, this duty requires directors to be knowledgeable about the business, be fully informed before making a decision, and to investigate signs of trouble or improprieties by other actors. See *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981). The duty of loyalty requires honesty, candor, and a subordination of personal interests to those of the corporation. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. Ch. 1939), *aff'd*, 19 A.2d 721 (Del. 1941).

101. The business judgment rule is a presumption that in making decisions, the board of directors has acted in good faith, on an informed basis, and in the best interests of the corporation. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). To rebut the presumption, the shareholder has the burden to show the decision was tainted by fraud, self-interest, illegality, or some other improper conduct. See *Kamin v. American Express Co.*, 383 N.Y.S.2d 807, 812, *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

102. Of course, the stock's liquidating value is usually less than the going concern value. Accordingly, the shareholder in the public corporation suffers when she is denied the choice of selling her shares on the open market.

103. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02 (3d ed. 1988).

the market; in particular, a small, private, or nonexisting market.¹⁰⁴ Under the latter view, a close corporation has few stockholders and little market exists for corporate stock.¹⁰⁵ Indeed, the participants in a close corporation often restrict transfer of stock to control entry into the enterprise and to avoid a close relationship with incompatible persons.¹⁰⁶ The distinctive nature of a close corporation has been recognized since the late 1950s. Many states have enacted special close corporation codes or included special provisions in the general corporation statutes.¹⁰⁷

Beyond structural differences, a close corporation is functionally and philosophically different from a publicly held corporation. Close corporations are "companies based on personal relationships" that give rise to certain "reasonable expectations" on the part of those acquiring an interest in the entity.¹⁰⁸ These "reasonable expectations" are many, and concern matters beyond the basic right to vote for directors and to receive dividends.

Unlike the typical shareholder in a publicly held corporation, who may be simply an investor or a speculator and does not desire to assume the responsibilities of management, the shareholder in a close corporation

104. See *id.*; see also Robert B. Thompson, *Corporate Dissolution and Shareholders Reasonable Expectations*, 66 WASH. U. L.Q. 193, 196 (1988).

105. See *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 511 (Mass. 1975); *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989).

106. See O'NEAL & THOMPSON, *supra* note 103, § 7.02.

107. Defining the close corporation has not been a simple matter. Some state statutes omit a definition and simply afford greater flexibility to all corporations by reducing the minimum number of incorporators and directors required, and by relaxing the manner of taking action; *i.e.*, by permitting meetings by conference call and by written consent. Other states have enacted special close corporation statutes that define the entity. The Delaware General Corporation Law contains a subchapter pertaining exclusively to corporations whose issued shares must be held by not more than 30 persons, subject to one or more authorized restrictions on transfer, and not sold in any public offering within the meaning of the Securities Act of 1933. See DEL. CODE ANN. tit. 8, § 342 (1991).

For a discussion of the various legislative approaches to the close corporation see WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS* 262-66 (6th ed. 1988). Cary and Eisenberg state:

The major problem [with close corporation statutes] can be simply stated: Most of the statutes are for most purposes, applicable only to corporations that opt in, by an explicit election, for special statutory treatment. However, the data convincingly shows that only a tiny fraction of newly formed corporations elect such treatment. . . . The number of previously existing corporations that make such an election is undoubtedly even smaller. The result is that for many practical purposes, these statutes are much ado about nothing. Most of the modern statutes continue to leave close corporations in the lurch in important ways.

Id. at 266 (citations omitted); see also O'NEAL & THOMPSON, *supra* note 103, § 9.26.

108. F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 886-87 (1978); see also *Meiselman v. Meiselman*, 307 S.E.2d 551, 558 (N.C. 1983).

considers himself or herself as a co-owner of the business and wants the privileges and powers that go with ownership.¹⁰⁹

The shareholder's principal source of income is often work in the corporation.¹¹⁰ Moreover:

[The shareholder] may or may not anticipate an ultimate profit from the sale of his interest, but he normally draws very little from the corporation as dividends. In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.¹¹¹

Because close corporations are often formed by family members or friends, participants simply do not believe disagreements could ever arise to frustrate these "reasonable expectations." Thus, participants often fail to document their agreement or an understanding of their role in the company.¹¹² The following is a typical scenario:

[T]he minority party, because of lack of awareness of the risks, or because of the weakness of his bargaining position, fails to negotiate for protection. Probably a common instance of this kind occurs where an employee or an outsider is given an opportunity to buy stock in a close corporation wholly or substantially owned by a single stockholder or a small group of associations, often a family. . . . [H]is enthusiasm and weak bargaining position make it unlikely almost to a certainty that he will ask for—let alone insist upon—protection for his position as a minority stockholder.¹¹³

When dissension developed, American courts traditionally were reluctant to interfere in the internal affairs of corporations.¹¹⁴ This reluctance placed the minority shareholder in a remediless situation. The minority shareholder

109. O'NEAL & THOMPSON, *supra* note 103, § 1.07.

110. O'NEAL & THOMPSON, *supra* note 103, § 1.07; *see also* O'Neal, *supra* note 108, at 887.

111. F. HODGE O'NEAL, *CLOSE CORPORATIONS* 14 (1st ed. 1958).

112. O'Neal, *supra* note 108, at 886.

113. J.A.C. Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, U. ILL. L. F. 1, 17-18 (1969). Of course, if the parties could muster pragmatism as well as the necessary trust when they contemplate the formation of a close corporation, the statutes of many states would let them include a variety of provisions in the corporate documents to avoid, as well as resolve, disputes. For example, under the Delaware statute, the parties can adopt directors' agreements and shareholders' voting agreements. *See* DEL. CODE ANN. tit. 8, §§ 350, 355 (1991). They can agree to submit certain matters to binding arbitration, and can even agree to dissolve upon the occurrence of a certain event or contingency. *Id.*; *see also* N.Y. BUS. CORP. LAW § 1002 (McKinney 1986); S.C. CODE ANN. §§ 33-18-200 to -330 (Law Co-op 1990); TEX. BUS. CORP. ACT ANN. art. 12, § 32(A)(5) (West 1991).

114. O'Neal, *supra* note 108, at 884.

had neither a partner's power to dissolve the business unit at will, nor the "way out" open to a shareholder in a publicly held corporation, which was the opportunity to sell shares in the open market.¹¹⁵

The illiquidity of a minority shareholder's interest in a close corporation thus rendered the shareholder vulnerable to exploitation by the majority shareholders.¹¹⁶ The minority shareholder fell victim to the "freeze-out," in which the shareholder was denied employment in the company, and denied all other economic return on investment if a spiteful board refused to declare dividends or make other distributions.¹¹⁷

Until the last two decades, the duties of care and loyalty largely determined the rights and interests of close corporation participants. This was true even though courts found majority shareholders owed a heightened level of loyalty to minority shareholders. The majority shareholders' duty was similar to the duty partners owe each other in a partnership. The similarity is due to the fundamental resemblance between the two entities. In *Donahue v. Rodd Electrottype Co.*¹¹⁸ the court described the duty as "utmost good faith and loyalty."¹¹⁹ This heightened duty requires that "[i]f the majority undertakes, either directly or indirectly, through the directors, to conduct, manage, or direct the corporation's affairs, they must do so in good faith, and with an eye single to the best interests" of the corporation.¹²⁰ Thus, "majority or controlling shareholders breach [their] fiduciary duty to minority or noncontrolling [sic] shareholders when control of the close corporation is utilized to prevent the minority" or noncontrolling shareholders "from having an equal opportunity in the corporation."¹²¹ In *Quarter Moon*, the Chapter 7

115. O'NEAL, *supra* note 111, at 166-67.

116. O'NEAL, *supra* note 111, at 166-67. The close corporation is unique in that it poses the potential for abuse not only of the minority by the majority shareholders, but conversely. See *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798, 802 (Mass. 1981) (veto power under certificate of incorporation provision requiring 80% vote for corporate action held by a minority shareholder had the substantial effect of reversing the usual roles of the majority and the minority shareholders, such that the minority became an ad hoc controlling interest). The New York Court of Appeals also recognized this peculiar vulnerability. See *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1180 (N.Y. 1984) (holding that it would contravene the remedial purpose of the statute to permit its use by minority shareholders merely as a coercive tool and that the "minority shareholder whose own acts, made in bad faith and undertaken with a view toward forcing an involuntary dissolution, give rise to the complained-of oppression should be given no quarter in the statutory protection.").

117. See *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505, 513 (Mass. 1975); see also *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657, 662 (Mass. 1976).

118. *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505 (Mass. 1975).

119. *Id.* at 515; see also *Alaska Plastics v. Coppock*, 621 P.2d 270, 276 (Alaska 1980); *Tillis v. United Parts*, 395 So. 2d 618, 619 (Fla. Dist. Ct. App. 1981); *Horizon House Microwave v. Bazy*, 486 N.E.2d 70, 76 (Mass. App. Ct. 1985); *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989).

120. *Crosby v. Beam*, 548 N.E.2d at 221.

121. *Id.*; see also *Alaska Plastics v. Coppock*, 621 P.2d at 27; *Tillis v. United Parts*, 395 So. 2d at 619; *Wilkes v. Springside Nursing Home*, 353 N.E.2d at 662; *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d at 518.

petition was filed at the insistence of the Addlemans, who controlled the board after the death of one of the founding members.¹²² The filing denied the Gilberts an equal opportunity in decision making within the corporation.

In recent years, the seemingly stringent requirements of the duty of loyalty for close corporation participants have offered insufficient protection. For example, a minority shareholder's discharge from the corporate office, leaving him with no economic return except dividends, might be upheld under the business judgment rule when there is a business purpose and no showing of bad faith.¹²³ A purchase of stock from majority shareholders might not violate the duty of loyalty if the price paid was fair, although it might otherwise have been acquired at a lower price.¹²⁴ Minority shareholders, then, would be left without redress when "[t]he real vice of such actions lies in the fact that they treat shareholders unequally, defeat legitimate expectations of a sort found in closely, but not publicly, held corporations or both."¹²⁵

A "reasonable expectations" analysis is a judicial theory developed to fill this gap in corporate law. It departs from traditional corporation doctrine because the court's inquiry focuses on the impact of majority actions on minority shareholders, rather than on any particular wrongdoing by those in control.¹²⁶

122. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 777 (Bankr. D. Idaho 1990).

123. CARY & EISENBERG, *supra* note 107, at 460.

124. CARY & EISENBERG, *supra* note 107, at 460.

125. CARY & EISENBERG, *supra* note 107, at 460. *See also* *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657 (Mass. 1976). In *Wilkes*, the majority shareholders breached their fiduciary duty by removing a minority shareholder from the payroll of a close corporation, which had never paid a dividend, where there was no legitimate business purpose for the removal. *Wilkes v. Springside Nursing Home*, 353 N.E.2d at 664. The court held that even if the board is able to articulate a legitimate business purpose, a minority shareholder should have the opportunity to show that the same end could be achieved by some less harmful means. *Id.* at 663.

126. *See Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983). Under the corporation statute applied in *Meiselman*, the court was empowered to make such order or grant such relief, other than dissolution, . . . including . . . :
 (1) Canceling or altering any provision contained in the charter or by-laws of the corporation; or (2) Canceling, altering, or enjoining any resolution or other act of the corporation; or (3) Directing or prohibiting any act of the corporation or of shareholders, directors, officers or other persons party to the action; or (4) Providing for the purchase at their fair value of shares of any shareholder, either by the corporation or by other shareholders.

Id. at 564 (quoting N.C. GEN. STAT. § 55-125(a) (1973) (repealed 1989)). The general business corporation act was revised in 1989, and specifically mentions only the last described form of relief. It states: "In any proceeding brought by a shareholder . . . in which the court determines that dissolution would be appropriate, the court shall not order dissolution if, after such determination, the corporation elects to purchase the shares of the complaining shareholder at their fair value." N.C. GEN. STAT. § 55-14-31 (1991).

A few states have adopted statutes specifically incorporating reasonable expectations analysis to resolve shareholder disputes in a close corporation. *See, for example*, MINN. STAT. ANN. § 302A.751(3)(a) (West Supp. 1992), which states:

[Under the theory,] a court should give relief, dissolution or some other remedy to a minority shareholder whenever corporate managers or controlling shareholders act in a way that disappoints the minority shareholder's *reasonable expectations*, even though the acts of the managers or controlling shareholders fall within the literal scope of powers or rights granted them by the corporation act or the corporation's charter or bylaws.¹²⁷

Thus, in addition to those shareholder rights found under traditional corporation doctrine, such as the right to vote, inspect records, and receive dividends, the rights and interests of close corporation participants include those derived from their reasonable expectations. These include a right to continued employment,¹²⁸ "fringe benefits which flow from association with

In determining whether to order equitable relief, dissolution, or a buy-out, the court shall take into consideration the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair, and reasonable manner in operation of the corporation and the reasonable expectations of the shareholders as they exist at the inception and develop during the course of the shareholders' relationship with the corporation and with each other.

Id.; see also CAL. CORP. CODE § 1804 (West 1990); N.D. CENT. CODE § 10-19.1-115 (1985); REVISED MODEL BUSINESS CORP. ACT, MODEL STAT. CLOSE CORP. SUPP. § 41(a) (1989).

The courts in several other jurisdictions have adopted the analysis, particularly in petitions for dissolution. See, e.g., *O'Donnel v. Marine Repair Servs.*, 530 F. Supp. 1199, 1207 (S.D.N.Y. 1982); *Stumpf v. C.E. Stumpf & Sons, Inc.*, 120 Cal. Rptr. 671, 673-75 (Ct. App. 1975); *Jaffee Commercial Fin. Co. v. Harris*, 456 N.E.2d 224, 229-32 (Ill. App. Ct. 1983); *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554, 561-62 (N.J. Super. 1979), *aff'd*, 414 A.2d 994 (N.J. Super. Ct. App. Div. 1980); *In re Kemp & Beatley*, 473 N.E.2d 1173, 1179 (N.Y. 1984); *In re Gene Barry One Hour Photo Processing*, 444 N.Y.S.2d 540, 543, 545 (N.Y. Sup. Ct. 1981); *In re Wiedy's Furniture Clearance Ctr. Co.*, 487 N.Y.S.2d 901, 903 (N.Y. App. Div. 1985); *Baker v. Commercial Body Builders*, 507 P.2d 387, 393-95 (Or. 1973); see also *Thompson*, *supra* note 104, at 216-19.

127. O'Neal, *supra* note 108, at 886 (emphasis added).

128. See generally *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657 (Mass. 1976); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987). But see *Ingle v. Glamore Motor Sales*, 535 N.E.2d 1311 (N.Y. 1989). In *Ingle* the court held a shareholder who was an at-will employee could be discharged under common law employee at-will and contract principles when the employee failed to plead that his discharge was designed to preclude his assertion of legal rights. *Ingle v. Glamore Motor Sales*, 535 N.E.2d at 1314. In rejecting the assertion of an exception to these principles in the case of close corporations, the court stated: "No duty of loyalty and good faith akin to that between partners, precluding termination except for cause, arises among those operating a business in the corporate form who have only the rights, duties and obligations of stockholders' and not those of partners." *Id.* (quoting *Weismann v. Awnair Corp.*, 144 N.E.2d 415, 418 (N.Y. 1957)). The dissent offered a different perspective on the plight of the close corporation shareholder:

[W]hether it be lack of mutuality or lack of consideration, the rationale for the employment at-will rule does not fit the situation of the typical minority shareholder-participant in a close corporation. For such participant is *not truly free* to quit at any time; and *there is consideration* which would support an implied understanding that, at least, the majority owner will not discharge him arbitrarily or in bad faith and without some legitimate business reason. Unlike the employee of a large corporation, the

the corporation,"¹²⁹ equal opportunities to sell stock to the corporation,¹³⁰ the continuation of long-standing distribution policies,¹³¹ "and meaningful participation in the management of the family business."¹³² In *Meiselman v. Meiselman*,¹³³ the North Carolina Supreme Court explained that "reasonable expectations" must be ascertained by

examining the entire history of the participants' relationship. That history will include the 'reasonable expectations' created at the inception of the participants' relationship; those 'reasonable expectations' as altered over time; and the 'reasonable expectations' which develop as the participants engage in a course of dealing in conducting the affairs of the corporation. The interests and views of the other participants must be considered in determining 'reasonable expectations.' . . . [T]hey must be known to or assumed by the other shareholders and concurred in by them. . . . Privately held expectations which are not made known to the other participants are not 'reasonable.'¹³⁴

As shareholder rights expand, the powers and prerogatives of the board of directors contract. Thus, when the immediate effect on minority shareholders is a freeze-out or a denial of other substantive rights as discerned

minority shareholder in a close corporation has typically invested a large percentage of his financial wherewithal in the business. He has been willing to do so because of what he expects will be his long-term association with the business and his ability to protect his investment and, he hopes, to make it grow. The same features of the minority owner-participant's status which makes him particularly vulnerable to action by the majority obviously work to compel him to stay on the job. He needs to do so to protect his investment and to share in any increase in its value.

Id. at 1321 (Hancock, J., dissenting).

129. *Meiselman v. Meiselman*, 307 S.E.2d 551, 564-65 (N.C. 1983).

130. See *Sugarman v. Sugarman*, 797 F.2d 3, 9-11 (1st Cir. 1986); *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 518 (Mass. 1975).

131. *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1180-81 (N.Y. 1984). The close corporation in *Kemp* was incorporated to design and manufacture table linens and sundry tabletop items. *Id.* at 1176. One petitioner, Dissen, a minority stockholder, had been employed by the company for 42 years, serving as vice president and a director before he resigned. *Id.* The other petitioner, Gardstein, also a minority stockholder, had been employed by the company for 35 years. *Id.* His employment was terminated in December 1980. *Id.* Apparent unhappiness surrounded petitioners' departure from the company. *Id.* Of particular concern, they no longer received any distribution of the company's earnings. *Id.* It had been a "long-standing company policy to declare *de facto* dividends based on stock ownership in the form of 'extra compensation bonuses.'" *Id.* at 1180. "[E]ither shortly before or shortly after petitioners' employment ended, this policy was changed." *Id.* Although extra compensation was still awarded by the company, it was no longer based on stock ownership, but on services rendered to the corporation. *Id.* "[T]his change in policy amounted to nothing less than an attempt to exclude petitioners from gaining any return on their investment through the mere recharacterization of distributions of corporate income." *Id.*

132. *Meiselman v. Meiselman*, 307 S.E.2d at 558, 565.

133. *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983).

134. *Id.* at 563.

from their reasonable expectations, a defense that the board's act is supported by a legitimate business purpose or was in the best interests of the corporation is insufficient. In a close corporation the authority of the board to act must be determined by an assessment of the parties' "reasonable expectations." A court should ascertain the parties' understanding or agreements on the balance of power, participation in management and policy decisions, and the issues precipitating the bankruptcy solution. In *Quarter Moon*, the stock was evenly divided; the Gilberts therefore could reasonably expect that they would share control and decision-making, and that the corporation would not be placed in a Chapter 7 liquidation proceeding without their consent.

E. Dissolution as a Discretionary Remedy

As the facts of *Quarter Moon* indicate, it was the Gilberts who first sought dissolution of the corporation under state law.¹³⁵ Should the Gilberts therefore be allowed to complain about the corporation's petition to liquidate under the bankruptcy code? The court believed the Gilberts filed the state court action to dissolve because of unresolvable deadlock among the shareholders.¹³⁶ A number of state statutes provide for involuntary dissolution on a showing of deadlock, but these statutes are generally interpreted to make dissolution discretionary even when deadlock is shown to exist.¹³⁷

135. The Idaho Code gives a court the power to "liquidate the assets and business of a corporation" in an action by a shareholder upon a showing:

- (1) That the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is being suffered or is threatened by reason thereof; or
- (2) That the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent and that irreparable injury to the corporation is being suffered or is threatened by reason thereof; or
- (3) That the shareholders are deadlocked in voting power, and have failed, for a period which includes at least two (2) consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election of their successors[.]

IDAHO CODE § 30-1-97 (1948). The Idaho Code also provides that in proceedings to liquidate, "the court shall have power to issue injunctions, [and] to appoint a receiver, with such powers and duties as the court" deems proper. *Id.* § 30-1-98.

136. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 781 (Bankr. D. Idaho 1990).

137. CARY & EISENBERG, *supra* note 107, at 446; see also *Gillingham v. Swan Falls Land & Cattle Co.*, 683 P.2d 895, 897 (Idaho Ct. App. 1984). In *Gillingham*, the court noted:

When the statutory requirements for liquidating a deadlocked corporation are met, a court may liquidate the corporate assets, but is not compelled to do so. [Idaho Code § 30-1-97] gives the court discretion to grant or deny a petition . . . that discretion should be exercised in light of the relevant factors which are reflected in the circumstances of the case and the relevant interests which are to be served.

Gillingham v. Swan Falls Land & Cattle Co., 683 P.2d at 897. Consider also § 14.30 of the Model Business Corp. Act, which states:

Grounds for Judicial Dissolution

The [. . . court . . .] may dissolve a corporation:

Courts have been reluctant to order the dissolution of a profitable corporation on deadlock grounds when the attendant economic costs (loss of going concern value) and social costs (the effects of one person's conduct or consumption on the welfare of others) overwhelm the expected benefits.¹³⁸ Although disso-

....
(2) in a proceeding by a shareholder if it is established that:

- (i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;
- (ii) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;
- (iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or
- (iv) the corporate assets are being misapplied or wasted . . .

MODEL BUSINESS CORP. ACT ANN. § 14.30 (Supp. 1992); *see also* N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986). *See generally* John E. Davidian, *Corporation Dissolution in New York: Liberalizing the Rights of Minority Shareholders*, 56 ST. JOHN'S L. REV. 24 (1981).

Shareholders in close corporations seek dissolution not solely because of deadlock, but often in response to conduct deemed oppressive or injurious to other rights or interests in the corporation. Courts have long maintained the power, based on equitable principles, to dissolve a corporation in cases involving oppression. *See* *Stefano v. Coppock*, 705 P.2d 443, 445-46 (Alaska 1985); *Rowland v. Rowland*, 633 P.2d 599, 605 (Idaho 1981); *Liebert v. Clapp*, 196 N.E.2d 540, 541-42 (N.Y. 1963); *Kruger v. Gerth*, 255 N.Y.S.2d 498, 500 (N.Y. Sup. Ct. 1964), *aff'd mem.*, 263 N.Y.S.2d 1 (N.Y. 1965).

The concept of oppression resists precise definition in the statutes and cases, although most would agree the term contemplates certain unjust, unfair, and perhaps harsh, conduct. A useful articulation of the concept is found in a recent Oregon decision:

[Oppression is] "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."

Baker v. Commercial Body Builders, 507 P.2d 387, 393 (Or. 1973) (citations omitted). An Illinois court described oppressive conduct as an "arbitrary, overbearing and heavy-handed course of conduct." *Compton v. Paul K. Harding Realty Co.*, 285 N.E.2d 574, 581 (Ill. App. Ct. 1972).

Reasonable expectations analysis has found application in oppression cases. In *Kemp & Beatley*, the court stated:

[T]he question [of oppression] has been resolved by considering oppressive actions to refer to conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise. . . . A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.

In re Kemp v. Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984); *see also* *Stefano v. Coppock*, 705 P.2d at 446; *Graham v. Mimms*, 444 N.E.2d 549, 556-60 (Ill. App. Ct. 1982); *Balvik v. Sylvester*, 411 N.W.2d 383, 385-88 (N.D. 1987).

138. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). In a dissolution of a profitable enterprise, participants suffer a loss of going-concern value of their investment,

lution for profitable companies may function as a price-fixing mechanism for an eventual buy-out, it is a cumbersome, inefficient, and costly process.¹³⁹ In addition, the general reluctance to order a profitable firm's dissolution also reflects a sense that the reasons for seeking this remedy include issues other than the firm's ability to function.

thereby reducing the total capital available for reinvestment or other consumption; employees suffer loss of employment and consequently a loss of net income; suppliers suffer a reduction of income from the loss of a customer; and consumers generally may suffer losses in the form of higher prices to the extent that the dissolution produces a measurable loss in competition. There are similar costs associated with bankruptcy:

In practice, bankruptcy is not costless, but generally involves an adjudication process which itself consumes a fraction of the remaining value of the assets of the firm. Thus the cost of bankruptcy will be of concern to potential buyers of fixed claims in the firm since their existence will reduce the payoffs to them in the event of bankruptcy The price buyers will be willing to pay for fixed claims will thus be inversely related to the probability of bankruptcy.

. . . . As the probability of bankruptcy increases, both the operating costs and the revenues of the firm are adversely affected. . . . For example, a firm with a high probability of bankruptcy will also find that it must pay higher salaries to induce executives to accept the higher risk of unemployment. Furthermore, in certain kinds of durable goods industries the demand function for the firm's product will not be independent of the probability of bankruptcy. The computer industry is a good example. There, the buyer's welfare is dependent to a significant extent on the ability to maintain the equipment, and on continuous hardware and software development. Furthermore, the owner of a large computer often receives benefits from the software developments of other users. Thus if the manufacturer leaves the business or loses his software support and development experts because of financial difficulties, the value of the equipment to his users will decline. The buyers of such services have a continuing interest in the manufacturer's viability[,] [with] their benefits com[ing] in the form of continuing services at lower cost.

Herbert L. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 320 (1976); see also 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, 27-34 (1977); Carlos L. Israels, *Problem of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952); Steven Wimpfheimer & Susan Dunn, *Corporate Squeeze Out: Aspects of Valuation*, 58 N.Y.S.B.J. 32 (1986); *Recent Cases, Deadlocked Corporation Warrants Dismissal of Dissolution Petition Without a Hearing*, 68 HARV. L. REV. 714 (1955).

A number of courts have also recognized the costs associated with bankruptcy. See *Hendley v. Lee*, 676 F. Supp. 1317, 1324 (D.S.C. 1987); *Rowland v. Rowland*, 633 P.2d 599, 606 (Idaho 1981); *Poliakoff v. Dole & Clark Bldg. Corp.*, 184 N.E.2d 792, 795-96 (Ill. App. Ct. 1962); *Fix v. Fix Material Co.*, 538 S.W.2d 351, 358-59 (Mo. Ct. App. 1976); *Gonseth v. K & K Oil Co.*, 439 S.W.2d 18, 26-27 (Mo. Ct. App. 1969); *In re Radom & Neidorff*, 119 N.E.2d 563, 565 (N.Y. 1954); *Baker v. Commercial Body Builders*, 507 P.2d 387, 395 (Or. 1973). *But see Stumpf v. C.E. Stumpf & Sons, Inc.*, 120 Cal. Rptr. 671, 674-75 (Ct. App. 1975); *Gidwitz v. Lanzit Corrugated Box Co.*, 170 N.E.2d 131, 138 (Ill. App. Ct. 1960); see also N.Y. BUSINESS CORP. LAW § 1111(b)(3) (McKinney 1992) ("dissolution is not to be denied merely because it is found that the corporate business has been or could be conducted at a profit"); MODEL BUSINESS CORP. ACT, MODEL STATUTORY CLOSE CORP. SUPP. § 43(b) (1989).

139. Hetherington & Dooley, *supra* note 138, at 27-34.

[E]xcept for the rare case where the petition is prompted by pique, a shareholder suing for dissolution is trying to accomplish one of three things: (1) to withdraw his investment from the firm; (2) to induce the other shareholders to sell out to him; (3) to use the threat of dissolution to induce the other shareholders to agree to a change in the balance of power or in the policies of the firm.¹⁴⁰

Two often cited New York cases illustrate the parties' and the courts' dilemma in these cases. In *In re Radom & Neidorff, Inc.*,¹⁴¹ Henry Neidorff and his brother-in-law, David Radom, were the sole and equal shareholders of a corporation engaged in the business of printing musical compositions.¹⁴² Henry died and left his stock to his wife, Anna, who was also David's sister.¹⁴³ Anna and David were estranged, and five months after Henry's death, David brought a proceeding to dissolve the corporation under the state statute.¹⁴⁴ David's petition stated that the corporation was successful, but Anna had refused to cooperate with David as president and had refused to sign his salary checks, thereby making it impossible to elect directors because of unresolved agreements.¹⁴⁵

The court of appeals reversed the lower court's order granting dissolution.¹⁴⁶ They apparently relied in part on the statute, which provided that "if upon the application for the final order for involuntary dissolution it shall appear that . . . dissolution will be beneficial to the stockholders [or members] . . . and not injurious to the public, the court must make a final order dissolving the corporation."¹⁴⁷ Nevertheless, the court explained that its power to order the dissolution of a corporation was discretionary and there was no absolute right to dissolution under the circumstances.¹⁴⁸ Instead, the order is granted only when the competing interests "are so discordant as to prevent efficient management' and the 'object of its corporate existence cannot be attained.'"¹⁴⁹ "[T]he primary inquiry is, always . . . whether judicially-imposed death 'will be beneficial to the stockholders or members and not injurious to the public.'"¹⁵⁰

140. Hetherington & Dooley, *supra* note 138, at 27. The authors propose a statutory reform to provide each shareholder with an automatic and unconditional right to demand that the corporation or the remaining shareholders purchase his shares at a price determined by agreement or appraisal. Hetherington & Dooley, *supra* note 138, at 1-3, 6.

141. *In re Radom & Neideroff*, 119 N.E.2d 563 (N.Y. 1954).

142. *Id.*

143. *Id.*

144. *Id.* at 563-64.

145. *Id.* at 564.

146. *Id.* at 565.

147. *Id.* at 569 (Fuld, J., dissenting).

148. *Id.* at 565.

149. *Id.* (quoting *In re Importers' & Grocers' Exch.*, 30 N.E. 401, 404 (N.Y. 1892)).

150. *Id.* (quoting *In re Importers' & Grocers' Exch.*, 30 N.E. at 404).

The corporation at issue was flourishing and making profits.¹⁵¹ Thus, court-ordered dissolution would leave Anna with only the liquidated value of the corporate assets, while David would have the going-concern value because he had the skill and associations to continue to operate the business.¹⁵²

In *Wollman v. Littman*,¹⁵³ the stock of the corporation was held equally by two distinct groups.¹⁵⁴ Each group had equal representation on the board of directors.¹⁵⁵ The corporation sold fabrics to garment manufacturers.¹⁵⁶ The plaintiffs were the daughters of the main stockholder of Louis Nierenberg, Inc., who procured the fabrics and sold them to the corporation.¹⁵⁷ In an earlier suit, the defendants charged that the plaintiffs and Louis Nierenberg, Inc. had lured away the corporation's customers to Louis Nierenberg, Inc., and had engaged in other "acts to affect the corporation's business adversely."¹⁵⁸ The plaintiffs countered with the suit for dissolution, claiming the earlier action indicated effective management was impossible.¹⁵⁹ The court explained that "irreconcilable differences even among an evenly divided board of directors do not in all cases mandate dissolution."¹⁶⁰ Rather,

a dissolution which will render nugatory the relief sought in the representative action would actually accomplish the wrongful purpose . . . [the Nierenbergs] are charged with in that action. It would not only squeeze the Littmans out of the business but would require the receiver to dispose of the inventory with the Nierenbergs the only interested purchaser financially strong enough to take advantage of the situation. Such a result, if supported by the facts, would be intolerable to a court of equity.¹⁶¹

Under the terms of [the current New York] statute, courts are instructed to consider both whether "liquidation of the corporation is the only feasible means to protect the complaining shareholder's expectation of a fair return on his or her investment" and whether "dissolution 'is reasonably necessary' to protect 'the rights or interests of any substantial number of shareholders' not limited to those complaining."¹⁶²

151. *Id.* at 564.

152. See Abram Chayes, *Madam Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1546-47 (1960) for an interesting comment on this case.

153. *Wollman v. Littman*, 316 N.Y.S.2d 526 (1970).

154. *Id.* at 527.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *In re Kemp & Beatley*, 484 N.Y.S.2d 799, 806 (N.Y. 1984). "Every order of dissolution, however, must be conditioned upon permitting any shareholder of the corporation to elect to

This limitation on a shareholder's right to dissolve has both philosophical and practical foundations. A right to withdraw capital from the firm, by an automatic buy-out provision or dissolution, may encourage opportunistic behavior by the minority. Persons with a relatively smaller stake in the enterprise are given the ability to impose costs on the others that would not be incurred under traditional fiduciary duty analysis, which requires a showing of some kind of fault for dissolution.¹⁶³ An absolute right to dissolve or withdraw capital would reverse the basic corporation majority rule principle and perhaps unfairly deprive the majority of a bargained-for veto of corporate decisions.¹⁶⁴ Similarly, a board of directors' unilateral power to dissolve the corporation through bankruptcy denies minority or non-controlling shareholders bargained-for and law-given rights, including those derived from reasonable expectations. In the context of intracorporate disputes, these rights include not only the right to vote on a fundamental matter like a dissolution, but also a right to a hearing on the wisdom and necessity of a dissolution and a right to a consideration of alternatives to dissolution.

V. LACK OF GOOD FAITH UNDER THE BANKRUPTCY CODE

Earlier in this Article some recent nonfinancial, but "tactical" and "creative" uses of the Bankruptcy Code by large, public corporations were noted.¹⁶⁵ Those who have studied the issue argue that such strategic uses by close and public corporations are not unqualified, but are limited by a "good faith" test.¹⁶⁶ Although the 1978 Bankruptcy Code did not expressly require

purchase the complaining shareholder's stock at fair value." *Id.* (citing N.Y. BUS. CORP. LAW § 1118 (McKinney 1979) (amended 1986)).

163. O'NEAL & THOMPSON, *supra* note 103, § 9.06.

164. O'NEAL & THOMPSON, *supra* note 103, § 9.06.

165. *See supra* text accompanying notes 69-99.

166. Ponoroff & Knippenberg, *supra* note 19, at 947. *See generally* DOUGLASS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY (2d ed. 1990); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987) (reviewing THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986)).

Some scholars have argued these new strategic and technical uses of bankruptcy reveal deeper problems residing in our economic and commercial systems. Petitioners are not solely seeking relief in a common pool problem, but rule changes: in labor law, the right unilaterally to terminate a collective bargaining agreement (as Continental and Eastern Airlines sought); in property law, the right to modify the force of a lien (like Texaco in the Pennzoil litigation); in tort law, the right to limit the amount and types of recoverable damages (as Johns-Manville in the asbestos litigation). *See* JACKSON, *supra*, at 195; Ponoroff & Knippenberg, *supra* note 19, at 968. Consider the following scenario: A debtor forms a new corporation on the eve of bankruptcy and

that a voluntary liquidation petition be filed in "good faith," a 1984 amendment added section 707(b), which provides that a Chapter 7 petition, in the limited context of an individual consumer debtor, may be dismissed if the court finds the filing to be a substantial abuse of the spirit of the law.¹⁶⁷ Even before the enactment of section 707(b), a considerable body of case law had developed that supports the theory that the bankruptcy court has the inherent power to dismiss any voluntary petition filed for fraudulent purposes or lacking good faith.¹⁶⁸ The good faith test has at least two aspects; one concerned with accomplishing the end purposes of the bankruptcy process, with primary reference to federal law, and the other concerned with protecting the sanctity of the court from abusive and fraudulent conduct, as these are conceived under state law.¹⁶⁹

A. *Achieving the End Purposes of Bankruptcy*

In a recent examination of the issue, two scholars¹⁷⁰ described the two predominant schools of thought on the purpose of bankruptcy. They wrote of "collectivism" and "the traditional theory."¹⁷¹ Collectivism holds that the

the secured assets of the debtor are placed in that new corporation. The corporation then files for bankruptcy. Jackson points out this is clearly not a common pool problem:

Instead, they reflect the consequences of a shift in relative values. . . . When the effect of using bankruptcy is to under-compensate secured creditors, delay works to the interest of the debtor or unsecured creditors because some of the costs of the delay are borne by the secured creditors. Such under-compensation, therefore, reflects another change in relative values that induces bankruptcy filings for purposes other than solving common pool problems.

JACKSON, *supra*, at 185. The mixed motive cases present a difficult problem, however, as the exercise of jurisdiction in such cases may in fact accomplish some sort of rule change, or at a minimum, some shift in the balance of power between the parties. The courts should accept only "those cases where there is likely to be a common pool problem and to exclude those cases that are likely to be fueled simply by a selfish claimant seeking a strategic advantage." JACKSON, *supra*, at 199.

167. 11 U.S.C. § 707(b) (1986); *see also* GEORGE M. TREISTER ET AL., *FUNDAMENTALS OF BANKRUPTCY LAW* 109 (2d ed. 1988) ("Only the court itself and the United States trustee have standing to raise this ground.").

168. *See, e.g.*, *Porterfield v. Gerstel*, 222 F.2d 137, 140 (5th Cir. 1955); *Zeitinger v. Hargadine-McKittrick Dry Goods Co.*, 244 F. 719, 722-23 (8th Cir.), *cert. denied*, 245 U.S. 667 (1917); *see also* JACKSON, *supra* note 166, at 193-203; TREISTER et al., *supra* note 167, at 109; Daniel J. Tyukody, Jr., *Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause*, 52 U. CHI. L. REV. 795 (1985). The good faith filing cases are legion. For a comprehensive collection and discussion of these cases, *see* Ordin, *infra* note 178 and Ponoroff & Knippenberg, *supra* note 19. For a history of the good faith requirement in bankruptcy doctrine *see In re Victory Constr. Co.*, 9 B.R. 549, 551-60 (Bankr. C.D. Cal. 1981).

169. *See In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072 (5th Cir. 1986); *In re Johns-Manville Corp.*, 36 B.R. 727, 733-38 (Bankr. S.D.N.Y. 1986); *In re Dutch Flat Inv. Co.*, 6 B.R. 470, 471-72 (Bankr. N.D. Ga. 1980); *In re Northwest Recreational Activities*, 4 B.R. 36, 38-43 (Bankr. N.D. Ga. 1980).

170. Ponoroff & Knippenberg, *supra* note 19, at 919.

171. Ponoroff & Knippenberg, *supra* note 19, at 948.

single end purpose of bankruptcy is or should be efficient debt collection.¹⁷² Under this theory, "bankruptcy is properly invoked only in response to a common pool problem . . . [i.e., a] situation created when a debtor's assets are insufficient to satisfy the demands of a common pool of claimants,"¹⁷³ and for the purpose of achieving maximum asset values.¹⁷⁴ The traditional view holds that "the bankruptcy system is and should be designed to address a broad range of interests affected by the collapse of a debtor enterprise."¹⁷⁵ "It avoids relegating the bankruptcy process to the status of a mere alternate debt collection device by seeking to protect the interest of non-creditors . . . victims of firm failure [that] would otherwise lack a champion."¹⁷⁶ This view "regards the central purpose of bankruptcy . . . as the apportionment of losses occasioned by firm collapse according to a set of principles, none of which being pre-eminent by definition."¹⁷⁷

One may invoke the protective provisions of the bankruptcy laws only for the historical and expressed legislative aims of bankruptcy.¹⁷⁸ Under

172. Ponoroff & Knippenberg, *supra* note 19, at 949-50.

173. Ponoroff & Knippenberg, *supra* note 19, at 950.

174. Ponoroff & Knippenberg, *supra* note 19, at 950-51. "Collectivism' . . . should be taken to mean the set of shared fundamental assumptions and postulates of a group of scholars writing mainly from an economics-based perspective of the law." Ponoroff & Knippenberg, *supra* note 19, at 949. Another commentator writes:

Bankruptcy law historically has done two things: allowed for some sort of a financial fresh start for individuals and provided creditors with a compulsory and collective forum to sort out their relative entitlement to a debtor's assets.

JACKSON, *supra* note 162, at 4.

175. Ponoroff & Knippenberg, *supra* note 19, at 961.

176. Ponoroff & Knippenberg, *supra* note 19, at 960.

177. Ponoroff & Knippenberg, *supra* note 19, at 962. The authors state their own view: First, we assume that no fixed purpose or even set of purposes is discoverable or, for that matter, imminent in the law of bankruptcy. . . . [W]e deny the permanent hegemony of an original first principle and, concomitantly, of a systematically knowable, ideal bankruptcy policy at work that is merely imperfectly expressed in bankruptcy law. The search for an immutable, ideal purpose or set of purposes is, therefore, necessarily an exercise in normative advocacy, not discovery.

Ponoroff & Knippenberg, *supra* note 19, at 962. The authors note that "courts have shown no inclination to reduce the number or limit the kinds of problems brought to the bankruptcy forum according to a single, agreed upon fundamental principle." Ponoroff & Knippenberg, *supra* note 19, at 966.

[Rather,] bankruptcy has evolved into a legal institution to which commercial concerns, both large and small, have turned to resolve basic business and economic problems that are not satisfactorily addressed elsewhere. In many instances, these problems are related only incidentally, if at all, to the problems of default and immediate financial ruin.

Ponoroff & Knippenberg, *supra* note 19, at 966. The courts have strived to limit access to bankruptcy relief based on the good faith test. Ponoroff & Knippenberg, *supra* note 19, at 970.

178. *In re Mogul*, 17 B.R. 680, 681 (Bankr. M.D. Fla. 1982); *see also In re Levinsky*, 23 B.R. 210, 215 (Bankr. E.D.N.Y. 1982); *In re 299 Jack-Hemp Assoc.*, 20 B.R. 412, 413 (Bankr. S.D.N.Y. 1982); *In re Century City, Inc.*, 8 B.R. 25, 31 (Bankr. D.N.J. 1980); *In re G-2 Realty Trust*, 6 B.R. 549, 552 (Bankr. D. Mass. 1980); *In re Tolco Properties, Inc.*, 6 B.R. 482, 487 (Bankr. E.D. Va.

either theory, a petition which reflects an intent to abuse the judicial process and the purpose of the code provisions¹⁷⁹ is inconsistent with the purposes of bankruptcy¹⁸⁰ and may be dismissed as lacking good faith.¹⁸¹ For example, courts have held the following tactics reflect a lack of good faith, and have dismissed petitions furthering them: Creating and organizing a new business rather than reorganizing, rehabilitating, or preserving an existing viable business;¹⁸² evading contractual obligations;¹⁸³ and delaying exercise of secured creditors' legitimate state law rights and remedies.¹⁸⁴ Also, petitions filed solely to create the automatic stay,¹⁸⁵ to carry out tax avoidance

1980); *In re Dutch Flat Inv. Co.*, 6 B.R. 470, 471 (Bankr. N.D. Cal. 1980); *In re Northwest Recreational Activities*, 4 B.R. 36, 42 (Bankr. N.D. Ga. 1980); JACKSON, *supra* note 166, at 194-95. See generally Robert L. Ordin, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 BUS. LAW. 1795 (1983); Ponoroff & Knippenberg, *supra* note 19.

179. In Chapter 11 cases, findings of lack of good faith have been based on the presence of certain recurring, but nonexclusive factors: the debtor has few or no unsecured creditors, the debtor or a related entity filed a previous bankruptcy petition, the petition effectively allows the debtor to evade court orders, the debtor has engaged in improper prepetition conduct, the debtor has few debts to nonmoving creditors, the petition was filed on the eve of foreclosure and the foreclosed property is the debtor's sole or major asset, the debtor has no ongoing business or employees, there is no possibility of reorganization, the debtor's income is not sufficient to operate the business, there is no pressure from nonmoving creditors, reorganization essentially involves the resolution of a two-party dispute, or a corporate debtor was formed and received title to its major assets immediately before the petition. See *In re Albany Partners, Ltd.*, 749 F.2d 670, 674 (11th Cir. 1984); *In re Northwest Place, Ltd.*, 108 B.R. 809, 814-15 (Bankr. N.D. Ga. 1988); *In re Turner*, 80 B.R. 618, 622-23 (Bankr. D. Mass. 1987); *In re Levinsky*, 23 B.R. 210, 217 (Bankr. E.D.N.Y. 1982); *In re Victory Constr. Co.*, 9 B.R. 549, 551-52 (Bankr. C.D. Cal. 1981); *In re G-2 Realty Trust*, 6 B.R. 549, 552 (Bankr. D. Mass. 1980); *In re Dutch Flat Inv. Co.*, 6 B.R. at 471-72. The court in *Turner* lamented that the "drafters of the Bankruptcy Code gave the courts an empty chalice in the bad faith standard." *In re Turner*, 80 B.R. at 622-23. Some of the decisions suggest that "two views have developed . . . , one requiring actual malice or the desire to harass or embarrass, and the other finding bad faith when the bankruptcy court is used as a substitute for customary collection procedures." *Id.* at 622. The court held that "bad faith . . . should be measured by the subjective and objective standards contained in Bankruptcy Rule 9011," which, tracking Federal Rule of Civil Procedure 11, requires a pleading be based on a reasonable inquiry into the facts and the law. *Id.* at 623. This view was adopted by the Fourth Circuit in *Carolin Corp. v. Miller*, 886 F.2d 693, 700-01 (4th Cir. 1989). Most of the "good faith" cases have arisen in Chapter 11 reorganization cases. See TREISTER, *supra* note 167, at 109.

180. See JACKSON, *supra* note 166, at 195.

181. *East-West Assocs. v. Nastasi-White, Inc.*, 106 B.R. 767, 771 (Bankr. S.D.N.Y. 1989); *In re Grieshop*, 63 B.R. 657, 664 (Bankr. N.D. Ind. 1986).

182. *In re Victory Constr. Co.*, 9 B.R. 549, 564 (Bankr. C.D. Cal. 1981).

183. *In re Savoy Record Co.*, 108 F. Supp. 957, 958-59 (D.N.J. 1952).

184. *Phoenix Picadilly, Ltd. v. Life Ins. Co.*, 849 F.2d 1393, 1394 (11th Cir. 1988); *Natural Land Corp. v. Baker Farms, Inc.*, 825 F.2d 296, 298 (11th Cir. 1987) (citing *Albany Partners, Ltd. v. Westbrook*, 749 F.2d at 674).

185. *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1071-72 (5th Cir. 1986); *In re Grieshop*, 63 B.R. at 663. Dismissal on this ground has been limited to cases in which the debtor lacked any intention to reorganize and save the property or the equity through a plan providing for refinancing, sale, or other arrangement. See *Cinema Serv. Corp. v. Edbee Corp.*, 774 F.2d 584, 585 (3d Cir. 1985).

schemes,¹⁸⁶ or as a litigation tactic¹⁸⁷ have been held to reflect a lack of good faith resulting in dismissal of the petitions.¹⁸⁸ On the same reasoning, a petition filed not for the purpose of addressing a common pool problem or the collapse of a debtor enterprise, but to preempt one faction in an intracorporate dispute in a state judicial dissolution proceeding, should be dismissed by the bankruptcy court.

B. Abusive Conduct

By turning away "debtors whose overriding motive is to achieve reprehensible purposes" and limiting the exercise of the courts' equitable powers to those debtors who come with "clean hands," the second aspect of the good faith test guards not only the court's jurisdictional reach, but also its integrity.¹⁸⁹ A bankruptcy petition filed in breach of a state law fiduciary duty is this sort of threatening conduct.¹⁹⁰ The decision in *Porterfield v. Gerstel*¹⁹¹ is instructive on this point. There, a close corporation was engaged in the business of purchasing raw aluminum and converting it into extruded products.¹⁹² The board was composed of five members.¹⁹³ Three members, who together owned fifty percent of the corporation's stock, voted to file a

186. *In re Maxim Indus.*, 22 B.R. 611, 612-13 (Bankr. D. Mass. 1982).

187. See, e.g., *In re Harvey*, 101 B.R. 250 (Bankr. D. Nev. 1989); *In re Holm*, 75 B.R. 86 (Bankr. N.D. Cal. 1987); *In re Karum Group, Inc.*, 66 B.R. 436 (Bankr. W.D. Wash. 1986). See generally Ponoroff & Knippenberg, *supra* note 19, at 938-39.

188. See generally Bacon & Spies, *Bad Faith Bankruptcies*, 26 HOUS. LAW. 33 (1985); Frank R. Kennedy, *Creative Bankruptcy? Use and Abuse of the Bankruptcy Law—Reflection on Some Recent Cases*, 71 IOWA L. REV. 199 (1985); Ordin, *supra* note 178; Daniel J. Tyukody, Jr., Note, *Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause*, 52 U. CHI. L. REV. 795 (1985). For a discussion of recent "tactical" and "creative" uses of Chapter 11 filings, see Ponoroff & Knippenberg, *supra* note 19, at 919-20.

Reorganization plans must also be filed in good faith. Section 1129(a) provides: "The court shall confirm a plan only if all of the following requirements are met: . . . (3) [t]he plan has been proposed in good faith and not by any means forbidden by law." 11 USC § 1129(a). To meet the "good faith" requirement, "courts have held that a reorganization plan must bear some relation to the statutory objective of resuscitating a financially troubled corporation." *In re Coastal Cable T.V.*, 709 F.2d 762, 765 (1st Cir. 1983); see also *Fidelity Assurance Assoc. v. Sims*, 318 U.S. 608 (1943); *Tennessee Publishing Co. v. American Nat'l Bank*, 299 U.S. 18, 22 (1936); *Lemm v. Northern Cal. Nat'l Bank*, 93 F.2d 709, 711 (9th Cir. 1937); *In re Nikron, Inc.*, 27 B.R. 773, 778 (Bankr. E.D. Mich. 1983); *In re Nite Lite Inns*, 17 B.R. 367, 370 (Bankr. S.D. Cal. 1982); *In re BBT*, 11 B.R. 224, 235-36 (Bankr. D. Nev. 1981); Ordin, *supra* note 178, at 1827-28.

189. *In re Little Creek Dev. Co.*, 779 F.2d at 1072 (5th Cir. 1986); see also *In re Dutch Flat Inv. Co.*, 6 B.R. 470, 472 (Bankr. N.D. Ga. 1980); *In re Northwest Recreational Activities*, 4 B.R. 36, 39 (Bankr. N.D. Ga. 1980).

190. *Porterfield v. Gerstel*, 222 F.2d 137, 140 (5th Cir. 1955); *In re Klein's Outlet*, 50 F. Supp. 557, 559 (S.D.N.Y. 1943).

191. *Porterfield v. Gerstel*, 222 F.2d 137 (5th Cir. 1955).

192. *Porterfield v. Gerstel*, 249 F.2d 634, 635 n.1 (5th Cir. 1957) (quoting the opinion of the referee in bankruptcy).

193. *Porterfield v. Gerstel*, 222 F.2d at 138.

voluntary Chapter 7 bankruptcy petition.¹⁹⁴ The other stockholders moved to vacate the order of adjudication of bankruptcy, contending the three directors fraudulently put the company into bankruptcy to freeze out the other stockholders and minority directors.¹⁹⁵

The movants asserted that less than a month before the bankruptcy petition was filed, the three defendant directors bought their fifty percent interest from the original owners, along with certain debentures of the corporation and other loans, investing directly and indirectly \$148,000.¹⁹⁶ Thereafter, the three were elected to the board.¹⁹⁷ One of these directors "advanced \$30,000 to the company on a [ninety] day note, and . . . represented . . . he would advance such other funds as the company needed and secure a line of credit of \$100,000 [at a low rate] if the stockholders would elect him as a director and chairman of the board."¹⁹⁸ The stockholders elected him on this representation, giving the new stockholders a majority on the board.¹⁹⁹ The movants claimed the newcomers had no intent to fulfill their promises; instead, they were conspiring to "get control of the corporation . . . and put it into bankruptcy for the sole purpose of wiping out the interests of [the movants]."²⁰⁰ Furthermore, "immediately after acquiring a majority position, . . . the newcomers . . . diverted funds of the corporation . . . and willfully injured the corporation's credit."²⁰¹

The movants alleged the company was solvent and earning a profit.²⁰² Although the corporation was solvent in the bankruptcy sense—its assets exceeded its liabilities by approximately \$80,000—it was insolvent in the equity sense because it was unable to pay its bills as they matured.²⁰³ The directors asserted the company was "running overdrafts in the bank; . . . borrowing from its officers; [and] failing to pay its aluminum suppliers," all of which could have meant the end of the company.²⁰⁴

The bankruptcy referee denied the motion to vacate, and the district court sustained the ruling.²⁰⁵ The Fifth Circuit reversed and remanded the case to the district court with instructions to order the bankruptcy referee to conduct a further hearing, giving the bankruptcy trustee an opportunity to meet the *prima facie* case made out by the challenging shareholders, or, in

194. *Id.*

195. *Id.*

196. *Id.* at 139.

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.* There was testimony to the effect that the defendant directors repeatedly said they would own the business after the proceedings were concluded. *Id.* at 141.

201. *Id.* at 139.

202. *Id.*

203. *Id.* at 138-39.

204. *Portersfield v. Gerstel*, 249 F.2d 634, 635 n.1 (5th Cir. 1957) (quoting the opinion of the referee in bankruptcy).

205. *Portersfield v. Gerstel*, 222 F.2d at 137.

default, to sustain the shareholders' motion to set aside the adjudication of voluntary bankruptcy.²⁰⁶ The court noted:

The law permits any ordinary business corporation to file a petition in bankruptcy to avail itself of the benefits of the bankruptcy statute. Ordinarily it is unimportant what may be the purpose or motive of the corporation, if in truth and in fact it is the act of the corporation and not of officers or directors acting for their own benefit as distinguished from that of the corporation to which they have a fiduciary responsibility.²⁰⁷

The court further explained that if the allegations of the challenging shareholders were true, the referee should have vacated the order of adjudication.²⁰⁸ Filing the petition "would be a fraud on the court as well as a fraud on the corporation and its other stockholders."²⁰⁹ Other courts have dismissed petitions filed to resolve a dispute over ownership and control of a nondebtor corporation²¹⁰ and to deprive a former spouse of any interest in the enterprise because they lacked good faith.²¹¹

206. *Id.*

207. *Id.* at 140 (footnotes omitted).

208. *Id.*

209. *Id.* On remand, the referee heard additional testimony, reviewed documentary evidence (including checks and minutes of the corporation), and again concluded that there was a good faith financial basis for the petition. *Porterfield v. Gerstel*, 249 F.2d 634, 635 (5th Cir. 1957). The district court confirmed the referee's order. *Id.* at 635. Because the court of appeals could not say that the district court's findings were clearly erroneous, the judgment was affirmed. *Id.* at 637.

210. *In re Golden Ocala Partnership*, 50 B.R. 552, 558 (Bankr. M.D. Fla. 1985).

211. *In re Stamford Color Photo*, 105 B.R. 204, 208 (Bankr. D. Conn. 1989); *see also In re Bicoastal Corp.*, 109 B.R. 467, 471 (Bankr. M.D. Fla. 1989); *In re Justus Hospitality Properties, Ltd.*, 86 B.R. 261, 264 (Bankr. M.D. Fla. 1988). *But see In re Stolrow's, Inc.*, 84 B.R. 167 (Bankr. 9th Cir. 1988) (rejecting challenge that sole motivation for the petition was to secure a tactical advantage in dispute over control because debtor was capable of satisfying the statutory requirement of proposing a plan in good faith which preserved going concern value and jobs). Compare, however, *In re Beck-Rumbaugh*, No. 85-4233, 1985 WL 38 (E.D. Pa. Sept. 11, 1985), in which the court followed principles stated in *Porterfield v. Gerstel*, but expressed a different view on the court's role in addressing the alleged abuse. In *Beck-Rumbaugh*, the board of directors filed a voluntary petition in bankruptcy. Rumbaugh, a 49% shareholder and a judgment creditor of the company (as a result of a state court judgment against the company) moved to dismiss the proceeding. *Id.* at *1. Rumbaugh charged a "fraudulent intention" on the part of Beck, the 51% shareholder and president of the company, that is, "a ploy to stay litigation on behalf of the corporation against the president and others for diversion of corporate funds." *Id.* at *4. The court recited the rule that "a bad faith filing for bankruptcy under Chapter 7 to defeat claims of creditors may be found to be fraud on the court and other parties." *Id.* But, rather than dismiss the petition on this ground, the court ruled:

[T]he matters referred to by [Rumbaugh] in his motion papers regarding other litigation . . . make clear that it is only in Bankruptcy Court that the affairs of this corporate entity can be untangled and if it is not now insolvent, litigation costs and numerous judgments may soon render it so. Proceeding in Bankruptcy Court at this time will permit a thorough investigation of any improprieties and preserve the assets

Courts have resisted calculating petitioners' efforts to convert the bankruptcy process into a refuge for the evasion of state law duties and obligations. In *In re Cook*²¹² a state court ordered an accounting by the debtors, but granted an extension of time within which to file the report.²¹³ Ten days before the new deadline, the debtors filed for bankruptcy.²¹⁴ The creditors argued the bankruptcy petition was filed to avoid the state court's order on the accounting.²¹⁵ The court stated:

Thus, it appears plainly that the instant proceeding was instituted not for the purpose of obtaining benefits afforded by the Act to a corporation in financial distress, but to enable appellees to escape the jurisdiction of another court where the day of reckoning for their alleged acts of misconduct was at hand. It is our conclusion that a [f]ederal [c]ourt should not extend its jurisdiction under such circumstances. To do so is to furnish a haven of repose for one accused and called to account by a court of competent jurisdiction. It is argued that an accounting may be required in the [f]ederal [c]ourt as effectively as in the state court. No doubt this is true, but it does not dispel appellees' motives in shifting jurisdictions under the circumstances presented. Their conduct and the demonstrated purpose of coming into the [f]ederal [c]ourt was a fraud, not only upon that court, but the state court as well.²¹⁶

As shown, shareholder rights under the close corporation doctrine are broader and qualitatively different than those under traditional corporation doctrine. They are extended by the parties' "reasonable expectations." A Chapter 7 petition not ratified by the shareholders of a close corporation that is not financially distressed defeats the reasonable expectations of a fifty percent shareholder in the continued participation in decision-making in the enterprise. The bankruptcy deprives the excluded shareholder of a state law right to a hearing on the merits of a dissolution and a consideration of alternatives. This unauthorized petition fails the "good faith" test under the jurisdictional reach aspect, because there is no common-pool problem or a collapse of a debtor enterprise, and also under the abusive conduct aspect when its sole purpose is to deny the rights of others.

of the debtor's estate. Appointment of a Trustee in Bankruptcy is clearly in the interests of the administration of justice.

Id. (citations omitted). This view on the competence of a bankruptcy court to address abusive conduct is misguided.

212. *In re Cook*, 104 F.2d 981 (7th Cir. 1939).

213. *Id.* at 982.

214. *Id.* at 983.

215. *Id.*

216. *Id.* at 985 (citations omitted). *Portersfield* and *Cook* were decided under earlier versions of the Code. However, as stated, courts have always insisted upon the presence of good faith under all versions of the Code and even in the absence of any specific provision requiring it. See *In re Victory Constr. Co.*, 9 B.R. 549, 551 (Bankr. C.D. Cal. 1981) for a history of the good faith requirement.

C. State Courts are Better Suited to Resolve Intracorporate Disputes

In *Quarter Moon*, the Gilberts argued the state court was better suited to adjust the rights and interests of all the relevant parties.²¹⁷ They argued that in a state court proceeding the company, rather than liquidate the enterprise, could “liquidate sufficient assets to pay all creditor claims and to ‘cash out’ the Addlemans’ equity in the company, with the remaining items of property to be distributed to the Gilberts so the . . . business could continue.”²¹⁸ The bankruptcy court responded that “Chapter 7 was carefully crafted by Congress to achieve a prompt, economical liquidation and a fair distribution of assets,” and the “[t]rustee . . . is a professional, and the Court stands prepared to protect the interests of any party requiring it.”²¹⁹ Moreover, the court stated that “[t]he success of such an approach would require [the] Gilberts to convince the state court that such is a desirable and legal alternative, potentially over the objection of [the] Addlemans.”²²⁰

The bankruptcy court might have considered declining jurisdiction under the abstention provisions of the Code when the “interests of creditors and the debtor would be better served” by a dismissal or suspension of proceedings.²²¹ These provisions are designed to encourage private, negotiated adjustments of creditor-company relations and “to allow out-of-court insolvency arrangements to continue if those arrangements are in the best interest of all concerned and the petition is filed by ‘recalcitrant creditors.’”²²² Although the Code fails to define the “interests” to be considered or to delineate criteria for determining when parties will be better served in or out of bankruptcy, courts have identified a number of relevant considerations. These include efficiency and economy in resolution of the matter, freedom

217. *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 782 (Bankr. D. Idaho 1990).

218. *Id.*

219. *Id.*

220. *Id.*

221. Section 305 provides:

(a) The Court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if—

(1) The interests of creditors and the debtor would be better served by such dismissal or suspension.

11 U.S.C. § 305 (1988).

222. *In re Colonial Ford*, 24 B.R. 1014 (Bankr. D. Utah 1982). According to the legislative history:

This section recognizes that there are cases in which it would be appropriate for the court to decline jurisdiction. Abstention under this section, however, is of jurisdiction over the entire case The court may dismiss or suspend under the first paragraph, for example, if an arrangement is being worked out by the creditors and the debtor out of court, there is no prejudice to the rights of creditors in that arrangement, and an insolvency case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment.

H.R. REP. No. 989, 95th Cong., 2d Sess. 35 (1978), reprinted in 1978 U.S.C.C.A.N. 6281.

from litigation, as well as "fairness, priorities in distribution, [the court's] capacity for dealing with frauds and preferences, and the importance of a discharge to the debtor."²²³ Equally significant in this regard is the motivation of the petitioners.

The holding in *Win-Sum Sports, Inc.*²²⁴ addresses this point. A fifty percent shareholder of a close corporation, who was also a creditor, entered into an agreement with other creditors to file an involuntary petition against the corporation.²²⁵ Although it was not disputed that the company was experiencing financial difficulties, "two of the three petitioning creditors testified that neither of them would have brought the involuntary petition had each not received a written indemnity agreement" from the petitioning shareholder.²²⁶ In fact, "except for the three creditor petitioners' debts," the corporation had "paid or made acceptable arrangements to pay all debts claimed by the petitioners."²²⁷

The court found the petition had followed the breakdown of negotiations for the petitioning shareholder's buy-out of the other fifty percent shareholder.²²⁸ The court also found the petitioning shareholder's real purpose was to "use the bankruptcy court as an alternate approach to state court procedures to resolve intracompany management and stockholder problems" to displace the other fifty percent shareholder from the management of the corporation.²²⁹ The petitioning shareholder and the petitioning creditors were thus "comparable to the 'recalcitrant' creditor described in the legislative history" of the abstention provisions of the Code.²³⁰ Accordingly, the petition was dismissed.²³¹

An abstention by the bankruptcy court in *Quarter Moon* could have been taken on the same grounds as in *Win-Sum*, and would have forced the parties to seek resolution of their intracorporate dispute through the dispute resolution tools available under state corporation doctrine.²³² The state court is the forum most competent and legally capable to assess and ameliorate the special circumstances of close corporation participants. A state court would determine the viability of the firm, then consider a range of remedies,

223. *In re Colonial Ford*, 24 B.R. at 1020; see also *In re Donaldson Ford, Inc.*, 19 B.R. 425, 435 (Bankr. N.D. Ohio 1982); *In re Michael S. Starbuck, Inc.*, 14 B.R. 134, 135 (Bankr. S.D.N.Y. 1981); .

224. *In re Win-Sum Sports*, 14 B.R. 389 (Bankr. D. Conn. 1981).

225. *Id.* at 390.

226. *Id.* at 391.

227. *Id.*

228. *Id.*

229. *Id.* at 394.

230. *Id.*

231. *Id.*

232. See *In re Quarter Moon Livestock Co.*, 116 B.R. 775, 780 (Bankr. D. Idaho 1990).

including ordering a buy-out at a fair price²³³ or issuing additional stock.²³⁴ The shareholder deadlock, which also produces a deadlocked board, could be treated by appointing a provisional director²³⁵ or a custodian.²³⁶ In other cases, a court could resolve disputes by ordering the board to meet to declare a dividend,²³⁷ cancel or alter a provision in the charter or by-laws, or enjoin certain acts by directors, officers, or shareholders.²³⁸

233. See CAL. CORP. CODE § 2000 (West 1990); MINN. STAT. ANN. § 302A.751(2) (West Supp. 1993); REVISED MODEL BUSINESS CORP. ACT, MODEL STATUTORY CLOSE CORP. SUPP. § 42 (1989).

The New York Business Corporation Law, § 1118 provides:

(a) In any proceeding brought pursuant to [§ 1104-a] of this chapter, any other shareholder or shareholders or the corporation may, at any time within ninety days after the filing of such petition or at such later time as the court in its discretion may allow, elect to purchase the shares owned by the petitioners at their fair value and upon such terms and conditions as may be approved by the court.

N.Y. BUS. CORP. § 1118 (McKinney 1986).

In one case, a minority shareholder of a close corporation brought an action to compel judicial dissolution of the corporation on grounds of oppression and wrongdoing. *In re Pace Photographers Ltd.*, 525 N.E.2d 713, 715 (N.Y. 1988). In reaction to the petition, the corporation elected to buy the shareholder's shares. *Id.* at 715. The court held that the value would be determined on the basis of what a willing purchaser in an arm's length transaction would offer for the corporation as an operating business, rather than as a business in the process of liquidation. *Id.* at 718. The court held further that a sale occasioned by an 1104-a petition premised on abuse by the majority does not fall within the contemplation of the shareholder's agreement providing for the buy-out of shares, the price to be set according to a certain formula. *Id.*

234. See, e.g., *Baker v. Commercial Body Builders*, 507 P.2d 387, 393 (Or. 1973).

235. See CAL. CORP. CODE § 1802 (West 1990); DEL. CODE ANN. tit. 8, § 352(b) (1991); N.J. REV. STAT. § 14A:12-7(1) (1991); REVISED MODEL BUSINESS CORP. ACT, MODEL STATUTORY CLOSE CORP. SUPP. § 41(a)(7) (1989).

236. See DEL. CODE ANN. tit. 8, § 226 (1991); REVISED MODEL BUSINESS CORP. ACT ANN. § 14.32 (1992).

237. See *Smith v. Atlantic Props.*, 422 N.E.2d 798, 804 (Mass. App. Ct. 1981); *Baker v. Commercial Body Builders*, 507 P.2d 387, 395 (Or. 1973); see also REVISED MODEL BUSINESS CORP. ACT, MODEL STATUTORY CLOSE CORP. SUPP. § 41(a)(8) (1989).

238. See, e.g., CAL. CORP. CODE § 1804 (West 1990); S.C. CODE ANN. § 21-155 (Law. Co-op 1990); REVISED MODEL BUSINESS CORP. ACT, MODEL STATUTORY CLOSE CORP. SUPP. § 41(a)(1), (2) (1989); see also *Smith v. Atlantic Props.*, 422 N.E.2d at 804; *Baker v. Commercial Body Builders*, 507 P.2d at 395-96; *Hockenberger v. Curry*, 215 N.W.2d 627, 628 (Neb. 1974); *Patton v. Nicholas*, 279 S.W.2d 848, 857 (Tex. 1955). See generally 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 (1982); Joseph Edward Olson, *A Statutory Elixir for the Oppression Malady*, 36 MERCER L. REV. 627 (1985); Annotation, *Relief Other Than by Dissolution in Cases of Intracorporate Deadlock or Dissension*, 34 A.L.R.4th 13 (1984); Annotation, *Dissolution of Corporation on Ground of Intracorporate Deadlock or Dissension*, 83 A.L.R.3d 458 (1978).

VI. CONCLUSION

The "reasonable expectations" analysis provides grounds for judicial relief to an affected minority shareholder in a close corporation, even when there is no showing of wrongdoing by those in control. The analysis reveals empathy for minority shareholders in the close corporation and a greater awareness of the economic rights of investors who fail to detail their rights and investment expectations in the written documents of their business enterprise. But this expanded concept of shareholder rights and interests and the array of dispute resolution tools available under statute and common law are designed not simply to protect the close corporation participant on notions of justice, but also to preserve business enterprises and avoid the social costs attendant a noneconomic based dissolution. These two objectives must guide bankruptcy courts.