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Abstract
This essay describes the contours of the shareholder’s duty to be fair and explores some of the problems caused by the law’s imprecision in defining the duty of fairness. Because this duty is best understood as a rejection of old norms, part one of this essay describes the traditional doctrines of intra-corporate responsibility. Part two describes the special characteristics of a close corporation and outlines how those characteristics pushed close corporation law to new concepts of fairness and shareholder duties. Part three attempts to delineate those duties of fairness and also to highlight some of the dangers that arise when the law places fairness above predictability. Part four examines cases where close corporation law and employment law overlap, and uses those cases to show that parties can put some limits on the ambiguity of “fairness.” Part five uses the lesson from part four and makes concrete suggestions to practitioners.

Keywords
Corporate law, corporate policy, business judgment rule, good faith, shareholder oppression, reasonable expectations, fiduciary duty, inter se

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WHY NOT GOOD FAITH? THE FOIBLES OF FAIRNESS IN THE LAW OF CLOSE CORPORATIONS

Daniel S. Kleinberger†

Equity is a roguish thing: for law we have a measure, know what to trust to, Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, so is Equity. 'Tis all one as if they should make the standard for the measure, we call, a Chancellor's foot, what an uncertain measure would this be? One Chancellor has a long foot, another a short foot, a third an indifferent foot. 'Tis the same thing in the Chancellor's conscience.¹

To argue, even restrainedly, against fairness seems a foolish thing, especially in the context of closely-held corporations. For decades traditional corporate doctrines have facilitated the oppression of minority shareholders. Lately concepts of shareholder expectations and shareholder fiduciary duty have emerged to rein in oppression. Fairness is displacing formalism. What could be the problem?

The problem is vagueness and lack of predictability in the law. While concepts of fairness have made life more dangerous for would-be oppressors, they have also made life frustratingly uncertain for entrepreneurs seeking to conform their conduct to the law.

This essay describes the contours of the shareholder's duty to be fair and explores some of the problems caused by the law's imprecision in defining that duty. Because the duty is best understood as a rejection of old norms, part one of this essay describes the traditional doctrines of intra-corporate responsibility.² Part two describes the special characteristics of a

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1. J. Seldon, EQUITY TABLE TALK 46 (Arber, Edward, ed. in English Reprints, nos. 1-7, London: 1869 [1689]).

2. The law of close corporations is generally a matter of state law, and this informal essay makes no attempt to catalogue the law of various states. Major trends
close corporation and outlines how those characteristics pushed close corporation law to new concepts of fairness and shareholder duties. Part three attempts to delineate those duties of fairness and also to highlight some of the dangers that arise when the law places fairness above predictability. Part four examines cases where close corporation law and employment law overlap, and uses those cases to show that parties can put some limits on the ambiguity of "fairness." Part five uses the lesson from part four and makes concrete suggestions for practitioners.

1. **The Structure of the Corporation in Traditional Corporate Law Doctrine**

Traditional legal theory recognizes three sharply distinct roles in corporate governance. The owners of the business, the shareholders, elect a board of directors, who function collectively to set policy for and superintend the operations of the business. The board, in turn, selects the top officers, who function as the chief administrators of the business and who manage day-to-day operations. The structure is tripartite and hierarchical.

With each role in the structure comes a different set of governance rights and responsibilities. For example, shareholders qua shareholders have little direct say about corporate policy, and in their efforts to affect corporate policy they owe each other no legal duties. They cannot choose how the corporation does business, with whom it does business or even who will run the business on a day-to-day basis. Except in the

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are similar throughout the country, and this essay uses examples from a number of different states. Notes 11, 23, 28, 36 and 40 infra discuss some special aspects of Minnesota law.

3. The same individual can, and frequently does, occupy more than one role, but in any particular situation that individual’s rights and responsibilities depend on the role or roles involved.

case of major organic change (e.g. amending the articles of incorporation), shareholders can act only indirectly, through the election of directors.

It is the directors who set corporate policy, and with that power comes certain responsibilities. Traditional doctrine views the directors as the independent guardians of the business’s interests, akin to trustees. Like trustees, directors must act with due care and disinterestedness. In addition, they must act independently. They are not elected to merely voice the dictates of the electorate; rather they must exercise their own judgment.

In serving the interests of the corporate business, the directors also serve the interests of the business’s owners, i.e. the shareholders. However, the directors owe no direct legal duty to the shareholders. Instead, they owe their duty to the corporate entity. Therefore most shareholder grievances about corporate policy are not directly actionable; the shareholders lack standing. In a legal sense, the corporation is the direct victim of any mistake in corporate policy; the cause of action belongs to it.

The decision to bring such an action rests with those people responsible for determining corporate policy—i.e., the board of directors. That allocation of authority works fine when the board considers injuries inflicted on the corporation by outsiders. When, however, the board itself may have harmed the corporation, the allocation is problematic. The directors are unlikely to authorize suit against themselves. They will typi-

5. See, e.g., Revised Model Business Corporation Act (RMBCA), § 10.03(b)(2) (1984).

6. See, e.g., Del. Code Ann., tit. 8, § 141(a) (1983) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); Securities Exchange Act of 1934, Rule 14a-8(c)(7), 17 C.F.R. § 240.14a-8(c)(7) (1989) (Corporation may omit from its proxy statement any shareholder-sponsored proposal which "deals with a matter relating to the conduct of the [corporation's] ordinary business operations."). Sometimes even major organic changes are beyond the shareholder’s direct influence. See, e.g., Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990) (Shareholders of Time had no right to choose between Time being acquired in a hostile takeover and Time acquiring another major company.).

cally conclude that suing the alleged miscreants is not in the corporation's best interests.

In such circumstances a disgruntled shareholder can get the corporation into court only through a derivative action. In essence, the shareholder must sue the corporation for having failed to sue the directors. In a derivative lawsuit the plaintiff must show not only that the directors' original decision harmed the corporation, but also that the board abused its managerial authority when it subsequently decided not to seek redress.

Derivative lawsuits face substantial odds. Since the corporate law vests the board with ultimate control of the corporation, the disgruntled shareholder may not sue without first trying to persuade the board to take action (against itself) or demonstrating that any attempted persuasion would be futile. Futility is not so easily proved; the mere fact, for instance, that each member of the board is a potential defendant is not by itself enough.

In addition to this procedural hurdle, the would-be derivative plaintiff faces the substantive burden of the business judgment rule. The rule presumes that whenever directors act, they do so with due care, in good faith and in the reasonable belief that they are acting in the best interests of the corporation. The courts will not disturb or even inquire into the merits of a board decision unless the derivative plaintiff can somehow rebut at least one of the presumptions. The protection of the business judgment rule applies to the board decision which displeased the shareholder in the first place and sometimes also to the board's decision not to sue.

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8. See, e.g., MINN. R. CIV. P. 23.06.


10. In rebutting one of the presumptions, the derivative plaintiff establishes a breach of director fiduciary duty. To win the lawsuit, the plaintiff must also show that the breach of duty proximately caused injury to the corporation.

11. For corporations organized under the law of the leading state of Delaware, the business judgment rule protects the not-to-sue decision unless the plaintiff can show that demand is excused. Aronson, 473 F.2d at 814-15. For New York corporations, a modified business judgment rule applies, regardless of whether demand is excused. The directors have the burden of showing good faith, independence and reasonable inquiry supporting the decision not to sue. If they meet that burden, the courts will not second guess the decision itself. Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). For Minnesota corporations, the rule is unclear. Until 1989, Minnesota Statute section 302A.243 allowed a board to appoint
Even if the shareholder plaintiff surmounts both the procedural and substantive problems, there remains the problem of remedy. According to legal theory, it was the corporation, not the shareholder, which suffered direct injury. Any recovery will therefore go to the corporation. If, for example, a lawsuit establishes that the board paid itself excessive fees, the money recouped will return to the corporate treasury, where its disposition will be controlled by the board of directors.\(^\text{12}\)

*Wilderman v. Wilderman*\(^\text{13}\) illustrates how the formalism of traditional corporate law can hamstring shareholder efforts to protect their interests. The case concerned a corporation owned by two individuals who had previously been married to each other. Mr. Wilderman served as the CEO and dominated the board of directors. Mrs. Wilderman brought suit alleging that the corporation had grossly overpaid Mr. Wilderman in his capacity as CEO. She wanted him to repay the excess, and she wanted the corporation then to distribute the repaid amounts as dividends. The dividend distribution would give her a share of the funds which had been unfairly diverted to her ex-husband.

She won the battle and lost the war. The court held that Mr. Wilderman had indeed received an excessive salary. However, since the claim for excessive salaries belonged to the corporation, it was to the corporation that the court ordered Mr. Wilderman to repay the excess. Mrs. Wilderman’s claim for dividends failed. The court recognized that she had the right to bring the dividend claim in her own name, since she was seeking to vindicate directly her rights as a shareholder, not indirectly the interests of the corporation. But the court also recognized that her dividend claim invaded the province of the board, the managing body of the corporation. The decision

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\(^{\text{12}}\) The plaintiff’s attorney will recover his or her fees from out of the recovery, on the theory that the attorney’s efforts helped create the recovery fund. Annotation, *Attorneys' Fees and Other Expenses Incident to Controversy Respecting Internal Affairs of Corporation as Charge Against the Corporation*, 39 A.L.R.2d 580 (1955).

\(^{\text{13}}\) 315 A.2d 610 (Del. Ch. 1974).
whether to declare dividends is at the core of the board’s managerial discretion, and the court was unwilling to assume that the board would abuse that discretion. The court therefore refused to award any of the recouped funds to Mrs. Wilderman.

II. The Nature of the Close Corporation and Close Corporation Law—Reality Diverges from Traditional Doctrine, and the Law Eventually Adjusts

A. The Nature of the Close Corporation

Certain key attributes characterize close corporations. Close corporations have a limited number of shareholders, and most, if not all, of the shareholders are active in the corporation’s day-to-day business. The corporation typically is an important (and often principal) source of income for each shareholder. Payout is frequently in the form of salary rather than dividends. The success of the business usually depends on harmony and cooperation among the co-owners.14

If things go sour, exit is difficult. To exit, a disgruntled shareholder must sell to the remaining shareholders, to the corporation itself, or to an outside investor. The corporation itself may not have enough liquid assets to “cash out” one of its owners, and even if it does the other owners may not want the corporation’s liquid assets used for that purpose. For parallel reasons, the other owners may themselves be unable or unwilling to buy out the would-be seller at an acceptable price.15

Outside investors are also an unlikely recourse, for both business and legal reasons. As a business matter, who would want to buy a company when the seller is leaving because “things turned sour”? As a legal matter, the seller’s stock may carry “stock transfer restrictions.” The founders of closely-


15. Price is especially problematic, if unfair treatment within the corporation causes a shareholder to seek to sell. The unfairness will likely continue as the other shareholders decide what they are willing to pay for the shares. The same problem of price exists with the corporation as potential buyer, since by hypothesis the “unfair” shareholders are controlling the corporation.
held businesses typically do not want outsiders to have unrestricted access to ownership. Outsiders are potentially disharmonious, so close corporations often impose a variety of approval and first refusal barriers to any transfer of shares.\textsuperscript{16}

There is no ready market for the shares in a close corporation, and a shareholder treated unfairly cannot escape the unfairness simply by selling out at a fair price. More than any other characteristic, this "no exit" phenomenon has pushed the law into developing special rules for shareholders in close corporations. Borrowing concepts from the law of partnerships, the law of corporations has developed along two lines: attempts to plan for control, and abuses in the absence of good planning. The latter development in particular has opened the courts to disgruntled shareholders of close corporations.

\textit{B. Planning for Control}

Parties forming a closely-held business often seek to predetermine important parts of their deal. They may, for instance, wish to preset power sharing arrangements, employment rights and the scope of the business. However natural such planning may be from a business perspective, predetermination clashes with the traditional theory of corporate structure. Under traditional corporate law doctrine, shareholders can agree in advance as to whom they will elect to the board, but they can go no further. To go further and predetermine matters of policy would invade the province of the board and unlawfully sterilize the discretion of the corporation's independent guardians.

For example, in 1934, the New York Court of Appeals decided \textit{McQuade v. Stoneham},\textsuperscript{17} a dispute among the co-owners of the old New York Giants baseball team. An agreement among the shareholders had guaranteed that the corporation would

\textsuperscript{16} The agreement at issue in Black & White Cabs v. Smith, 370 S.W.2d 669, 670–71 (Mo. Ct. App. 1963), put it well: "Each of said parties acknowledges that by reason of the confidence reposed by each in the other, they are desirous of not having strangers acquire any of the shares of stock held by any of the parties in the event of the happenings hereinafter stated." \textit{See also} Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 287, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1954) ("Bylaws restricting transfer in closed corporations are frequently essential to a successful enterprise; they perform an important function in precluding unwanted intrusions by outsiders; they preserve the integrity of the functioning entity.").

\textsuperscript{17} 263 N.Y. 323, 189 N.E. 294 (1934).
employ a particular shareholder, and that shareholder sought enforcement of the contract. Citing the public policy requirement that directors retain their independent judgment, the court refused to enforce the agreement—even though every one of the shareholders had initially agreed to and signed the agreement.

For years, *McQuade* was a very influential case, but gradually the law of predetermination changed to reflect business reality. One key reality is that directors in close corporations are not truly independent. As Judge Lehman noted in his concurrence in *McQuade*: “The theory that directors exercise in all matters an independent judgment in practice often yields to the fact that the choice of directors lies with the majority stockholders and thus gives the stockholders a very effective control of the action by the board of directors.”18

Another key reality is that close corporations do not manifest the tripartite, hierarchical structure which the law deems characteristic of a corporation. In a large organization the tripartite construct makes sense; investment, control and administration are all largely separate. In the typical close corporation, however, no such separation exists. Passive investors are rare, and often all of the principals are simultaneously shareholders, officers and directors.

The co-owners of a close corporation do not choose the corporate form because it allows for role differentiation; they choose it because it protects them from personal liability. On issues of internal organization and *inter se* relationships, “stockholders [in a close corporation] . . . generally prefer certain of the attributes of partnership, particularly with respect to control . . . . In effect, they want an ‘incorporated partnership.’”19

First advanced by a commentator, the concept of the “incorporated partnership” has liberated corporate law’s approach to issues of planning, predetermination and board sterilization.20 The concept informs many modern cases,21 and many

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18. *Id.* at 396, 189 N.E. at 239.
20. The concept has had a nationwide influence, but an Ohio statute makes the concept’s impact particularly clear:
   No close corporation agreement is invalid among the parties or in respect of the corporation on . . . [the grounds that the] agreement is an attempt to
state corporation statutes now expressly authorize shareholders to predetermine all sorts of control issues and policy matters. In some states, for example Delaware, the authorization applies only when a corporation has formally elected statutory close corporation status.22 In other states, including Minnesota, no election is necessary.23

C. Controlling Oppression

Close corporation law has also begun to confront the problems of shareholder oppression which may arise in the absence of adequate planning. The board of a close corporation

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23. See, e.g., Minn. Stat. §§ 302A.455 (shareholder agreements), 302A.457 (shareholder control agreements) (1988). Section 302A.457 applies to validate unanimous agreements. Section 302A.455 does not require shareholder unanimity. It is unclear just how far an agreement can intrude into the directors' province and still be valid under section 302A.455. The language of section 302A.455 seems to reach conduct which sterilizes the board; i.e., the section validates agreements "relating to the voting of . . . shares." An agreement to vote to remove any director who does not follow a particular, predetermined policy could therefore be a section 302A.455 agreement.

The Reporter's Notes to section 302A.455 take that view. They state: "The agreement may cover any matter which affects the corporation, including the voting of shares . . . in a manner designed to insure that the corporation follows a particular policy." Minn. Stat. Ann. § 302A.455 (West 1985) (Reporter's Notes, General Comment). In support of that interpretation, the Notes cite Hart v. Bell, 222 Minn. 69, 78, 23 N.W.2d 375, 380 (1946), a pre-chapter 302A case which upheld shareholder agreement restrictions on the board's discretion.

But if 302A.455 indeed has such an expansive scope, why did the legislature bother to enact section 302A.457? Sterilization of the board is what section 302A.457 is all about. Subdivision 1 expressly validates agreements "relating to the control of any phase of the business and affairs of the corporation, its liquidation and dissolution, or the relations among shareholders."

Reading 302A.455 expansively does more than turn subdivision 1 of 302A.457 into surplusage. It also undercuts the protection provided to minority shareholders by other parts of section 302A.457. Section 302A.457, subdivision 2 requires shareholder unanimity before a sterilizing agreement is valid. Subdivision 3 expressly reallocates director responsibility and liability to those who exercise power under the sterilization agreement. Section 302A.455 lacks any such protection.
is dominated by the shareholder or shareholders holding a majority of the voting power. Given this practical reality, traditional corporate law doctrine facilitates the oppression of minority shareholders. In traditional theory, ultimate authority resides with the board of directors, and the business judgment rule makes it very difficult for a disgruntled shareholder to challenge the board's decision. The majority shareholder has no duty to the minority. In practice, therefore, the board and the shareholders who control the board can freeze out minority shareholders from participation in the enterprise and thereby deprive the minority shareholders of the economic rewards which attracted them to the enterprise in the first place.

Freeze out techniques include:

a. withholding dividends;

b. excluding minority shareholders from employment;

c. siphoning off profits through
   i. excessive salaries to officers and directors, or
   ii. self-dealing leases and contracts with majority shareholders and their affiliates;

d. sale of business assets to majority shareholders or their affiliates;

e. forced redemption of shares; and

f. merger, with the minority shareholders "cached out" at an unfairly low price.24

Like problems of planning, problems of oppression pushed close corporation law toward the partnership analogy. Partnership law's concept that co-owners are mutual fiduciaries provided a remarkably strong antidote to the oppression facilitated by the traditional theory. In the words of the Massachusetts Supreme Judicial Court:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the opera-

24. For further "freeze out" and "squeeze out" techniques, see generally 2 F. HODGE O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 8.07 n.1 (3d ed. 1987) (listing freeze out techniques, treatises and law review articles); 2 F. HODGE O'NEAL & R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS, ch. 6 (2d ed. 1985) (miscellaneous squeeze out techniques).
tion of the enterprise that partners owe to one another. . . .
We have defined the standard of duty owed by partners to
one another as the "utmost good faith and loyalty."25

Spurred by the partnership analogy, modern close corpo-
ration law recognizes both a shareholder's right to not be op-
pressed and a shareholder's duty to not perpetuate
oppression. For example, the Minnesota Business Corpora-
tion Act recognizes "the duty which all shareholders in a
closely held corporation owe one another to act in an honest,
fair, and reasonable manner . . . ."26 New York law similarly
prohibits shareholders from engaging in oppressive conduct
toward each other.27

Under the partnership model, shareholders gained the part-
ner-like right to predetermine their relationships and to di-
rectly control the corporation. In the exercise of that partner-
like right, however, shareholders also assumed partner-like ob-
ligations inter se.28

D. Opening the Courts to Disgruntled Shareholders

The law's recognition of shareholder-to-shareholder rights
and duties has opened the courts to shareholders disgruntled
by the operations of close corporations.29 The partner-like
rights are personal to each shareholder, and offenses against
those rights injure the shareholder, not the corporation. The
resulting cause of action is not derivative; it is direct. The of-
fended shareholder has no obligation to make a demand on

(1975) (footnotes omitted) (citing Cardullo v. Landau, 329 Mass. 5, 8, 105 N.E.2d
843, 845 (1952)).
1980); N.Y. Bus. Corp. Law § 1104-a(a)(1) (McKinney 1986) (Dissolution may be
granted if "[t]he directors or those in control of the corporation have been guilty of
illegal, fraudulent or oppressive actions toward the complaining shareholders"). See
generally 2 F. Hodge O'Neal & B. Thompson, O'Neal's Oppression of Minority
Shareholders § 7.17 (2d ed. 1985).
28. In some jurisdictions the newfound duties run also from the corporation's
directors and officers to the shareholders. See, e.g., Minn. Stat. § 302A.751, subd.
29. The right to plan can also occasion direct shareholder litigation. See, e.g.,
McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); RMBCA § 7.31(b)
/shareholder voting agreements specifically enforceable); Minn. Stat. § 302A.455
(1988) (making shareholder voting agreements "specifically enforceable by and
against the parties to the agreement"); Minn. Stat. § 302A.457 (1988) (making
/shareholder control agreements specifically enforceable).
the board. If the board chooses to oppose the shareholder's claims, no presumption of correctness attaches to that decision.\textsuperscript{30} Perhaps most importantly, any recovery goes straight to the shareholder, not into the corporate treasury. The barriers to suit erected by traditional corporate doctrine are gone.

III. Delineating the Concept of Fairness

Modern close corporation doctrine thus makes life much more difficult for would-be oppressors. But the contours of those difficulties are imprecise, and "good guys" and "bad guys" alike suffer from that imprecision. The right to predetermine control in an "incorporated partnership" is clear enough, but what precisely does the law mean when it obliges shareholders to treat each other with "the punctilio of an honor the most sensitive"?\textsuperscript{31} This part of the essay seeks to answer that question and, along the way, to highlight some of the dangers which arise when the law places fairness above predictability.

Most decisions on shareholder fiduciary duty involve alleged abuses by a majority shareholder or a group of shareholders who control a majority of the voting power. Some jurisdictions initially imposed a duty only where a single shareholder had majority power, but the trend is toward treating controlling shareholders and control groups alike.\textsuperscript{32} At least one jurisdiction has sanctioned a minority shareholder for wrongfully exercising a veto power granted him under a shareholders’

\textsuperscript{30} Indeed, if the board chooses to use corporate resources to defend a controlling shareholder's conduct, that decision may breach the board's duty to the corporation. The corporation is an entity separate and distinct from any of its shareholders, and the board's first duty is to the corporate entity. The interests of the corporation may be different than those of its controlling shareholder, and a board which automatically sides with the controlling shareholder may be coming to the defense of the wrong entity. \textit{See infra} note 67. Some courts accord deference to the decisions of a controlling shareholder, but that deference falls short of the business judgment rule. \textit{See infra} note 38 and accompanying text.


\textsuperscript{32} Jaffe Commercial Finance Co. \textit{v.} Harris, 119 Ill. App. 3d 136, 143, 456 N.E.2d 224, 230 (1983) (extending the fiduciary duties formerly imposed only on single controlling shareholders to a group of shareholders who comprised a majority); \textit{Donahue}, 367 Mass. at 578, 328 N.E.2d at 518 (imposing fiduciary obligations on a shareholder "control group").
agreement.33

Shareholder fiduciary duties divide into two categories: the protection of shareholders' reasonable expectations and the observance of requirements of good faith and fair dealing. The former category includes contract-like issues. The duties of the parties arise from the particular understandings they have with each other. The second category includes tort-like issues. The parties' obligations arise from a society-based sense of what is appropriate conduct.

A. Reasonable Expectations

At first glance the reasonable expectations category seems sensible. What made cases like McQuade v. Stoneham so objectionable was that they disappointed expectations—even though the parties had expressed their unanimous expectations in writing at the outset of the venture. In the context of close corporations, as in any other area involving consensual ventures, the law ought to protect the understandings which initially bring parties to the venture.

The proper protection of expectations presupposes, however, their accurate identification. Memories can fade and recollections can differ, especially when money is on the line. When the law seeks to protect expectations elsewhere, it takes at least some care with the identification of the problem. For example, section 2-201 of the Uniform Commercial Code, the Statute of Frauds section, renders certain alleged promises unenforceable unless they are written down and signed by the party to be charged. Similarly, section 2-209 of the UCC allows parties to protect their documented understandings from claims that oral commitments or a course of dealing have created new expectations.

In the law of close corporations the reasonable expectation doctrine generally lacks such safeguards. For example, Minnesota Statute section 302A.751 seeks to protect "the reasonable expectations of the shareholders."34 In the service of those expectations, courts may order a full range of remedies, including buy-outs and dissolution. But how does the court identify those expectations worthy of protection? There is no require-

34. Minn. Stat. § 302A.751, subd. 3a (1988).
ment that expectations be documented to be enforceable. Nor is there a requirement that expectations be held unanimously to be enforceable.

By the time a court gets involved it is almost inevitable that the shareholders will be remembering and voicing sets of markedly different expectations. What if a shareholder presses expectations which were previously inchoate, imprecise, or unexpressed? Suppose that one shareholder perceives a pattern of past conduct and interprets that pattern to create certain expectations. Suppose also that the other shareholders either deny the pattern or dispute the interpretation. Whose claimed memories, perceptions and interpretations does the court enforce?

What if a shareholder claims expectations that differ from the language of a written agreement? From the language of the Minnesota Statute, it is not clear that even a unanimous comprehensive and signed statement of agreement is safe from claims of unwritten (and perhaps even unspoken) evolutions in expectations. Subdivision 3a of section 302A.71 commands courts to consider not only shareholder expectations "as they exist at the inception," but also as the expectations "develop during the course of the shareholders' relationship with the corporation and with each other." If not carefully applied, the doctrine of shareholder expectation will destroy one of the most important expectations a business person can have—predictability in the rules of the game.

B. Good Faith and Fair Dealing

This category of duties further divides into two subcategories: substantive fairness and procedural fairness. The former subcategory contains rules controlling the outcomes of shareholder conduct. The latter contains rules controlling the tactics shareholders use when dealing with each other. 36

35. Id.

36. In Minnesota law the doctrines have support in both the caselaw and the statutes. The principal case is Evans v. Blesi, 345 N.W.2d 775 (Minn. Ct. App. 1984), discussed infra note 49 and accompanying text. Two parts of MINN. STAT. § 302A.751 (1988) supply statutory authority. Subdivision 3a is ostensibly a remedy provision, but also seems to codify into existence a set of duties among shareholders which justify the existence of remedies. Subdivision 1(b)(2) takes a similarly oblique approach, authorizing equitable remedies inter alia when "directors or those in control of the corporation have acted . . . in a manner unfairly prejudicial toward one or
1. Substantive Fairness

It is substantively unfair and a breach of fiduciary duty for a controlling shareholder or group of shareholders to appropriate overmuch of the enterprise's economic benefits. Those in control may not "freeze out" minority shareholders, either directly (e.g., by cutting dividends and selectively cutting salaries) or indirectly (e.g., by siphoning off assets to other ventures).

Many freeze outs are quite blatant, but not every tinge of controller self-interest is remediable as a freeze out. In the words of the Massachusetts Supreme Judicial Court:

The majority, concededly, have certain rights to what has been termed "selfish ownership" in the corporation which should be balanced against the concept of their fiduciary obligation to the minority. . . . [T]he controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation. . . . If called on to settle a dispute, our courts must weigh the legitimate business purpose [advanced by the majority], if any, against the practicability of a less harmful alternative.

When "selfish ownership" takes the form of preferential redemption, at least some states have adopted a per se approach. Under the rule of Donahue v. Rodd Electrotype Co., if the corporation buys out the stock of a member of a controlling group of shareholders, then the corporation must offer to redeem the stock of minority shareholders on a pro rata basis.

Problems can arise in determining the existence of a control
group. In Donahue the situation was straightforward. Members of the Rodd family caused the corporation to buy-out their father's stock. He was a co-founder of the business and was ready to retire. The family members were apparently eager to assume greater responsibilities within the business, so they were ready to have him retire. The widow of the other co-founder, who had a substantial minority interest in the corporation, brought suit. Citing the close family ties and the particular interests shared by the Rodd family, the court had no difficulty identifying a control group. It is not so clear, however, what would happen if a more ad hoc coalition of shareholders caused a corporation to buy-out a stockholder outside the coalition who, for example, was causing great disharmony or was in great financial need.41

41. The court held that the party seeking control of the corporation would have to show a breach of good faith in order to invoke Donahue. See id. at 571-72. The court rejected the argument that a corporation with a non-voting board of directors could use the Donahue doctrine to prevent minority shareholders from having a say in control of the corporation. Id. at 573-74. The court also rejected the argument that Donahue applies only to situations where the controlling shareholder is a co-founder of the corporation. Id. at 574-75.
2. Procedural Fairness

Doctrines of procedural fairness limit the ways in which shareholders in close corporations may deal with each other. These doctrines focus on process, not outcome.\(^{42}\)

In the words of the foremost student of shareholder fiduciary duty: "Any general formulation or even categorization of these duties is difficult and runs the risk of being vague and incomplete."\(^{43}\) Fools rush in,\(^{44}\) however, so following is at least a partial list.

*Arbitrary Exercise of Discretion or Veto Power*: Even where a shareholder agreement gives a shareholder complete discretion to veto particular corporate actions, the law may impose a duty not to act arbitrarily. For example, in *Smith v. Atlantic Properties, Inc.*,\(^{45}\) a shareholder repeatedly exercised his right under the shareholder agreement to veto any declaration of dividends. Eventually the failure to declare dividends caused the corporation to be liable for an accumulated earnings tax. There was no evidence that the "nay-sayer" had any corporate purpose in mind for the retained earnings, and the Massachusetts Court of Appeals held him liable for damages to the corporation.\(^{46}\)

On its facts, the case seems reasonable. When it became clear that any further vetoes would cause unnecessary and unwarranted tax liability, there was no possible justification for the vetoes. A broad reading of the case, however, would be quite troublesome. One of the purposes of according a party complete discretion is to safeguard decisions from the cost and uncertainty of judicial second guessing.\(^{47}\) If the law automati-

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42. It would, however, be extremely unlikely for a court to undo a decision merely on grounds of procedural abuse. There must be at least some element of outcome unfairness as well. The analysis here parallels the analysis previously suggested in Leff, *Unconscionability and the Code—the Emperor’s New Clause*, 115 U. Pa. L. Rev. 485 (1967) for determining questions of unconscionability under the Uniform Commercial Code. For a court to overturn a provision as unconscionable, the court must find at least a modicum of both substantive and procedural unconscionability.

43. 2 F. Hodge O’Neal & R. Thompson, O’Neal’s Oppression of Minority Shareholders, § 7.17, at 121 (2d ed. 1985).

44. A. Pope, Essay on Criticism, Part III, 1. 66 (1711). The full quotation is: "Fools rush in where angels fear to tread."


46. Id. at 209, 422 N.E.2d at 803.

cally transforms "in X's sole discretion" to "in X's sole discretion unless Y can show that X acted arbitrarily," then no decision of X will be free from the risk of judicial intervention.

**Oppressive and Unfair Negotiating Tactics:** Shareholders in a close corporation can be simultaneously co-venturers with shared interests, and potential adverse parties. At the outset of the venture, for example, discussion about compensation may put the mutual fiduciaries at opposite ends of the bargaining table. The parties' interests may also diverge once the relationship is underway. This one wants to take a lot of money out of the business now, because she has a child heading for college. That one's children are young, and he wants the business to retain earnings and aim for growth.

Whenever shareholders in a close corporation negotiate with each other, they act under special restraints. They must refrain from overly aggressive tactics, even though in the workaday world conduct would conform to the rough "morality of the marketplace." 48 While tactics prohibited in an arm's length transaction, such as fraud and duress, are of course forbidden in the fiduciary context, even less extreme conduct can be actionable. For example, in *Evans v. Blesi*, 49 one shareholder used surprise, bluster and intimidation to persuade the other shareholder to sell out. The "victim" was an experienced business person, and the perpetrator was mostly threatening to do things which he had the right to do. The surprise consisted of advance consultation with an attorney and presentation, without advance warning, of a detailed buy-out agreement. 50 The conduct probably did not amount to duress in any ordinary sense, but in the context of a close corporation the Minnesota Court of Appeals had no trouble overturning the deal. 51

**Duty to Disclose:** In arm's length bargaining situations each party is acting in its own self-interest and, short of fraud, may profit from its possession of information the other party lacks. 52 Moreover, "the morality of the marketplace" accepts

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49. 345 N.W.2d 775 (Minn. Ct. App. 1984).

50. *Id.* at 778.


and even expects some game-playing in the negotiating process. Although the game-playing ought not include misrepresentations of material fact, lesser forms of posturing are considered expedient and even normal.

For shareholders in a close corporation, there is, however, a different norm. Fiduciaries owe each other the duty of loyalty, and that duty entails what is often called an obligation of complete candor. How complete the candor must actually be in shareholder-to-shareholder situations is unclear.

At the very least, when two shareholders negotiate with each other they must not hide ulterior motives. In *Helms v. Duckworth* the court overturned a stock purchase agreement because during the original negotiations one of the parties had concealed a bad motive. The stock purchase agreement set the price at which the surviving owner could buy the stock of the owner who died first. The agreement called for periodic discussions to adjust the buy-out price. One of the stockholders was considerably older than the other, and the younger one entered into the agreement while secretly intending never to accept any modifications in the stated price. No modifications were ever made, and when the older shareholder died the set price was far below any fair value. The younger stockholder's failure to disclose empowered the court to invalidate the agreement.

Like *Smith v. Atlantic Properties, Inc.*, on its facts *Helms* seems sensible. But the case has language which goes far beyond its facts. According to then Judge Burger, "the holders of closely held stock in a corporation . . . bear a fiduciary duty to deal fairly, honestly, and openly with their fellow stockholder and to make disclosure of all essential information.”

Just what information is essential? Assume, for instance, that two shareholders are contemplating dissolving the corporation and they are negotiating over which one will buy the other out. They are certainly obliged to make available to each other any information that belongs to the corporation, but are they also obliged to share independent appraisals? Surely, one

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53. 249 F.2d 482, 487 (D.C. Cir. 1957).
54. *Id.* at 483–84.
55. *Id.* at 487 (emphasis added).
shareholder is not obliged to confess an urgent need for cash, although just as surely such information "would have assumed actual significance in the deliberations" of the other shareholder.\footnote{56}

When shareholders negotiate with each other, each faces a dichotomy of values. Each shareholder naturally seeks to advance her personal interests; at the same time, each shareholder must be to some extent "his brother's keeper." Self-interest intertwines with fiduciary duty.

Close corporation cases never really grapple with the dichotomous nature of shareholder-to-shareholder negotiations, so the law does not provide any clear guidelines in this area. No case has held that a shareholder must "lay every card face up on the table," but all the cases suggest that fiduciary duty puts a limit on the "workaday" benefits of secrecy.

IV. THE CLASH BETWEEN FIDUCIARY DUTY AND DISCRETION—THE SHAREHOLDERS' DUTY OF GOOD FAITH VS. A SHAREHOLDER'S EMPLOYMENT AGREEMENT

In the past several years, an overlap between employment law and close corporation law has caused courts to consider the extent to which shareholders can sign away their rights to fiduciary "fairness." In the typical scenario, a shareholder employee signs an agreement entitling (or requiring) the corporation to buy back his or her stock if employment terminates. Some time later the corporation does terminate the employment and seeks to buy back the stock. The employee resists the buy-back and also usually the termination, claiming \textit{inter alia} a breach of shareholder fiduciary duty.

This scenario differs from traditional "freeze outs" in which a controlling shareholder simply fires a minority shareholder. Typically in those circumstances, no buy-back provision exists. Since salaries constitute the major payout mechanism, the termination of employment excludes the shareholder from the

\footnote{56. The quoted language reflects how federal securities law defines "materiality." The quotation is from TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), which defined "materiality" in the context of the obligation to disclose material information in proxy solicitations. In 1988 the Supreme Court followed the circuits and adopted the same definition for the purposes of Rule 10b-5. Basic Inc. v. Levinson, 108 S. Ct. 978, 979 (1988).}
benefits of his or her investment. At the same time, the excluded shareholder’s investment remains locked in the corporation, since there is no ready market for the shares of a minority owner.

The more traditional approach of “freezing out by firing” has occasioned many lawsuits, and in some the plaintiffs have succeeded. The buy-back cases, however, have generally gone in favor of the defendants, and these cases provide important and perhaps generally applicable guidance for those seeking to control the unpredictability inherent in current doctrines of shareholder duty.

In most of the reported buy-back cases, a buy-back agreement exists but there is no express contract authorizing the termination of employment. The corporation (representing the views of the controlling shareholders) argues that the termination of employment was proper under the employment-at-will doctrine and that the termination triggered a proper buy-back agreement. The ex-employee/ex-shareholder typically advances a range of arguments that the termination was improper. For the purposes of this essay, the most interesting one is that the termination violated, or served to evade, the fiduciary duty owed the employee as a shareholder in a closely-held corporation.

The courts have used three different approaches to reject the ex-shareholder’s fiduciary duty claim. The New York courts hold that when a buy-back agreement is in place “no fiduciary obligation arises” with respect to matters the agreement covers. The New York view is that the law of close corporations does not affect the law of employment and therefore shareholder status does not affect the employment-at-will doctrine. That doctrine sanctions the termination of employment, and the buy-back contract controls stock ownership. The contract apparently displaces any fiduciary concerns.


59. Ingle v. Glamore Motor Sales, Inc., 73 N.Y.2d 183, 190, 535 N.E.2d 1311, 1314 (N.Y. 1989). But see id. at 190, 192, 535 N.E.2d at 1315, 1317 (Hancock, J., dissenting) (contending that the employment-at-will doctrine has no place among shareholders in a close corporation).
Other courts take a slightly different approach toward the same result. The leading case of Coleman v. Taub holds that a shareholder who signs a buy-back agreement signs away any fiduciary claims:

[A] minority shareholder may bargain away the "additional interest" in corporate participation which might otherwise be the basis for a fiduciary duty on the part of the majority. . . .

. . . [T]here is no reason why an appeal to general fiduciary law should be used by either party as a pretext for evading his contractual obligations.

Contractual waivers on fiduciary rights can increase predictability and can shelter entrepreneurs from costly and vexatious litigation. Coleman recognizes quite forcefully that these are important values: "Coleman [the ex-employee/ex-shareholder] bargained for the right to be a shareholder only while he remained an employee. He did not bargain for the privilege of being a dissident, litigious, outside minority stockholder and the obvious purpose of the buy-back clause was undoubtedly to avoid such a situation."

A third approach holds that some employee shareholders cannot make fiduciary claims because mere employees are not real "partners" in the business. In Harris v. Mardan Business Systems, Inc., the Minnesota Court of Appeals used that rationale to deny recovery to an ex-employee who had given up a lucrative position with a major corporation in order to take a five percent share in a close corporation. The court consid-

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60. 638 F.2d 628 (3d Cir. 1981) (Delaware law).
61. Id. at 636.
62. Id. at 637. One court has held that the bargain sticks even when termination of employment occurs just before a significant increase in the buy-back price. Gallagher v. Lambert, 145 A.D.2d 313, 313, 532 N.Y.S.2d 255, 257 (1988). But see Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 439 (7th Cir. 1987) (terminating employment for the purpose of preventing appreciation of stock would be wrongful discharge).

The "bargained-away" approach also appears in a case involving both a buy-back agreement and an employment contract. The employment agreement expressly authorizes the termination, but that fact did not figure into the "bargained away" analysis. Instead the court focused exclusively on the buy-back agreement. Jenkins v. Haworth, Inc., 572 F. Supp. 591, 601-02 (W.D. Mich. 1983) (Michigan law). The employment agreement could have helped the court find against the employee shareholder, because the existence of that agreement moots Justice Hancock's argument in Ingle, discussed supra note 59, that the employment-at-will doctrine ought not apply to shareholder employees in close corporations.
ered it significant that the ex-employee had not helped found the business and had not invested any money in the business.\textsuperscript{64}

The Minnesota approach is specious. Nothing in close corporation law or in the law of partnership makes contribution of capital or "being in at the beginning" prerequisites to "partner" status. Harris, the ex-employee, had made a significant commitment and contribution to the enterprise. He abandoned a well-paying and secure position in order to bring his expertise to a risky and relatively new venture. He was precisely the kind of minority shareholder whom fiduciary doctrines developed to protect. The buy-back provision was enforceable because Harris had agreed to it, not because Harris' stake was too little or too new to worry about.

V. COPING WITH UNCERTAINTY—PRACTICAL SUGGESTIONS

Modern close corporation law invites shareholders to plan their \textit{inter se} relationships.\textsuperscript{65} The buy-back cases suggest that such planning can limit the uncertainty inherent in concepts of shareholder fiduciary duty. For limiting efforts to succeed, the venturers must conduct extensive exploratory discussions and the lawyers must take special care in drafting corporate documents.

Notions of "fairness" and "expectations" are especially problematic when parties confront problems they have never anticipated. By the time a problem actually arises, the circumstances define each party’s stake in the outcome. As a result, it is often too late for people to consider matters dispassionately; it is too late to form a consensus notion of fairness.

As the philosopher John Rawls has suggested, the best way for people to evaluate the fairness of particular arrangements is to be ignorant of how those arrangements may eventually affect them.\textsuperscript{66} Thus, the most constructive time to explore issues of fairness in the close corporation is when those issues exist only in the abstract.

In such explorations, the lawyers play a crucial role as guides to potential problems and as generators of workable solu-

\textsuperscript{64} \textit{Id.} at 353.

\textsuperscript{65} \textit{Whestone v. Hossfeld Mfg. Corp.}, 1990 WL 83676 (Minn. 1990) (court vindicated a plan designed to protect a minority shareholder and held that a material deviation from the design entitled the minority shareholder to be bought out).

\textsuperscript{66} \textit{J. RAWLS, A THEORY OF JUSTICE} § 24 (1971) ("the veil of ignorance").
The lawyers need not, however, be constantly present in order to perform this role. Clients on tight budgets can do much of the initial discussion on their own. The lawyers can supply a letter describing the issues in plain English terms and giving examples of problematic solutions. The clients can then discuss matters among themselves, and for each issue either reach a tentative agreement on an approach or develop specific concerns for further discussion. The lawyers can then rejoin the process, to clarify and test the understanding and eventually to develop a legal structure to effectuate the business objectives.

In developing that legal structure, the lawyers should take special care to delimit the fiduciary duties of good faith and fairness. Shareholders likely cannot "opt out" of their fiduciary duties, but they may well be able to partially define them. A comprehensive operational definition is probably impossible; no court has yet succeeded and few have even tried. But an agreement can specify particular conduct which the shareholders deem consistent with their fiduciary duties to each other. At least for the conduct specified, the legal conse-

67. The suggestions which follow assume that each party will have separate representation. Under the Rules of Professional Conduct it may be possible for one lawyer to represent "the deal." The lawyer would have to satisfy the consultation and agreement requirements of Rule 1.7(b). Joint representation can be quite constructive, but it does raise some special malpractice issues. For example, it may be dangerous for a lawyer to represent both the corporation and the corporation's majority shareholder. In Evans v. Blesi, 345 N.W.2d 775, 780-81 (Minn. Ct. App. 1984), such joint representation destroyed the attorney-client privilege. The court of appeals approved the trial court's "theory that by representing both the majority shareholder and the corporation, the lawyers were in a conflict of interest position and had a duty to advise . . . the minority shareholders of their advice regarding corporate matters." Id. Even the appearance of joint representation can be troublesome. A lawyer representing a close corporation should make clear just whose interests he or she represents. Cf. Felty v. Hartweg, 169 Ill. App. 3d 406, 523 N.E.2d 555 (1988) (absent an agreement, attorney for close corporation owed no duty to minority shareholders; minority shareholders were not third-party beneficiaries); Schuler v. Meschke, 435 N.W.2d 156, 162 (Minn. Ct. App. 1989) (attorney for cooperative not the attorney for cooperative's members).

68. Some practitioners may object to the idea of clients negotiating without the lawyers present. What if an aggressive individual takes advantage of a passive one? To this concern, there are at least two answers. First, the "ground rules" can include a specific understanding that the non-lawyer negotiations are only exploratory and that no commitments will be made until the lawyers rejoin the process. Second, if overbearing conduct occurs even in preliminary discussions, it is likely to recur once the enterprise is operating. It is an advantage for the parties to see each other "in their true colors" before they become irrevocably committed.
quences should be predictable.\textsuperscript{69}

This definitional approach is borrowed from the Uniform Commercial Code. Under section 1-203 of the UCC, “Every contract or duty within this Act imposes an obligation of good faith in its performance. Section 1-102(3) prohibits any disclaim of the obligation of good faith, but invites the parties “by agreement [to] determine the standards by which the performance of such obligations is to be measured.”

To protect the specified standards, and all other stated provisions, from the evolution of “shareholder expectations,” the lawyers should describe to the clients the Pandora’s box of dangers which will open if the parties allow the legal document and the business reality to get “out of synch.” The lawyers should emphasize the importance of amending the document to reflect any changes in circumstances or expectations.\textsuperscript{70} The document itself should explicitly preclude oral modifications and modifications through course of dealing. The lawyers should integrate into the text of the document clear and strong explanations of the dangers all parties fear from “evolving” claims.

As a fall-back, the document should perhaps include a contractual “statute of repose” on claims of evolving expectations. Suppose, for example, that the reference in Minnesota Statute section 302A.751, subdivision 3a to “reasonable expectations . . . as they . . . develop” precludes any absolute prohibition against non-written modifications. A shareholders’ agreement might still succeed in barring a party from claiming an understanding unless that party has, within a specified period, formally brought the supposed new understanding to the attention of the other shareholders.

**CONCLUSION**

The modern law of close corporations requires that share-

\textsuperscript{69} This approach has succeeded in dealer termination cases. Often in such cases a dealer terminated under a no-cause termination provision argues that the no-cause termination breaches the covenant of good faith. The courts usually see the no-cause termination provision as specifying the parties’ agreed-upon standard of good faith and therefore reject the dealer’s claim. Corenswet, Inc. v. Amana Refrigeration, Inc., 594 F.2d 129, 138 n.10 (5th Cir.), reh’g denied, 597 F.2d 772 (5th Cir.), cert. denied, 444 U.S. 938 (1979).

\textsuperscript{70} Kleinberger, Contracts and Disputes—Waging the War or Winning the Peace, BENCH AND BAR OF MINNESOTA, October 1987, at 15, 20.
holders treat each other fairly. Developed in response to truly egregious conduct, the requirement is both powerful and imprecise. When controlling shareholders engage in unambiguously unfair conduct, the power succors minority shareholders and the imprecision is immaterial.71 However, when the facts do not shout unfairness, the combination of power and imprecision creates troubling uncertainty. The uncertainty can be somewhat confined by good planning at the outset of a venture, followed by careful efforts to keep the business practices and the legal documents in accord with each other. Some uncertainty will remain, however—the cost of a rule of law which decrees that people must act fairly while failing to explain with precision the meaning of unfairness.