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Heightened Fiduciary Duties in Closely Held Corporations: Donahue Revisited

STEVEN N. BULLOCH*

In 1975, the Massachusetts Supreme Judicial Court decided the landmark case of Donahue v. Rodd Electrotype Co. of New England, Inc. The decision challenged the assumptions under which closely held corporations operated. Prior to Donahue, the rights and liabilities of the majority shareholders in a closely held corporation vis-a-vis the minority were defined reasonably well. Donahue, however, changed the law applicable to closely held corporations. After Donahue, any maneuver by a majority shareholder that in any way impinged upon the rights of minority shareholders or that benefited only the majority shareholders was subject to attack by the minority. Donahue was used by minority shareholders in a variety of situations, sometimes successfully. The decision even was used against minority shareholders whose actions harmed the majority shareholders.2

This article will demonstrate that Donahue was a well-reasoned decision that should be extended. To effectuate that purpose, the author will trail the impact of Donahue on closely held corporations by considering the Donahue progeny. Situations in which Donahue was not applied thereafter will be examined, with the author evaluating whether that decision should have been followed. Before discussing the impact of Donahue, however, that case first must be explored.

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2. See infra notes 62-81 and accompanying text.
Donahue: Opening the Door for Minority Shareholders

Donahue involved a small electrotype corporation, the stock of which was owned by two families, the Rodds and the Donahues. The company originally had been a subsidiary of Royal Electrotype Company. Its stock, however, had been purchased by Harry Rodd, the person primarily responsible for the success of the company, and by Joseph Donahue, a long-time employee who was involved in the operation of the company, but who never really had participated in the "management" aspect of the business.

At one time, Rodd owned eighty percent of the outstanding stock, while Joseph Donahue owned twenty percent. As Harry Rodd grew older, he sold or gave stock to his children and also brought them into the business. The Rodd family continued to control a majority of the stock in the corporation.

In 1970, when Harry Rodd reached the age of 77, he and his sons decided he should retire. As part of his retirement plan, the Rodd family decided that his remaining shares would be purchased by the corporation. To assure that the minority shareholders would have no grounds for complaint, the parties pegged the purchase price of the stock at book and liquidation value.

4. Id. at 581, 328 N.E.2d at 509.
5. See id. at 582, 328 N.E.2d at 509.
6. Id. at 581, 328 N.E.2d at 509.
7. Id. at 582, 328 N.E.2d at 509.
8. See id. at 582, 328 N.E.2d at 510.
9. Id. at 583, 328 N.E.2d at 510.
10. See id. The book value of shares in a corporation with only one class of stock is determined by subtracting the total corporate liabilities from total assets and dividing this figure by the number of shares outstanding. See Schaffer v. Below, 278 F.2d 619, 625 (3d Cir. 1960). This value is not necessarily an accurate reflection of the true value of the shares for a number of reasons. First, under this valuation method, the assets of a corporation are not revalued periodically, but rather are shown at cost less depreciation. Thus, increases in the value of individual assets, due to inflation or other reasons, are ignored. Second, this approach fails to consider the value of the enterprise as a going concern but rather considers only the aggregate value of the individual corporate assets. Book value nevertheless is one method that has some reliability for valuing an interest in a corporation. See generally M. Hood, A. Kurtz & P. Shors, Closely Held Corporations in Business and Estate Planning §9.4 (1982) (indicating problems with book value but recognizing it as a valid starting point for determining share valuation). The liquidation value of shares is based on the price that the assets of the enterprise would bring if the enterprise ceased doing business and the assets were sold. After subtracting total liabilities, the liquidating value per share is determined by dividing the remaining figure by the number of shares outstanding. As is true with book value, liquidating value per share normally does not reflect the true value of the shares since no adjustment is made for the value of the enterprise as a going concern. This method also tends to produce a low value because it assumes that sales upon liquidation will require some urgency and, therefore, the price to be obtained for some of the assets will be depressed. This method, however, gives the absolute bottom value for a business below which liquidation, rather than sale as a going concern, is preferable.
The transaction occurred, apparently without the knowledge of the Donahues. After learning of the repurchase they requested that their shares also be repurchased at the same price per share as was paid to Harry Rodd. Their request, however, was rejected by the corporation.

The Donahues then brought suit. They argued that the decision of the Rodd family to cause the corporation to repurchase only Harry's stock, and not to offer this same opportunity to them, was a breach of the fiduciary duties owed by the majority to the minority shareholders. The trial court ruled in favor of the defendants because the Rodds and their attorneys had pegged the repurchase price at the book and liquidation value of the stock. The transaction, therefore, seemed fair to the corporation and the minority shareholders, who apparently would not be affected adversely by the transaction. The trial court applied the prevailing rule, which approved transactions fair to the corporation. Massachusetts followed this rule at the time Donahue was decided.

The Massachusetts Supreme Court, however, declined to follow the prevailing law and reversed, stating that participants in closely held

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12. Id. at 584, 328 N.E.2d at 511.
13. Id.
14. Id. at 585, 328 N.E.2d at 511.
15. Id. at 580, 328 N.E.2d at 508.
16. See supra note 10 and accompanying text.
17. Although book and liquidating values are not likely to reflect accurately the fair market value of stock, a sufficiently close relationship exists between the fair market value and values arrived at through the use of these methods to at least raise a presumption of reliability. See supra note 10.
18. Since the Rodd family represented the corporation as purchaser and because one of the family members, Harry Rodd, was the seller, this transaction created a conflict of interest on the part of the Rodd family. This is because the family's duty to the corporation to obtain the lowest price for the stock conflicted with the family's self-interest in obtaining the highest price for the shares of a family member. Under the common law prevailing in most jurisdictions today, a transaction fair to the corporation will not be struck down. See, e.g., In re Westec Corporation, 434 F.2d 195, 202 (5th Cir. 1970). Applying Texas law, the court stated: "because of his fiduciary obligation, an officer's contract with his corporation for his personal gain will be subjected to the scrutiny of the courts. It will not be upheld unless the officer shows that it is fair and made in good faith." Id. In many jurisdictions, statutory resolutions of this problem have superseded the common law. Statutory solutions generally are less protective of the interests of the corporation than is the common law. See, e.g., DEL. CODE ANN. tit. VIII §144 (1983). This statute provides that transactions tainted with conflict of interest are not invalid if: (1) approved by a vote of the disinterested directors; (2) ratified by the shareholders (including interested shareholders); or (3) fair to the corporation. Id. Under the Delaware statute, therefore, a transaction that is not necessarily fair to the corporation may be upheld by a vote of the shareholders, the outcome of which could be decided by an interested party who owns sufficient shares.
corporations owe heightened fiduciary duties to each other. The court held that this corporation was a closely held corporation and that the decision to repurchase the stock of one of the majority shareholders, without affording that same opportunity to the minority shareholders, breached those heightened fiduciary duties. The analysis by the court of each of these points is instructive.

A. Defining a Closely Held Corporation

Commentators and courts always have grappled with the problem of defining a closely held corporation. Obviously, the line that separates closely held from mid-sized corporations cannot be drawn with certainty. In Donahue, the court advanced two approaches to this problem. First, the court said that a corporation is "closely held" if it has (1) a small number of shareholders, (2) no ready market for the corporate stock, and (3) substantial majority shareholder participation in the operation of the enterprise. Second, the court analogized a closely held corporation to a partnership, pointing out that closely held corporations are often called "incorporated partnerships" because the internal relationships of the participants are similar to those of partners while the enterprise is clothed with benefits peculiar to a corporation, such as limited liability for the participants.

B. Heightened Duties in Closely Held Corporations

Once a closely held corporation is defined, the next inquiry focuses on why majority shareholders in closely held corporations owe heightened fiduciary duties to the minority. The court offered two reasons. First, minority shareholders in a closely held corporation tend to have a greater stake in the venture than do their counterparts in a publicly held corporation. This is an empirical assumption that is probably true, but for which the court offered no support.

Second, a minority shareholder in a closely held corporation has

21. Id. at 601, 328 N.E.2d at 519-20.
22. See id. at 599, 328 N.E.2d at 518-19.
23. Israels, The Close Corporation and The Law, 33 Cornell L.Q. 488, 491 (1948). Professor Israels stated that "no satisfactory all-purpose definition of a close corporation appears ever to have been worked out, a fact which itself has led to some of the confusion in the cases, springing from the willingness or unwillingness of particular courts to grant legal recognition to the clearly separate economic concept of the close corporation." Id.
25. Id. at 586-87, 328 N.E.2d at 512.
26. See id. at 590-91, 328 N.E.2d at 514.
no ready market for his shares. This, of course, is one of the factors utilized in defining a closely held corporation. It is true for a number of reasons. For instance, unlike a public corporation, no organized market exists for shares in a closely held corporation. Also, interests in closely held corporations are notoriously difficult to value, and interests often are impaired by transferability restrictions. Furthermore, transferability of stock of a minority shareholder in a closely held corporation is diminished when relationships between majority and minority shareholders are less than cordial. No informed person would put himself in the position of the minority under these circumstances.

Given these two assumptions, the court stated that the majority can inflict severe harm upon minority shareholders in a closely held corporation. The majority, for instance, can utilize a variety of schemes to "freeze out" the minority. In particular, the majority may use its power to control the board of directors and deny the minority employment in the corporation. Denying employment can dry up the minority shareholder's investment return because most closely held corporations pay salaries, instead of dividends, to distribute

27. Id. at 591, 328 N.E.2d at 514.
29. Absent provisions in the articles, bylaws or other document, shares of stock in a corporation are freely transferable. Fayard v. Fayard, 293 So. 2d 421, 423 (Miss. 1974). "Corporate shares of stock are universally considered personal property and in the absence of valid restrictions the owner has an inherent right incident to ownership to sell and transfer at his will." Id. Free transferability of ownership interests is a characteristic that distinguishes corporations from other types of business organizations, such as partnerships. In closely held corporations, the free ownership transferability of a typical corporation generally is not viewed favorably by the participants, who work with one another in the day-to-day management of the enterprise and therefore are concerned with the compatibility and competence of fellow shareholders. Ownership interests in closely held corporations frequently are subject to share transfer restrictions because of this concern. These restrictions can take on a variety of forms, but rights of first refusal on behalf of the corporation or remaining shareholders and buy-out agreements are most common. A right of first refusal gives the corporation or remaining shareholders the option to purchase a departing shareholder's shares before he can transfer them to a third party. Under a buy-out agreement, the departing shareholder, on the one hand, is obligated to sell his shares to the corporation or the remaining shareholders at a certain price upon the occurrence of a certain event, and the corporation or remaining shareholders, on the other hand, are obligated to purchase the shares for that price when the event occurs. Both types of restrictions are beneficial to the remaining shareholders because they prevent the departing shareholder's shares from falling into the hands of unwanted outsiders. Only a buy-out agreement, however, is beneficial to the departing shareholder, who is provided with a market for his shares. See 2 F. O'Neal, CLOSE CORPORATIONS §§7.01-7.29 (2d ed. supp. 1984) for a general discussion of share transfer restrictions.
30. Orchard v. Covelli, 590 F. Supp. 1548, 1557 (W.D. Pa. 1984). "Dissension within the close corporation tends to make the minority interest even more unattractive to a prospective purchaser." Id.
32. Id. at 588-89, 328 N.E.2d at 513.
33. Id.
funds to their shareholders. 34 Unless the statutory norm of majority rule were altered when the corporation was formed, 35 the minority shareholder also could lose his position as director or officer of the corporation through the actions of the majority. Moreover, as mentioned previously, the minority shareholder has no recourse because a ready market in which to sell his shares does not exist. Thus, given the substantial impact that the majority shareholder can have on the wealth and general well-being of the minority shareholder, heightened fiduciary duties are justified.

The application of heightened duties to the repurchase of a majority shareholder's stock is not self-evident. A corporate repurchase is not the classic "squeeze out" as just described. 36 The Donahue court nevertheless applied the concept to repurchases, concluding that a minority shareholder had to be afforded an equal opportunity to resell shares to the corporation. 37 The court reasoned that the repurchase provided only the majority with a market for its shares in a situation in which, by definition, no ready market for the shares exists 38 and that the repurchase afforded only the majority shareholder access to corporate assets. 39 The court concluded, therefore, that the Donahues, as minority shareholders, had to be given an equal opportunity to resell their shares. 40 Subsequent decisions have refined the sweeping doctrine advanced in Donahue.

34. As long as salaries are reasonable in amount they are deductible as an ordinary and necessary business expense by the corporation. I.R.C. §162(a)(1) (1982). Dividends, on the other hand, are not deductible. 1 F. O'Neal, supra note 29, §2.04. Since participants in closely held corporations generally are involved in the day-to-day operation of the corporation and because salaries are deductible by the corporation, distributions to participants are made through the payment of salaries rather than dividends.

35. In almost all jurisdictions today, ordinary decisions of the shareholders and directors are determined by a vote of a majority of a quorum. See, e.g., Cal. Corp. Code §602; Del. Code Ann. tit. VIII, §216. One device for protecting minority shareholders is to place a high vote requirement in the articles or bylaws when the corporation is formed. This can be done because the statutory norm of majority rule is not immutable. See, e.g., Del. Corp Ann. tit. VIII §141(b). "The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number." Id. Utilization of a high vote requirement is a technique often used in closely held corporations and is effective in protecting minority interests. See Roach v. Bynum, 403 So. 2d 187, 192 (Ala. 1981). "The requirement of unanimity or high quorum/vote for shareholder and director action is one of the most effective methods of protecting the interests of the minority shareholders and preventing the majority from 'squeezing out' the minority." Id.

36. No minority shareholder was deprived of a return on his investment or of his share in the control of the corporation. Rather, only the majority, and not the minority, was given a benefit, the repurchase of stock.

38. Id. at 599, 328 N.E.2d at 518.
39. Id. at 599, 328 N.E.2d at 518-19.
40. Alternate relief in the form of rescission of the transaction between Harry Rodd and
THE LAW AFTER DONAHUE

The Massachusetts Supreme Court refined Donahue in Wilkes v. Springside Nursing Home, Inc. Wilkes involved a classic squeeze-out situation. Wilkes and three others formed a corporation to own and operate a nursing home. The enterprise was a typical closely held corporation because all four shareholders were to be involved in the management of the business. The business operated smoothly until a controversy arose over the price that Quinn, one of the shareholders, should pay for some land he sought to purchase from the corporation. Wilkes convinced the other two shareholders to hold out for a price higher than Quinn desired to pay. This infuriated Quinn and thereafter the relationship of Wilkes with Quinn, as well as with the other two shareholders, deteriorated. The squeeze out then began. First, employment of Wilkes with the corporation was terminated by the other three shareholders through their control of the board of directors. Then, at the next shareholders meeting, Wilkes lost his position on the board.

At this point, Wilkes became an outsider. He no longer received any return on his investment because the corporation distributed funds to the shareholders through salaries, rather than dividends, and he no longer was employed by the corporation. Furthermore, he could no longer participate in the control of the corporation since he had lost his positions as an officer and director. Wilkes could not sell his stock because no organized market existed for his stock and no rational person would purchase a minority interest in a closely held corporation in which the minority was feuding with the majority.

As a result of their squeeze out, Wilkes filed suit, alleging that the majority shareholders had breached their fiduciary duties to him. In Wilkes, the Massachusetts Supreme Court defined more carefully

the corporation also was granted. Id. at 578, 603, 328 N.E.2d 505, 520-21 (1975); see Comolli v. Comolli, 241 Ga. 471, 246 S.E.2d 278 (1978) (result similar to Donahue).
42. Id. at 844, 353 N.E.2d at 659.
43. See id. at 845 n.8, 353 N.E.2d at 660 n.8.
44. Id. at 846, 353 N.E.2d at 660.
45. Id.
46. See id. at 846-47, 353 N.E.2d at 660.
47. See id. at 847, 353 N.E.2d at 661.
48. Id.
49. Id. at 850 n.13, 353 N.E.2d at 662 n.13.
50. The group of remaining shareholders was the one potential buyer for the stock. The price they were willing to pay Wilkes, of course, was extremely low, and the court found that forcing Wilkes to sell his shares to them “may have been at the heart of [their] plan.” Id. at 852, 353 N.E.2d at 664.
51. Id. at 843, 353 N.E.2d at 658-59.
the duties that majority shareholders owe to the minority. The court recognized that the majority must be accorded some flexibility in operating the corporation because it controlled the enterprise and thus had a right to maximize corporate efficiency.52

The *Wilkes* court developed a balancing test to accommodate the interests of the majority and minority shareholders in the corporation.53 Under this test, the initial burden is placed on the majority to demonstrate some legitimate corporate purpose for taking actions that harm the minority shareholder.54 If the majority demonstrates a corporate purpose, the minority then must demonstrate how this corporate purpose could have been accomplished through alternative means less harmful to the minority shareholders.55 If this is done, the court then must weigh the legitimate corporate purpose "against the practicality of [the suggested] less harmful alternative."56

In *Wilkes*, the judicial inquiry was simple because the majority had shown no legitimate corporate reasons for terminating plaintiff's employment.57 Testimony taken at trial had shown that Wilkes had been a competent employee and had done nothing to indicate that he was acting other than in the best interests of the corporation.58 The actions of the majority apparently were designed to force Wilkes to sell his stock in the corporation at an unreasonably low price.59

The development of the balancing test in *Wilkes* is sensible primarily because majority shareholders should have some ability to maneuver when running an enterprise. The test, however, does emphasize astute fact presentation at the trial court level. Indeed, in *Wilkes*, the majority should have been able to present some arguably reasonable justification for its actions, and this would have made the task of the court substantially more difficult.60

52. *Id.* at 851, 353 N.E.2d at 663.
53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.* at 852, 353 N.E.2d at 664.
59. *See supra* note 50.
60. *See Zidell v. Zidell*, Inc., 277 Or. 413, 560 P.2d 1086 (1977) (an example of a more conservative approach to a situation similar to *Wilkes*). In *Zidell*, one shareholder had resigned his position with the closely held corporation after a dispute with the majority shareholders. He also lost his directorship with the corporation. He later sued the majority shareholders arguing that they had breached their fiduciary duties to him by paying unreasonably low dividends, while at the same time paying themselves unreasonably high salaries. The court, ignoring that the corporation was closely held, employed the business judgment rule in reviewing the decision of the majority regarding the amount of the dividends. Use of the business judgment rule almost always guarantees that defendants will prevail because under the rule, "any plausible business reasons supportive of the [defendant's] decision" will suffice. 277 Or. at 419, 560
Wilkes involved the situation in which the heightened fiduciary duty is most compelling.\textsuperscript{61} In other situations, however, the application of the concept is less certain. Another Massachusetts case, Smith v. Atlantic Properties, Inc.,\textsuperscript{62} involves one of these more difficult and less compelling situations.

In Smith, four persons formed a corporation to construct certain housing units.\textsuperscript{63} When the corporation was formed, the participants included provisions in the articles and bylaws stating that any proposed action by the shareholders, directors, or officers, required the assent of the holders of eighty percent of the corporate stock.\textsuperscript{64} This supermajority provision had the practical effect of requiring unanimous consent since each shareholder had sufficient stock ownership to block any proposal.\textsuperscript{65}

The corporation was successful, but a problem arose because the defendant Wolfson's outside income was much greater than that of his fellow shareholders.\textsuperscript{66} Thus, distributions of income from the corporation were not beneficial to him because he did not need the money as much as the others and he would pay a greater percentage of such distributions in taxes because he was in a high tax bracket. Wolfson's intransigence caused the corporation to accumulate substantial retained earnings. Consequently, either a plan for the use of the earnings or a distribution to shareholders was necessary to avoid imposition of a penalty tax.\textsuperscript{67} Wolfson wanted to utilize the excess cash to improve

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\textsuperscript{61} See also Hallahan v. Haltom Corp., 7 Mass. App. Ct. 68, 385 N.E.2d 1033, 1034-35 (1979), in which the court applied the Wilkes analysis to a similar squeeze out.


\textsuperscript{63} Id. at 202, 422 N.E.2d at 799.

\textsuperscript{64} Id.

\textsuperscript{65} Id.

\textsuperscript{66} Id. at 207-08 n.8, 422 N.E.2d at 802 n.8.

\textsuperscript{67} See id. at 203, 422 N.E.2d at 800. The accumulated earnings tax is a penalty imposed on corporations accumulating earnings that exceed the reasonably anticipated needs of the business. See I.R.C. §§531-537 (1982). This tax is imposed to deter individuals from forming a corporation and unreasonably retaining earnings within the corporation because the marginal tax rates for corporations are lower than those for individuals. See B. Bittker & J. EuStice, Federal Income Taxation of Corporations and Shareholders, §8.01 at 8-2 (1979); compare I.R.C. §11 (1982) (individual income tax) with I.R.C. §1 (1982) (corporate income tax). This
corporate property. The other shareholders, however, wanted to distribute the earnings because they needed the cash and they were in lower tax brackets.

The shareholders could not reach an agreement, and, because of the supermajority vote requirement, Wolfson was able to veto the distribution. Eventually, the penalty tax was imposed, and the other shareholders brought suit, claiming that Wolfson had breached his fiduciary duty by vetoing the proposed distribution and thereby causing the corporation to incur the tax.

The Smith court, therefore, was asked to extend the Donahue concept to a minority shareholder. The court held that the Donahue doctrine applied. The court stated that because of the eighty percent requirement, the minority "becomes an ad hoc controlling interest." The court reasoned that heightened fiduciary duties should be imposed on the minority in this context. The court then proceeded to utilize the balancing test developed in Wilkes and concluded that Wolfson should be held liable because his actions were not based on a legitimate corporate reason. This result seemed inevitable because the trial court had found that Wolfson's refusal to vote for dividends was based on tax avoidance and ill will toward fellow shareholders.

Extension of the concept of heightened fiduciary duties to minority shareholders is tenuous. In applying Donahue to the minority, the Smith court focused on the power given to the minority under a supermajority vote requirement. Extending Donahue even under these circumstances, however, is debatable. Donahue rested on the assumption that the majority, through control of the machinery of a closely held corporation, could inflict great harm on a minority shareholder who was likely to have a substantial percentage of his wealth tied

penalty may be avoided either by distributing the earnings, which depletes accumulated earnings of the corporation, or by development of a plan detailing the reasons why accumulated earnings are necessary to satisfy the reasonable needs of the business. See I.R.C. §537 (1982).

Wolfson wished to reinvest the earnings in the corporation, but his proposal was not certain enough to satisfy the Internal Revenue Service. 12 Mass. App. Ct. at 203, 422 N.E.2d at 800 (1981).

Id.

Id.

See id.

See infra note 106 and accompanying text for a discussion of the ramifications of extending fiduciary duties to minority shareholders because of a high vote requirement and of the other situations in which this extension should occur.
up in the corporation and who would be unable to sell his interest because no market existed for his stock.\textsuperscript{78} Wilkes represents the classic illustration of how majority control of corporate machinery can abuse the minority shareholder. Even when a supermajority vote requirement exists, however, the power of the minority shareholder is not overwhelming. He has, for instance, no power to initiate actions or schemes which may harm the majority, and his veto power is the same as that of any other shareholder. In reality, the minority shareholder does not constitute an ad hoc majority.

In \textit{Smith}, for example, Wolfson had no greater power than any of the other three shareholders. Wolfson's goals for corporate earnings differed from those of his fellow shareholders because of his high income and tax bracket. Moreover, although his motives may have been selfish, Wolfson's desire to reinvest corporate earnings was as reasonable as the desire of the other shareholders to distribute them. The court, therefore, should not have held that Wolfson breached a fiduciary duty to the other shareholders even though his position was motivated by personal concerns as long as some corporate justification existed for his position. Why should the desires of the majority, which were also motivated by selfishness, be given precedence over his? The answer must be in Wolfson's failure to advance any corporate justification for his actions.\textsuperscript{79} Any corporate justification for retention of earnings should have been enough to prevent him from being held liable. The shareholders' stand-off is a natural consequence of the decision to employ a supermajority voting requirement, and they must all suffer the resulting consequences.\textsuperscript{80} Once the stand-off occurs, pointing the finger at one shareholder because he has exercised his voting rights is not a solution; rather, the use of dispute resolution mechanisms, such as arbitration, is proper.\textsuperscript{81}

\textsuperscript{78} See \textit{supra} notes 26-35 and accompanying text.

\textsuperscript{79} See \textit{supra} note 76 and accompanying text.

\textsuperscript{80} Although high vote requirements are an effective way to protect a minority shareholder in a closely held corporation, the use of this tool can lead to deadlocks that ultimately can paralyze the corporation. See, e.g., Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 119, 60 N.E.2d 829, 831 (1945) (“prima facie in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined.”). See also Kaplan v. Block, 183 Va. 327, 335-36, 31 S.E.2d 893, 896-97 (1944).

\textsuperscript{81} Deadlocks are much more likely to arise in closely held corporations than in publicly held corporations. High vote requirements often employed in many closely held corporations lead to deadlocks when shareholders cannot agree. Even in closely held corporations without high vote requirements, stock ownership often is divided evenly between two shareholders or shareholder groups, which means that disagreements turn into deadlocks. For this reason, deadlock-breaking devices are an important planning tool for a closely held corporation. Arbitration is recommended widely and probably is the most common of these tools. Field, \textit{Resolving Shareholder Disputes and Breaking Deadlocks in the Close Corporation}, 58 Minn.
Smith represents the extreme case. When high vote requirements are imposed, each shareholder is a fiduciary because each can use the veto to exercise control over the corporation. This control will impact substantially on fellow shareholders if the Donahue assumptions, that each shareholder has a significant percentage of his wealth invested in the corporation and that this wealth cannot be easily extracted from the enterprise, are accepted. Nevertheless, because no one minority shareholder possesses any greater power than the other shareholders, the fiduciary duty of a minority shareholder should be less than that imposed on a majority shareholder. The court should not require that the actions of a minority shareholder be more reasonable than those of his fellow shareholders, but only that they be reasonable. In other words, the defendant-minority shareholder should prevail if he presents some reasonable corporate justification for his actions. Smith, therefore, was correctly decided only because Wolfson failed to show any reasonable corporate basis for vetoing the distribution of corporate earnings. The fiduciary duties owed by participants in closely held corporations become paramount when battles for control occur.

Fiduciary Duties in the Context of Quests for Control

Control of a closely held corporation can be of paramount importance to the participants. Essentially, the person in control can operate the enterprise as though he were a sole proprietor even though he did not provide all of the capital required for the venture. Consequently, battles for control frequently occur within closely held corporations. These fights for control arise in a variety of factual patterns. Each of these fact patterns will be examined and the devices utilized by the person seeking control will be analyzed in the context of the fiduciary duties owed to each other by participants in closely held corporations.

A. Failure to Exercise the Corporation’s Right of First Refusal in Order to Gain Control of the Corporation

The validity of using the corporate machinery to cause the cor-

poration to reject an option to repurchase the stock of a selling shareholder in order to gain control is examined in the cases of *Boss v. Boss* and *Lash v. Lash Furniture Company of Barre, Inc.* In both of these cases, repurchase by the corporation would have preserved the proportionate interests of the remaining shareholders. The failure to exercise the option, however, allowed the defendant to purchase the selling shareholder’s stock and gain control of the corporation.

*Boss v. Boss* presented an unusual situation in which three members of the Boss family and a fourth person, George Brown, owned all of the outstanding shares of the A.T. Cross Pencil Company. Ethel Boss’s interest consisted of a life interest in sixty shares that were to be divided equally between her son, Walter, and her stepson, Ellery, upon her death. Walter presently owned three shares, while Ellery owned two. Brown owned six shares, but wanted to sell four of them.

The shares were subject to a right of first refusal by the corporation. If the corporation failed to exercise the option, Brown planned to sell the shares to Walter. This transaction was important because if the shares were sold to Walter, he would have had a majority interest in the corporation after his mother’s death. If the corporation exercised the option, Brown would continue to be the swing vote and neither Walter nor Ellery would have had a controlling interest in the corporation. When the question of whether to exercise the option was voted upon by the directors, Walter abstained, Ellery

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82. 98 R.I. 146, 200 A.2d 231 (1964).
83. 130 Vt. 517, 296 A.2d 207 (1972).
85. Id.
86. Id. at 147, 200 A.2d at 232.
87. Id. at 147, 200 A.2d at 233.
88. Id.
89. Id.; see supra note 29 for a discussion of share transfer restrictions. Litigation in the Boss case would have been avoided if the share transfer restriction in question had been drafted properly. Giving the corporation a right of first refusal or option to purchase shares before they could be sold to a third party was a good planning technique. Purchase by the corporation would have caused the proportionate interests of the remaining shareholders to remain the same and would have stopped the shares from falling into the hands of an unwanted outsider. Successive options, however, should have been provided in the event the corporation failed to exercise the first option. Initially, a second option to the remaining shareholders in proportion to their respective interests and operative only if the corporation failed to exercise the first option, should have been provided. If, however, one of the remaining shareholders failed to exercise his portion of the second option, proper drafting required a third option in favor of other shareholders in proportion to their respective interests in the corporation. Otherwise, the possibility that some of the shares would be sold to an outsider still existed. In Boss, such draftsmanship would have precluded Walter from purchasing all four shares in the event the corporation failed to exercise the option and the lawsuit could have been avoided.
voted in favor of exercising the option and Ethel voted against the exercise. The decision was passed on to the shareholders because of the director deadlock. At this level, the option was rejected because Ethel and Walter voted their shares against the exercise of the option, while Ellery voted his in favor of the exercise.

Ellery sought to enjoin Walter from purchasing the four shares and to require the corporation to purchase them instead. The trial court granted the requested injunction. The Supreme Court of Rhode Island reversed, however, holding that although directors do have fiduciary duties to the corporation, and presumably to the shareholders who own it, no decision was made at that level. The court further stated that the shareholders were free to vote their shares as they pleased since they owed no fiduciary duties to one another. The court therefore refused to scrutinize even minimally the reasons of the majority for voting to reject the option. The Boss court thus accepted the traditional notion that shareholders of a corporation may act in their own self-interests without regard to the interests of the corporation or other shareholders.

The use of the Donahue-Wilkes analysis in Boss would have been appropriate because the majority utilized the corporate machinery to reject the option and thereby assure continued control after Ethel's death. If the court had applied the Donahue-Wilkes analysis in Boss, the results of that case might have been different. The majority shareholders, Ethel and Walter, would have been required to demonstrate some legitimate corporate justification for their decision to cause the corporation to reject the option to purchase Brown's shares. Perhaps they could have done so based on the price of the shares, the financial situation of the corporation, or an array of other conceivable factors. The court, however, most likely would have viewed with skepticism any justification offered by the majority because Walter apparently purchased the shares at the same price at which they were offered to the corporation.

90. 98 R.I. at 148, 200 A.2d at 233.
91. Id.
92. Id. at 149, 200 A.2d at 234.
93. Id. at 147, 200 A.2d at 233.
94. Id. at 152, 200 A.2d at 235.
95. Id. at 152-53, 200 A.2d at 235.
97. The remainder of the Wilkes test is inapplicable here because the harmful activity of the majority was inaction—failure to exercise the option—as opposed to action—the firing of Wilkes in Wilkes. The less harmful alternative branch of the Wilkes test, therefore, would
Lash v. Lash Furniture Company of Barre, Inc. 98 was the other case in which the defendant caused the corporation to reject an option to purchase a selling shareholder’s shares in order to buy them himself and obtain control of the corporation. In Lash, the three Lash brothers, Wallace, Ralph, and Herman, each had a one-third interest in a family corporation. 99 Wallace desired to sell his shares and arranged a tentative sale to Ralph. 100 The shares, however, were subject to a right of first refusal by the corporation. 101 When the transaction was voted upon, Wallace abstained and Ralph and Herman were divided on the question of whether the corporation should exercise the option. 102 No authorization to exercise the option was forthcoming, therefore, and Ralph was free to purchase Wallace’s shares and obtain control of the corporation.

Herman sued and both the trial court and Supreme Court of Vermont ruled in his favor, requiring that Wallace’s stock be transferred to the corporation. 103 The Lash court, in a decision diametrically opposed to that of the Boss court, stated that Ralph’s interest in ultimately purchasing the stock conflicted with his duty to the corporation to evaluate the offer objectively, and therefore he was barred from voting. 104 While the Boss court did not go far enough in protecting the rights of shareholders in a closely held corporation, the Lash court went too far. The Lash court failed to consider any evidence justifying Ralph’s decision to vote against the exercise of the option. Under the Donahue-Wilkes analysis, the defendant-shareholder is at least accorded the opportunity to justify his actions. Another potential criticism of the analysis by the Lash court was that Ralph was not a majority shareholder. Rather, he and Herman possessed the same amount of control over the corporation. 105 This second potential criticism of Lash, however, is not well-founded. Ralph’s vote was needed for the option to be exercised; this made him the “ad hoc” majority in the same sense that Wolfson was an “ad hoc” majority in the Smith...
Therefore, since this situation clearly involved a closely held corporation, Ralph should have been subject to the same heightened fiduciary duties that were imposed on Wolfson in the *Smith* case. In other words, he should have been required to justify his reasons for voting to reject the repurchase option. If he had met this burden, however, no liability should have existed because, as previously indicated, he did not have a controlling interest in the corporation and, therefore, the court should not require his actions to be more reasonable than the actions of the other shareholders. *Lash* may have been decided properly, but Ralph should have been given the opportunity to justify his actions.

In summary, neither the *Boss* nor the *Lash* analysis was correct. The *Donahue-Wilkes* test should have been employed, and although the results might not have differed in either case, at least the competing interests of the parties would have been accorded the protection to which they were entitled. Fiduciary duties also may be involved when transactions occur between shareholders.

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106. *See supra* notes 62-81 and accompanying text. The ramifications of extending the *Smith* analysis to the *Lash* situation are far-reaching. The logical conclusion of this extension is that any time a minority shareholder’s vote is decisive, he owes fiduciary duties to his fellow shareholders. Alternatively, a minority shareholder always owes fiduciary duties to his fellow shareholders, but these duties are apparent only when his vote is critical to a determination of an issue. When a unanimity requirement exists, a minority shareholder’s vote is always critical because he can veto the proposed action. Other critical circumstances exist, such as when a sufficient number of other shareholders abstain or fail to attend the meeting or when the other shareholders are divided evenly on a question. The extension of *Smith* to each of these circumstances is warranted, because in each of them the minority shareholder has control over the corporate machinery through his ability to decide the issue. Thus, as with Wolfson in *Smith*, the minority shareholder controls the wealth of his fellow shareholders in each of these instances.

107. *See supra* text accompanying notes 81-82.

108. *See also* Hallahan v. Haltom Corp., 7 Mass. App. Ct. 68, 385 N.E.2d 1033 (1979), *supra* note 61, in which one group of shareholders, the Thompsons, squeezed out the other group, the Hallahans, by terminating their employment without showing a reasonable business justification for so doing. The squeeze out was possible because a small number of shares had been issued to a cousin of the Thompsons, giving the Thompsons a majority interest in the corporation. The Hallahans were aware of the issuance of these shares but thought that control of the corporation still would be divided equally between the two groups. To remedy the squeeze out, the court of appeals required the corporation to repurchase the cousin’s shares. The repurchase thus “restored the balance of control among the Hallahans and Thompsons which the trial judge found the parties had envisioned and which they had a fiduciary duty to each other to maintain.” *Id.* at 69, 385 N.E.2d at 1034.

109. Use of the corporate machinery to obtain control takes other forms. For instance, in Schwartz v. Marien, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975), two families each owned fifty percent of the shares of a closely held corporation and had two members on the board of directors. A board member of the plaintiff group died, allowing the defendant group to fill the vacancy with an associate. The defendants thereafter used their control at the board level to cause the corporation to issue treasury shares to themselves and two key employees. The remaining member of the plaintiff group brought suit to require that she be permitted to purchase sufficient shares to maintain her proportionate ownership of the corporation. The court noted the tremendous adverse affect the issuance of the treasury shares had on plaintiff, whose equality of ownership of the closely held corporation was disturbed.
B. Fiduciary Duties with Respect to Transactions Between Shareholders

Several cases have involved stock transactions between shareholders in a closely held corporation. These transactions affect control of the enterprise, but unlike Boss and Lash, the use of corporate machinery is not involved. Rather, control hinges upon transactions between two shareholders of the corporation. The question remains whether any duties are owed to the nonparticipating shareholders whose share in the control of the corporation is affected by the transfer. The results differ in two reported cases.

In Johns v. Caldwell, the stock of the corporation was owned by three persons. Plaintiff Johns and defendant Caldwell owned forty-five percent of the stock, defendant Moore owned the remaining ten percent. From the inception of the corporation, Johns and Caldwell operated and controlled the enterprise to the exclusion of Moore. Moore never was an officer and was removed as a director by Johns and Caldwell after serving for several years on the board. Moore, furthermore, did not receive a return on his investment because dividends were not paid by the corporation and he did not draw a salary. Tired of this situation, Moore offered his shares to Caldwell, who agreed to purchase them. This transaction would have given Caldwell a majority interest in the corporation. When Johns found out about the transaction, he brought suit to prevent the transfer or, alternatively, to require equal division of Moore's stock between himself and Caldwell. Johns' suit was based on the theory that the three shareholders had a confidential relationship that required Moore's stock to be equally divided between the remaining shareholders. Johns argued that his relationship with Caldwell and Moore was analogous

The court then fashioned a test similar to that later developed by the Wilkes court to ascertain the permissibility of defendants' actions. The court stated that the defendants must show that the issuance was done to achieve a bona fide business objective and that such "objective could not have been accomplished substantially as effectively by other means which would not have disturbed the proportionate stock ownership." Id. at 492, 335 N.E.2d at 338, 373 N.Y.S.2d at 127. The court further stated that if the evidence showed that the stock was issued to advance an independent corporate interest and also to place the complaining shareholder at a disadvantage, then the defendants had to show that no other means were available to accomplish the legitimate corporation objective. Id. at 493, 335 N.E.2d at 338, 373 N.Y.S.2d at 128.

110. 601 S.W.2d 37 (Tenn. Ct. App. 1980).
111. Id. at 39.
112. Id. at 40.
113. Id.
114. Id.
115. Id.
116. Id. at 39.
117. Id.
to a partnership relationship and that therefore his fellow shareholders owed to him the same fiduciary duties that partners owe to each other.\(^{118}\) His arguments failed at both the trial and appellate court levels.\(^{119}\)

The *Johns* court took the position that any analogy to fiduciary duties of partners was not appropriate because the participants had chosen to operate their business as a corporation.\(^{120}\) This analysis, however, elevated form over substance. The internal relationships of shareholders in a closely held corporation are precisely the same as partners of a general partnership.\(^{121}\)

In discussing the restrictions that exist on transferability of shares,\(^{122}\) the court did not distinguish between closely held and public corporations. The court concluded, therefore, that the only restrictions on share transfers were based on prohibitions against insider trading.\(^{123}\) The majority rule regarding insider trading, which states that a director or officer of a corporation is free to buy and sell shares in that corporation as long as he does not "affirmatively act or speak wrongfully or intentionally conceal facts with reference to it,"\(^{124}\) was applied. The court found no affirmative misrepresentations with respect to this transaction, which was allowed to stand.
This entire analysis based on notions of insider trading was ill-founded. The objecting party was not privy to the transaction, and restrictions on insider trading are only designed to protect a party to a transaction from the person with whom he is trading. Once the analogy to insider trading was employed, therefore, the conclusion of the court in *Johns* was foregone.

A contrary result was reached in *Cressy v. Shannon Continental Corporation.* As in *Johns*, the initial premise of the court determined the outcome of the case. In *Cressy*, Cressy and Russell formed a corporation in which they each purchased 425 shares of stock. Other individuals also received stock in return for professional services performed for the corporation. Notwithstanding the issuance of shares to the professionals, the court still found that Cressy and Russell had agreed to be "fifty-fifty partners." Several years after the formation of the corporation, additional shares were issued to Russell's parents. Soon thereafter, one of the professionals, DeFries, sold his stock to Cressy. After these events, the equal ownership interests of the two controlling shareholders had been altered, and each sued the other to enjoin consummation of the transaction that caused him to lose equality in ownership.

Unlike the *Johns* court, the *Cressy* court stated that shareholders in a closely held corporation, like partners, have fiduciary duties to one another. The *Cressy* court then stated that these duties of dealing "fairly, honestly and openly" with one another included the duty to maintain equal ownership and control of the business if that was the expectation of the parties. Finding this expectation, the court then gave credence to the implied understanding of the parties and restored equal stock ownership to the two main shareholders.

The initial premises of the *Cressy* and *Johns* courts were contrary to one another and dictated the result in each case. Neither court,

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125. See, e.g., Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 59 (1960). Professor Conant noted: "The minority rule courts state that the officer and director . . . must disclose every material fact he knows about the corporation's activities to the shareholder who is about to sell shares to him." Id. (emphasis added).


127. Id. at 943.

128. Id. at 943 n.2.

129. Id. at 944.

130. Id.

131. Id.

132. Id. at 945.

133. Id.

134. Id.

135. Id. at 946.
furthermore, referred to the analysis in *Donahue* in reaching the decision. Freedom to buy and sell shares, with only a few limitations on the methods that could be used,\textsuperscript{136} was the conservative premise of the *Johns* decision. Followers of this approach would argue that if restrictions were desired, they should have been placed in a shareholders agreement. Because the shareholders had not done so, the transfer was permissible. The *Cressy* court, on the other hand, reached fairly easily the conclusion that the shareholders of a closely held corporation are similar to partners and, therefore, if an implied understanding of equal ownership exists, it should be given credence. Application of the *Donahue* analysis is helpful in ascertaining which view is correct. First, the heightened fiduciary duties required of the majority, either real or ad hoc, by the *Donahue* court are based on the assumption that majority misuse of the corporate machinery has a great effect on the minority. This is because the minority has a great stake in the venture and because it is unable to extricate itself from an unfavorable or oppressive situation due to the nonexistence of a market for its stock.\textsuperscript{137} Stock transactions between shareholders, however, do not involve misuse of the corporate machinery because the corporate machinery is not used at all. Moreover, these situations never involve an oppressive majority because a shareholder with an already-existing majority interest will not attempt to purchase more shares.

As recognized by the *Donahue* court itself, therefore, the justifications it utilized to give rise to heightened fiduciary duties are not applicable to transactions between shareholders that do not involve the corporate machinery.\textsuperscript{138}

The analogy to partnerships, therefore, is the only rationale for requiring each shareholder's share in the control of the corporation be protected from change due to stock transactions between shareholders. Unquestionably, the analogy between close corporations and partnerships is a sound one.\textsuperscript{139} The relationships between participants in each of these ventures are precisely the same. The only real distinction involves the decision to incorporate the business, and this decision is usually made on advice of attorney, based on tax considerations and the advantages of limited liability of shareholders. Moreover, fiduciary duties should be imposed in both situations

\textsuperscript{136} See *supra* notes 109-24 and accompanying text.
\textsuperscript{137} See *supra* notes 26-35 and accompanying text.
\textsuperscript{138} *Donahue*, 367 Mass. 578, 593 n.18, 328 N.E.2d 505, 515 n.18 (1975).
\textsuperscript{139} See *supra* note 121 for cases upholding the analogy.
because intimate business ventures such as these demand trust among the participants in order to succeed. Extending these duties to include the requirement that continuing proportionate interests be maintained is sensible. To place each participant on guard to protect his proportionate interest against transfers by fellow shareholders is inimical to the interests of the participants and the enterprise in general. *Cressy*, therefore, was decided correctly, even though it represents a substantial extension of the heightened fiduciary duty concept of *Donahue*.\(^{140}\) The *Johns* court, on the other hand, simply ignored the characteristics that differentiate a closely held corporation from larger, public corporations.

**CONCLUSION**

The *Donahue* case was well reasoned and correctly decided because the *Donahue* court profoundly grasped the peculiarities of life in a closely held corporation. Moreover, the refinement of *Donahue*, by introduction of a balancing test in *Wilkes*, further represents insightful decision making. The analysis contained in these two cases applies to any activity in a closely held corporation in which the use of the corporate machinery harms the minority.

In addition, extending the majority shareholder’s fiduciary duties to a minority shareholder whose action determines the outcome of an issue is logical. The minority shareholder in these situations controls the corporate machinery. Because the minority shareholder, unlike the majority shareholder, cannot initiate corporate actions, however, the duties imposed upon him should not be as great as those imposed upon a majority shareholder.

The only situation in which the *Donahue* analysis is not appropriate is when the shareholders act outside of the corporate context. A

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140. The heightened fiduciary concept arguably should apply to a transaction in which a majority shareholder sells his shares to a third party. In *Clagett* v. *Hutchison*, 583 F.2d 1259 (4th Cir. 1978), plaintiff argued that under the *Donahue* “equal opportunity” rule, the majority shareholder has a fiduciary duty to the minority shareholders “to afford them an equal opportunity to sell their minority shares or a pro rata part of their shares to the purchaser of the controlling stock on the same or substantially the same terms and conditions as were offered to [the majority].” *Id.* at 1263. Plaintiff’s argument was rejected. Application of the rule, said the *Clagett* court, “would likely result in the stifling of many financial transactions due either to a purchaser’s inability to purchase the additional shares, or from a lack of inclination to purchase those shares.” *Id.* at 1264. *Clagett* was decided correctly. Application of the *Donahue* “equal opportunity” concept to the type of transaction involved in *Clagett* is not appropriate. In *Donahue*, the “equal opportunity” was held to exist because the majority, through control of the corporate machinery, created a market for shares and caused an unequal distribution of the corporate assets to itself. When a third party offers to purchase a majority shareholder’s stock, no use of the corporate machinery and no unequal distribution of corporate assets are present because the corporation is not the purchaser of the stock.
shareholder's potential control over the corporate machinery, the basis for heightened fiduciary duties in Donahue, is irrelevant in these situations. To impose fiduciary duties when shareholders do not act in a corporate context, an analogy must be drawn between shareholders in a closely held corporation and partners in a partnership. This analogy is a sound one, and the fiduciary duties of partners should be considered in determining whether the activities of the defendant-shareholder are permissible when corporate machinery is not used.