Investing in the Close Corporation: What the Minority Shareholder Needs to Know Before Giving Up Money and Power

Shawn Diedtrich[*]

Introduction

Imagine you are the attorney for the New York Yankees. Soon after the World Series, you get a call from the Boston Red Sox attorney demanding that you share your marketing profits for the past year. You try to keep from laughing out loud, but kindly refuse to offer any amount of money to your archenemy. The Sox attorney continues on stating that if you do not turn over a portion of your profits, he will sue the New York Yankees and George Steinbrenner for breach of fiduciary duty. He claims that MLB Properties is a close corporation and as a league owner, and therefore shareholder of MLB Properties, your actions with respect to marketing violate your fiduciary duty to the league. You politely decline again and hang up the phone. Your next thought is: fiduciary what? In a close what?[1]

Now consider, that your buddy from college calls up and ask you to invest a small amount of money in his new corporation. You help him out by buying 5% of the corporation. A few years later you open up a business of your own. A few days later after opening, your buddy class demanding that you will owe him your profits because you are an investor in his business.

---

[*] 2004 J.D. Candidate, Franklin Pierce Law Center; 1999 M.B.A., Carlson School of Management, University of Minnesota; 1995 B.S. Chemistry/Political Science, University of Minnesota.

[1] *See generally* Timothy Watson, *What's Love Got to Do with It?: Potential Fiduciary Duties Among Professional Sports Team Owners*, 9 Sports Law. J. 153 (2002). Steinbrenner and the Yankees successfully settled with MLB Properties based on contract claims, however, Watson's article shows that a fiduciary analysis may have defeated the venerable Steinbrenner.

Again, fiduciary duties and close corporation shareholder is mentioned in the heated conversation. Your next thought is: fiduciary what? In a close what?

While the above situations are hypothetical, the issue of minority shareholders owing a duty to the majority in a close corporation is far from hypothetical. It has been reality for at least 20 years and still remains unsettled. It is this reality that founders of businesses need to be aware of before making a choice of entity. Two types of entities are generally available to a founder: partnerships and limited liability entities. Choosing one entity over the other typically involves analyzing tax, administrative and liability issues. Oversimplified, the choice is between greater administrative flexibility (partnerships), or limited liability (corporations). However, what is almost never considered, or glossed over, is the impact of fiduciary duties on the owners of the business. Fiduciary duties are a set of behavioral rules that owners agree to follow. Generally, partners owe each other and the partnership these duties. They agree to act with the highest regard to each other. On the other side of the continuum are shareholders of a corporation. Except in limited circumstances, they do not owe anyone fiduciary duties. For some the choice is easy, choose limited liability and one can act freely with one's investment.

Unfortunately, a special case exists within close corporations that demand discussion about fiduciary duties by corporate planners. Courts have imposed partner-like fiduciary duties on corporation-like shareholders. A partner who desires to limit liability in a partnership exchanges control for limited liability in the partnership. Generally, any shareholder in a corporation need not worry about liability, but involvement in a close corporation morphs the relationship into one resembling an "incorporated partnership." Like a partner in a partnership, the minority shareholder in a close corporation must deal fairly with his fellow shareholders.

Unlike a shareholder in a corporation however, the minority shareholder owes a fiduciary duty to the majority.

The purpose of this paper is to warn close corporation participants, especially minority investors, of the special duties one incurs by being involved with a close corporation. Part I outlines the primary concepts involved in choosing an entity. Part II discusses the close corporation and the evolution of the minority shareholder fiduciary duty and two opposing views of the status of the fiduciary duty in the close corporation. Part III proposes advice to persons forming businesses and investors in close corporations generally to deal with the potential consequences of these expanded fiduciary duties.

I. Choice of Entity Decision

One of the early decisions founders face in starting a new business is the choice of entity. In today's environment, numerous business forms are available to choose from: Partnerships, Limited Partnerships, S and C Corporations, LLC, LLP, LLLP are just some of these forms. The decision is primarily based on liability limits, tax impacts, management, and financing that generally boil down to administrative ease vs. limited liability. However, little attention is paid to considering fiduciary duties of the participants in the chosen entity.[2] This section will briefly outline four primary factors in choosing an entity and discuss the differences between partnerships and corporations.[3]

A. Liability Limits

[2] *E.g*. Zolman Cavitch, *Business Organizations with Tax Planning* (Matthew Bender & Co., Inc. 2003). Notice the lack of discussion of general fiduciary duties.
[3] Financing will not be discussed in this article. The form and availability of financing may vary with the type of entity, however too many variations of the theme are available depending on the circumstances of the business owners and investors.

The main difference between a partnership and corporation concerning liability is simple: unlimited liability vs. limited liability. Partners in a general partnership are jointly and severally liable for the entity's obligations.[4] In other words, a partner's liability can be unlimited.[5] For example, if the partnership takes a loan from a creditor and defaults, each partner is separately liable for the *whole* debt.[6] Similarly, if while conducting business a partnership employee or partner commits a tort, all partners can be personally liable for the consequences of the tort.[7] This means one can sue the partnership and the partners individually and gain access to their partnership and individual assets.[8] Furthermore, liability is not limited by the amount of a partner's investment.[9] So, a 10% minority partner will be liable for 100% of the partnership obligations.[10]

A corporation is a creature of statute.[11] One or more shareholders that file incorporation papers with a particular state can form a corporation.[12] Shareholders who form the corporation are not liable for the entity's obligations, except in extremely limited circumstances.[13] Nor are the shareholders personally liable for the actions of the corporation, its officers or its directors.[14] So, a shareholder risks only the amount of investment placed with the corporation.[15]

B. Tax Treatment

---

[4] Unif. Partn. Act § 306(a) (1997).
[5] There are exceptions. *See* Unif. Partn. Act §§ 305-307.
[6] Unif. Partn. Act § 306, 307.
[7] Unif. Partn. Act § 305, 307.
[8] Unif. Partn. Act § 307.
[9] Limited partnerships and similar entities can be used to limit financial liability to the amount invested. In that case general partnership rules and other attributes do not fully apply to the entity.
[10] Unif. Partn. Act § 306.
[11] Model Bus. Corp. Act § 2.01 (1994). *See e.g.* 8 Del. Code Ann. § 101 (2003).
[12] Model Bus. Corp. Act § 2.01.
[13] Model Bus. Corp. Act § 6.22.
[14] Model Bus. Corp. Act § 6.22.
[15] Model Bus. Corp. Act § 6.22(a).

The main differences in tax treatment of these entities concerns income/loss distribution, timing, and complexity. Partnerships are considered flow-through entities meaning income at the entity level is not taxed.[16] Income and deductions are passed on to the individual partners.[17] The partners include these items on their individual tax returns according to tax rules that apply to individuals.[18] All income in the partnership is imputed to the partners regardless if it is actually distributed to them or not.[19] This is an important concept for smaller businesses. Partners are not considered employees in the tax sense; they are partners. Their income will not be limited to an arbitrary salary. Rather the partner will be taxed on his distributive share. Additionally, partners do not have control over the timing of their income or losses. All income or loss items must be reported (that is distributed) on a yearly basis whether cash is actually received by the partner or not. So it is possible that in a partnership that generates $1 million in income, the partner will pay taxes based on the $1 million even though the partners agreed to give themselves $30,000 a year in "salary."

The desirability of this form stems from the pass through of losses to the partners.[20] Because depreciation or other expenses could create losses even when there may be a cash gain, the partners may be able to set off personal income and lower their personal marginal tax rates.[21] However, a partner's loss is limited by the amount of basis a partner has in his interest in the

---

[16] I.R.C. § 701 (2003).
[17] I.R.C. § 704.
[18] Zolman Cavitch, *Business Organizations with Tax Planning* § 2.03 (Matthew Bender & Co., Inc. 2003).
[19] I.R.C § 701-704.
[20] Cavitch, *supra* n. 18.
[21] Cavitch, *supra* n. 18.

partnership.[22] The larger and more complicated a partnership becomes, the more sophisticated and complex the tax planning can become.[23]

A corporation's taxing system appears much simpler. Corporations are taxed as separate entities.[24] They declare income and take deductions in a manner similar to individuals.[25] Shareholders generally receive their return on investment through dividends or sale of their stock.[26] This income is again taxed creating the primary disadvantage of the corporate form: double taxation.[27] A shareholder receiving dividends is usually taxed at higher ordinary income levels. A corporation does not pass through its losses, so a shareholder cannot use the corporation to offset gain. If the shares in the corporation decline in value or become worthless, the shareholder is able to takes appropriate losses upon sale or disposition of the shares.

The advantages of the corporate form directly offset the disadvantages of partnership taxation. A corporation does not need to distribute income causing unwanted gains for shareholders.[28] It has flexibility in timing its distributions.[29] Net operating losses can be carried forward year to year to offset future income.[30] And accounting for a shareholder's investment in the firm is simple: a share is directly proportional to the firm's total value. An additional benefit for the small business is that owners can be paid corporate salaries that are considered deductible

---

[22] I.R.C. § 704(d).
[23] More partners means accounting for more partnership interests and adjusted bases. This task is relatively simple with three or four partners. Consider a partnership with 50 or 100 partners with different ownership percentages. Every partner's interest and bases in partnership property needs to be accounted for and reported separate making the task Herculean.
[24] I.R.C. § 11(a).
[25] *E.g.* I.R.C. § 162.
[26] Cavitch, *supra* n. 18, at § 2.04.
[27] I.R.C. §§ 11(b), 61(a). Section 11 imposes the tax on coporate income, then section 61 imposes the tax on a shareholder's dividends. Therefore, the income is "double-taxed."
[28] Cavitch, *supra* n. 18.
[29] Cavitch, *supra* n. 18.
[30] I.R.C. § 382.

employee expenses.[31] So, a small business corporation can pay out most of its income in salaries to the shareholder-employees and avoid double taxation. The income is taxed only once; it is taxed only at the shareholder level as ordinary income.

C. Management

Differences in management of the entities are theoretical more than practical as savvy planning and well-thought out contracts can easily make one entity manage like the other. Partners manage the partnership through the partnership agreement.[32] The agreement may be formal or informal.[33] Each partner is able to act for and bind the partnership, however, this may be varied by agreement.[34] The default is that each partner is considered equal and has a right to equally manage the partnership.[35] Each partner is assumed to have authority to bind the partnership except in specific circumstances that require written statements to be filed with authorities.[36] Unmodified by agreement, issues are decided by majority vote of the partners regardless of the amount of capital contributed to the partnership.[37] No formal meeting or other requirements are imposed upon a partnership's management. Lastly, any partner may dissolve the partnership by simply stating he no longer wishes to be a partner or through a partner's death. Once this event happens, the partnership must wind up and dissolve.[38]

---

[31] I.R.C. § 162(a)(1).
[32] Unif. Partn. Act § 103.
[33] If no agreement exists, states usually provide default provisions similar to the Uniform Partnership Act.
[34] Unif. Partn. Act § 303.
[35] Unif. Partn. Act § 401(f).
[36] *E.g.* Unif. Partn. Act § 303(e).
[37] Unif. Partn. Act § 401(f), (j).
[38] Unif. Partn. Act § 601. These can be modified through agreement to provide for the continuing operation of the partnership is absence of a particular partner to temper the harshness of the default provision.

Corporations are creatures of statute. Owners must formally file incorporation papers with the state in order to be recognized.[39] Minimal, but formal, requirements are imposed upon the operation of a corporation such as requirements to hold at least annual meetings, procedures for calling meeting, and electing of directors.[40] Shareholders elect management by voting for directors according to a shareholder agreement made during incorporation.[41] Unmodified by agreement, one share equals one vote. Directors then choose officers to manage the corporation on a daily basis.[42] Only officers and directors may act for or bind the corporation; shareholders have no power to act in the name of the corporation.[43] A corporation's existence is perpetual. It is dissolved through shareholder action. Unlike the partnership, one shareholder cannot alone dissolve the entity.

Techniques, as well as other entities, exist for planners and entrepreneurs to be able to choose the best of both worlds concerning liability, taxation and management. Thus, it may appear that the choice of entity decision has little meaning as long as one can plan around the disadvantages through contract. However, the concept of fiduciary duty rains on the planner's parade. A different set of fiduciary duties is imposed upon business participants depending on the entity chosen. While these duties may not affect how the outside world deals with the entity, they have a major affect upon the interactions between the owners of the business. This decision is rarely addressed between those starting a business and can have important implications in the operation of the business and the conduct of the participants including investors desiring

[39] Model Bus. Corp. Act § 2.01, 2.02.
[40] Model Bus. Corp. Act § 2.05, 7.01.
[41] Model Bus. Corp. Act § 2.05, 8.03.
[42] Model Bus. Corp. Act § 8.40.
[43] Model Bus. Corp. Act § 8.01.

passivity.[44] The next section discusses the importance of understanding this decision. Choosing an entity is basically choosing the rules by which the owners wish to be governed. Choosing the wrong set can have serious implications for owners and investors when things go awry.

D. Fiduciary Duties

A fiduciary duty is the highest standard implied by law requiring one to act for the interests of another, while subordinating one's own interests.[45] Fiduciary relationships are found in many areas of law including attorney-client, executor-heir, and principal-agent relationships.[46] Part of American law since its beginning, its definition to this day lacks precision.[47] The concept originated with English courts of equity and from the law of trusts.[48] Other relationships with trust-like attributes also were adjudicated under this concept that became known as fiduciary law.[49] The two most fundamental fiduciary duties are: (1) the duty of care, and (2) the duty of loyalty.[50] Derived from the law of agency, the duty of loyalty requires the fiduciary (1) not to compete with the partnership; (2) not to profit from the relationship at the expense of the partnership or partners; (3) to refrain from adverse conduct; and (4) to not disclose confidential information.[51]

1. Partnership fiduciary duty

---

[44] *E.g.* Cavitch, *supra* n. 18. lacks a discussion about fiduciary duties. The main focus is upon other factors listed above.
[45] Lawrence Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. Pa. L. Rev. 1675, 1683-1687 (1990); *Black's Law Dictionary* 640 (Bryan A. Garner ed. 7th ed. West 1999).
[46] Mitchell, *supra* n. 45.
[47] Andrew D. Shaffer, *Corporate Fiduciary - Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 Am. Bankr. Inst. L. Rev. 479, 482 (2000).
[48] Shaffer, *supra* n. 47.
[49] Shaffer, *supra* n. 47.
[50] Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 Del. J. Corp. L. 515, 519 (2001).
[51] Unif. Partn. Act § 404.

Partners are fiduciaries to the partnership and each other.[52] Of the above fiduciary duties, only the duty of loyalty and care are required of a partner.[53] Case law development began with the landmark case *Meinhard v. Salmon*[54] which imposed fiduciary duties on co-adventurers holding that "[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[55] That standard of behavior is the "duty of the finest loyalty."[56] *Meinhard* involved two joint venturers who entered into an agreement to lease and manage a building.[57] Near the end of the lease Salmon secured a lease from the owner for another new business opportunity.[58] He kept the opportunity to himself and did not share it with Meinhard.[59] Meinhard successfully sued Salmon stating that the fiduciary duty between partners required Salmon to share the opportunity with Meinhard and allow him the chance to compete.[60]

2. Corporate fiduciary duty

Unlike the partners in a partnership, shareholders in a corporation do not owe a fiduciary duty to each other or to the corporation.[61] Corporate directors and officers owe fiduciary duties to the corporation.[62] In general these directors and officers do not owe a duty to the shareholders.[63] However, through shareholder derivative suits, shareholders are able to protect

---

[52] Unif. Partn. Act § 404.
[53] Unif. Partn. Act § 404(a).
[54] 249 N.Y. 458 (1928).
[55] *Id.* at 465.
[56] *Id.* at 464-5.
[57] *Id*. at 461.
[58] *Id*. at 463.
[59] *Id.*
[60] *Id.* at 464-65.
[61] J. Mark Meinhardt, *Note: Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited Liability Business Organizations: Delaware Law and Its Adherents,* 40 Washburn L.J. 288, 295 (2001).
[62] Meinhardt, *supra* n. 61; *See also* Dalley, *supra* n. 50, at 526.
[63] Dalley, *supra* n. 50, at 526.

their investments due to a breach of fiduciary duty.[64] In some cases, controlling shareholders also owe fiduciary duties either to the minority shareholders, the corporation, or both.[65] These duties are balanced by court developed doctrines such as the business judgment rule allowing directors and officers to escape liability by showing they honestly believed their actions were in the best interests of the corporation.[66]

A problem with the court application of fiduciary duties is that courts have written "opinions that, while correct, have generally failed to articulate the principles underlying their rulings and have relied instead on rhetoric, frequently with moral overtones."[67] This method of development of fiduciary law as applied separately to partnerships or corporation appears to be sufficient.[68] However, as applied to close corporations, which exhibit attributes of both partnerships and corporation, fiduciary analysis breaks down.[69] If choosing an entity means choosing the set of rules one wants to be governed under, the lack of underlying principles for fiduciary breaches has created a serious issue for the planner and owners desiring the close corporation business form. The next section explores the development of fiduciary duties in the close corporation and explains how the minority shareholder, usually in a vulnerable position, has come to owe fiduciary duties to the majority.

II. The Close Corporation

[64] Dalley, *supra* n. 50, at 526.
[65] Dalley, *supra* n. 50, at 555.
[66] Dalley, *supra* n. 50, at 520, n. 10.
[67] Dalley, *supra* n. 50, at 517.
[68] Dalley, *supra* n. 50, at 517.
[69] *See* Mitchell, *supra* n. 45.

Although the lion's share of Fortune 500 companies are incorporated in Delaware, close corporations generally incorporate in the state they do business.[70] Ninety percent of all corporations are close corporations.[71] Of those corporations, few elect close corporation status.[72] Close corporations are defined by statute in some states and loosely defined by common law in others.[73] A close corporation is typically one where shareholders are few, the stock is not publicly traded, and the shareholders are most often the directors, officers, and employees of the corporation.[74] Frequently, close corporation shareholders have invested significant percentages of their total wealth in the business and expect the investment to be a major source of income.[75] As a result of all these factors, close corporation shareholders, especially minority shareholders, may seem trapped in their investment with little hope of exit.[76]

A close corporation is typically managed by all or most of the shareholders.[77] That is, the shareholders are also the directors and officers of the company.[78] A minority shareholder is dependent upon the majority to make fair and balanced decisions because the minority has no managerial control.[79] Power to make decisions such as employment or dividend declarations can easily be abused by the majority.[80] For example, the majority could fire a minority shareholder-

---

[70] Shannon Stevenson, *Note: The Venture Capital Solution to the Problem of Close Corporation Shareholder Duties*, 51 Duke L.J. 1139, 1141, n. 15 (2001).
[71] Tara Wortman, *Note: Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. Rev. 1362 (1995).
[72] Wortman, *supra* n. 71, at 1362. This percentage has not been updated or verified by the author.
[73] *E.g.* 8 Del. Code Ann. § 342; *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578 (1975).
[74] *Donahue*, 367 Mass. at 585.
[75] Stevenson, *supra* n. 70, at 1142.
[76] Stevenson, *supra* n. 70, at 1142.
[77] Stevenson, *supra* n. 70, at 1142.
[78] Stevenson, *supra* n. 70, at 1142.
[79] Stevenson, *supra* n. 70, at 1142.
[80] Stevenson, *supra* n. 70, at 1142.

employee and refuse to declare dividends.[81] Because close corporation shares are not readily available to the public, the minority is unable to easily dispose of his shares.[82] Thus, the shareholder is trapped in a non-performing investment.[83]

A problem is created because participants in a close corporation generally do not seek comprehensive legal advice.[84] Due to this fact, many close corporation shareholders are uninformed as to their rights and duties and do not seek to incorporate their expectations in contractual form.[85] Most close corporation litigation revolves around majority shareholders, in their role as directors, officers or shareholders, exerting oppressive power over the minority.[86] As a result, some states have enacted close corporation statutes altering some general corporation rules intended to, among other things, benefit the minority shareholder.[87] However, most corporations who qualify for this status do not organize under these statutes.[88] This is probably attributable to incorporator ignorance, attorney disfavor, or trusting pre-existing relationships between the shareholders.[89]

A. Development of a Minority Shareholder's Fiduciary Duty

1. Fiduciary Duty for Majority Shareholders

Containing more morality than legality, *Meinhard* was the beginning of the road for imposing fiduciary duties on a minority shareholder.[90] Some states adopt Delaware's approach in refusing to attribute enhanced fiduciary duties to close corporation shareholders past that

---

[81] Stevenson, *supra* n. 70, at 1142.
[82] Stevenson, *supra* n. 70, at 1142.
[83] Stevenson, *supra* n. 70, at 1142.
[84] Stevenson, *supra* n. 70, at 1143.
[85] Stevenson, *supra* n. 70, at 1143.
[86] Stevenson, *supra* n. 70, at 1147-1148.
[87] Stevenson, *supra* n. 70, at 1147-1148.
[88] Wortman, *supra* n. 71, at 1362.
[89] Wortman, *supra* n. 71, at Part II.
[90] Mitchell, *supra* n. 45, at 1692.

already imposed on public corporation shareholders.[91] However, other states such as Massachusetts, Minnesota, and Illinois base their analysis on *Meinhard* and have adopted an enhanced fiduciary duty that all shareholders, majority and minority alike, owe each other fiduciary duties in a close corporation.[92]

In the corporate form, fiduciary duties are imposed between managers and the directors, directors and the shareholders, and majority and minority shareholders. As stated above, the "content" of fiduciary duties for public corporations can be fuzzy. However, courts view the close corporation shareholder as being in a different category as their public shareholder counterpart. In doing so, they have created a new area of law that applies fuzzy standards from partnership law and corporation law to create an even fuzzier picture for a potential minority shareholder considering an investment in a close corporation.[93]

Close Corporation Stockholder Fiduciary Duty: Two Views

Whether shareholders in a close corporation owe each other fiduciary duties has two rather binary views: they do, or they do not. Delaware, where a majority of corporations are incorporated, holds the minority view that closely held shareholders should not receive any special benefits.[94] Massachusetts, and the majority of states, takes the view that those same shareholders should owe partner-like duties because of the intimate nature of the close corporation.[95]

The Minority View:*Nixon v. Blackwell* [96]

---

[91] Stevenson, *supra* n. 70, at 1147-1148.
[92] Stevenson, *supra* n. 70, at 1147-1148; *Donahue*, 367 Mass. at 593.
[93] The terms 'close' and 'closely-held' appear interchangeable in the much of the law literature.
[94] *See infra*, n. 100.
[95] *See infra*, n. 109.
[96] 626 A.2d 1366 (Del. 1993).

Delaware adopted the minority view of close corporation fiduciary duties when its highest court refused to uphold a trial court's ruling that non-employee shareholders were entitled to relief when employees received stock in a close corporation on different terms than non-employees.[97] Plaintiffs argued that by providing liquidity only for the employees through the ESOP plan while excluding the minority shareholders was a breach of the director's fiduciary duties to the minority.[98] The lower court agreed describing the plan as "inherently unfair."[99] The Delaware Supreme Court reversed the ruling stating that Delaware corporation law does not require all stockholders to be treated equally.[100] The court explained that before investing in a close corporation, minority shareholders have a variety of contractual provisions available to them to protect their interests in the corporation.[101] Any special relief for minority shareholders in this instance would be inappropriate "judicial legislation."[102] Even though the corporation at issue was not a statutory close corporation, the court also stated that the result probably would not have been different.[103] Coupled with Delaware's longstanding "independent legal significance" doctrine, whether a statutory close corporation or not, a minority shareholder

---

[97] *Id.* at 1380-1381. The corporation did not elect to be treated as a close corporation under Delaware statutes.
[98] *Id.* at 1373.
[99] *Id.*
[100] *Id.* at 1376.
[101] *Id.* at 1379-1380.
[102] *Id.* at 1381.
[103] *Id.* at 1380, n. 19. Delaware's Close Corporation statute does not impose fiduciary duties between stockholders due to the election of close corporation status. Most of the provisions allow a close corporation to forgo corporate formalities and gain more management flexibility that may resemble a partnership. 8 Del. Code Ann. §§ 342-356.

cannot rely on enhanced fiduciary duties for protection.[104] As a result, fiduciary duties will not be imposed on minority shareholders.

Donahue v. Rodd Electrotype Co. of New England[105]

Donahue represents the majority view of enhanced fiduciary duties in a close corporation where the Supreme Judicial Court of Massachusetts held that stockholders in a close corporation owed each other partner-like fiduciary duties.[106] A minority shareholder, Euphemia Donahue, sued the corporation, the directors, and the controlling shareholders for breach of a fiduciary duty.[107] Rodd Electrotype was a close corporation with the majority of ownership owned by the Rodd family.[108] When Harry Rodd, the most senior in the family, retired, the Rodd family enacted a plan that included the corporation repurchasing his shares at less than liquidating or book value.[109] Donahue first learned of this action after it occurred and voted against a resolution that would have ratified the action.[110] Donahue later offered her shares to the corporation but was denied.[111]

The court declared Rodd Electrotype a close corporation and held that all shareholders in a close corporation owe a fiduciary duty to each other.[112] Ordinarily, a corporation may repurchase its stock without prejudice to stockholders, however, a close corporation's controlling

[104] The independent legal significance principle states that if one part of a transaction is legal under one provision of the Delaware code, it will not be subject to standards of another unrelated portion of the code. *Nixon*, 626 A.2d at 1381.
[105] 328 N.E.2d 505 (Mass. 1975).
[106] *Id.* at 593.
[107] *Id.* at 508.
[108] *Id.* at 509.
[109] Alan H. Farnsworth, *Close Corporations*, 61 Cornell L. Rev. 986, 988 (1976).
[110] *Donahue*, 328 N.E.2d at 510.
[111] *Id.*
[112] *Id.* at 515.

stockholders also "must have acted with the utmost faith and loyalty to other stockholders."[113] This stricter requirement was imposed because minority stockholders have little opportunity to protect themselves in these situations.[114]

Wilkes v. Springside Nursing Home, Inc.[115]

Realizing this broad standard may cause trouble for majority shareholders acting as directors and officers in effectively running the business, the court later narrowed its holding in *Wilkes* by instituting a balancing test.[116] Wilkes was a founding minority stockholder, treasurer and employee of a nursing home qualifying as a close corporation.[117] The expectation of the founding shareholders was that each shareholder would receive compensation as long as each was active within the business.[118] Each active shareholder/officer was guaranteed a directorship.[119] Wilkes had been active in the management, and therefore elected as a director, for over fifteen years.[120] During this time, Wilkes and the other directors drew a salary from the operational cash flow of the nursing home.[121] Dividends were never declared.[122] Year's later, "bad blood" developed between Wilkes and the other shareholders.[123] As a result, three of the four shareholders failed to re-elect Wilkes as a director or officer of the corporation that resulted in Wilkes also losing his salary.[124]

---

[113] *Id.* at 518.
[114] *Id.*
[115] 353 N.E.2d 657 (Mass. 1976).
[116] *Id.* at 663.
[117] *Id.* at 659-660.
[118] *Id.* at 660.
[119] *Id.* at 660, n. 7.
[120] *Id.* at 660, n. 9.
[121] *Id.* at 660.
[122] *Id.* at 663, n. 13.
[123] *Id.* at 660.
[124] *Id.*

The *Wilkes* court, concerned with "untempered application" of the *Donahue* standard, fashioned a balancing test that allowed the majority to manage the corporation when the actions taken were for legitimate business purposes.[125] Once the majority demonstrates its actions were taken for a legitimate business purpose, the minority must demonstrate that the action could have been achieved in a practicably less harmful manner.[126] Applying the standard to Wilkes, the court found that the failure to elect Wilkes as a director originated from the tense relationship between the shareholders and not any misconduct on Wilkes' part.[127] The court found that the majority's action disregarded the founding policy of employment with participation and the knowledge no dividend had ever been declared which effectively lessened Wilkes return from the corporation to zero.[128] In reality, the majority attempted a freeze out, a type of action that typically violates the majority's fiduciary duty to the minority.

2. Fiduciary Duty for Minority Shareholders

Much has been written about the majority's duty to the minority in close corporations especially in the case of the majority oppressing the minority.[129] Most case law and close corporation statutes are concerned with protecting the minority interest in a close corporation (rightfully so). One may think that a minority shareholder has little or no duty to the corporation or the majority shareholders. However, *Donahue* left open a small hole, through dicta, that imposes a fiduciary duty on the minority to the majority.[130]

---

[125] *Id.* at 663. Examples include setting dividend policy, mergers and acquisitions, setting corporate salaries, and hiring or firing of directors or corporate employees.
[126] *Id.* at 663.
[127] *Id.* at 664.
[128] *Id.* at 664.
[129] *See e.g.* F. Hodge O'Neal, O'Neals Oppression of Minority Shareholders: Protecting Minority Rights in Squeeze-Outs and Other Intracorporate Conflicts (2d ed. 1985).
[130] *Donahue*, 367 Mass. at 515.

In *Smith v. Atlantic Properties, Inc.*[131], a minority shareholder who wielded veto power over the majority was held to owe a fiduciary duty to the majority shareholders. Four investors formed Atlantic Properties in order to manage a real estate concern.[132] During incorporation, each investor agreed to insert a provision that required an 80% affirmative vote of the Board of Directors to effectively make any major decision regarding the corporation ("veto provision").[133] The corporation became profitable, retain a significant amount of its earnings, and later found itself in trouble with the IRS due to unreasonable accumulation of corporate profits.[134] As in so many troubled cases involving close corporations, ill will developed between the shareholders.[135] Due to the threat of IRS action, three shareholders wished Atlantic to declare dividends.[136] However, Dr. Wolfson refused to vote to declare any dividend.[137] As a result, the IRS fined Atlantic.[138]

Exploiting a footnote in the *Donahue* court's dicta[139], the *Smith* court agreed that majority shareholders can seek protection from a minority.[140] Because the veto provision effectively

---

[131] 422 N.E.2d 798 (Mass. App. Ct. 1981).
[132] *Id.* at 799.
[133] *Id.*
[134] *Id.* at 800.
[135] *Id.*
[136] *Id.*
[137] *Id.* Dr. Wolfson claimed that refused to declare dividends because he wished the excess profits to be used for repair and improvement to Atlantic's properties. However, the trial court found that his refusal originated more in his dislike for his partners and personal tax avoidance than for any true maintenance program. *Id.* at 800.
[138] *Id.*
[139] In the tradition of full disclosure, this author disagrees with the outcome and application of fiduciary law to the facts of the Smith case. However, this article is concerned with alerting minority shareholders to the duties they owe to other shareholders and the protections that may reasonably be asserted in light of these duties. Discussing the merits of applying partnership-like fiduciary duties to investors who knowingly choose the corporate form of governance, which outside of close corporation generally do not apply strict fiduciary principles to minority shareholders, will be left for a later discussion.
[140] *Id.* at 801.

made any minority shareholder a "controlling group," *Donahue* and *Wilkes* were applicable to the facts of the case.[141] The court held Dr. Wolfson owed a fiduciary duty to the majority and violated it according to the *Wilkes* balancing test because his conduct went beyond reasonable in light of the warnings of penalties from the IRS.[142]

Although cases are few, the situations where the minority is found to owe a fiduciary duty are actions better described as torts than breach of fiduciary duty.[143] An early case, *Helms v. Duckworth*, involved a 49% shareholder who negotiated a shareholder agreement requiring each stockholder to place his shares in a trust.[144] Upon death of either shareholder, the deceased stock would be sold to the surviving member at the par value of $10 per share unless modified by a subsequent agreement.[145] The trust agreement also provided that the majority could not vote for a dissolution or complete asset sale of the corporation without the minority's consent.[146] The majority shareholder Helms, who was 70 when the agreement was made, later died without ever having agreed to raise the value at which a surviving shareholder can buy the remaining stock.[147] As a result, Duckworth was able to purchase Helms' shares at $10 per share when the corporation's current value was $80 per share. The Appeals Court reversed the lower court's summary judgment for Duckworth holding that he owed Helms a fiduciary duty "to deal fairly, honestly, and openly with . . . fellow stockholders . . . ."[148] Finding that Duckworth never intended to increase the stock purchase price, the court held that his bargaining tactics

---

[141] *Id.* at 802.
[142] *Id.* at 803.
[143] *E.g. Rexford Rand Corp. v. Ancel*, 58 F.3d 1215 (7th Cir. 1995); *Helms v. Duckworth*, 249 F.2d 482, 483 (D.C. Cir. 1957).
[144] *Helms*, 249 F.2d at 483.
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.* at 487.

constituted a "flagrant breach of a fiduciary duty."[149] The court all but ignored any misrepresentation or fraud analysis, but rather put itself in the shoes of the deceased and assumed the agreement Helms made was not his intention.[150]

More confusion is created because states disagree whether minority shareholders who have been frozen out still owe a fiduciary duty to the majority.[151] In both cases, the minority shareholder was "frozen out" by the majority.[152] Yet, in one case the minority was allowed to open a competing business,[153] and in the other, the minority violated a lingering fiduciary duty.[154] The difference appeared to be in the minority's conduct while being "frozen out." In *J Bar H*, the minority was wrongfully terminated and prevented from fulfilling her duties as a director.[155] Frustrated, she began a competing business.[156] The court held she did not violate her fiduciary duty even though she remained a director and shareholder.[157] Treated as if she had resigned, the court held that a wrongfully terminated shareholder/director/employee is effectively stripped of any status that imposes a duty reasoning that "the fiduciary duty . . . depends on the ability to exercise the status which creates it."[158]

---

149 *Id.*
150 *Id.* at 486. Even though Duckworth admitted that it was his intent from the beginning never to increase the stock purchase price, Helms never requested a meeting in an attempt to change it. This is an early example of the distance courts will travel in order to find a fiduciary duty when they smell a bad deal regardless of the facts before them.
151 *Compare Rexford*, 58 F.3d 1215 (7th Cir. 1995) *with J Bar H, Inc. v. Johnson*, 822 P.2d 849 (Wyo. 1991).
152 *Rexford*, 58 F.3d at 1217; *J Bar H*, 822 P.2d at 853-854.
153 *J Bar H*, 822 P.2d at 861.
154 *Rexford*, 58 F.3d at 1221.
155 *J Bar H*, 822 P.2d at 853-854.
156 *Id.* at 854.
157 *Id.*
158 *Id.* at 861.

The Seventh Circuit reached the opposite result explicitly refusing to accept the reasoning in *J Bar H*.[159] Gregory was a long-time employee of Rexford Rand before being fired by the majority shareholder/directors.[160] A few years later, the corporation failed to file its annual report with the state and as a result was administratively dissolved.[161] This caused its trade names to become available.[162] Discovering this fact, Gregory registered Rexford Rand's trade names preventing the corporation from re-incorporating under it original name.[163] The Appeals Court affirmed the lower court stating that the "freeze-out did not deprive Gregory of his status of shareholder" and therefore he "should have placed the interests of the corporation above his interests" and not appropriate the name in order to achieve the aim of a fair buyout of his stock by the majority.[164]

Other than demonstrating that a minority's fiduciary duties are far from settled, *Helms*, *J Bar H* and *Rexford* reveal that a minority shareholder in a close corporation must walk softly. Whether a fiduciary duty is owed to the majority appears not to be the central issue. Rather the courts appear to apply a clean hands or tort-like analysis to the minority's actions and declare a fiduciary duty if they do not like what they see.[165] Both minority shareholders in *J Bar H* and *Rexford* held shares in their respective corporations at the time of the alleged duty breaching actions.[166] Each action the minority took, analyzed in a vacuum, is arguably a breach of fiduciary duties. Applying partnership law suggests that these actions are breaches of fiduciary

[159] *Rexford*, 58 F.3d at 1220.
[160] *Id.* at 1217.
[161] *Id.*
[162] *Id.*
[163] *Id.*
[164] *Id.* at 1220.
[165] *E.g. id.* ("The method by which [Gregory] sought to induce a settlement, however, is troubling.").
[166] *Rexford*, 58 F.3d at 1217; *J Bar H*, 822 P.2d at 855.

duties. Applying corporation law suggests the opposite. In either instance, it is important that the planner include a discussion about fiduciary duties, not just limited liability or tax consequences, in order for any shareholder to fully understand their responsibilities.

B. Implications for the Minority Shareholder

Typically, the disadvantages to being a minority shareholder can be contracted around.[167] For example, venture capital firms taking a minority position develop shareholder agreements that preserve the power to control the corporation and keep their investment liquid.[168] Provisions allow the firm to veto board decisions, control officer compensation, and require the majority shareholders or the corporation to buy-out its shares.[169] Also, electing close corporation status provides additional protections for minority shareholders (e.g. dissolution requirements) not available to public corporation minority shareholders.[170]

However, most statutes fail to further define fiduciary duties leaving interpretation to the common law.[171] The common law's "progress has been uncertain and incomplete" leaving the hole opened by *Donahue* and *Smith* as to when a minority investor may be violating his fiduciary duty to the majority.[172] In other words, how does one know when protecting one's minority investment crosses the fiduciary line?

As revealed by*Smith* , using veto power to overrule the majority causes the minority calls into question the minority's fiduciary duty. Arguably, the conduct of the minority doctor was egregious, but this only substitutes one problem for another. If only egregious conduct violates a

---

[167] Stevenson, *supra* n. 70, at 1145.
[168] Stevenson, *supra* n. 70, at 1154.
[169] Stevenson, *supra* n. 70, at 1155-1164.
[170] Minn. Stat. Ann. § 302A.751 (2001).
[171] One exception is Minnesota's statute which defines enhanced fiduciary duties. Minn. Stat. Ann. § 302A.751(1)(a)(2) (2001).
[172] Stevenson, *supra* n. 70, at 1175 (internal quotations omitted).

minority's duty to the majority, what is egregious conduct? This refocuses the inquiry on one's conduct and forgets to answer the question whether a fiduciary duty should be imposed in the first place. Focusing on minority shareholder conduct does not solve the problem either. *J Bar H* and *Rexford* minority shareholders both took action in order to preserve their investment. Both types of actions have been declared breaches of fiduciary duty in the past: opening a competing business and appropriating corporate property for one's own benefit. However, another imperceptible line was drawn describing one action as a breach and the other not a breach. Again, the discussion did not answer the question whether the minority should have owed a duty to the majority in the first place.

So, if not in a state that has adopted Delaware's philosophy, a minority shareholder must realize that courts may analyze a minority shareholder's assertion of power on the same level as a majority's action. The minority must also realize that he cannot frustrate the legitimate business actions of the majority regardless of the power given up to him under contractual agreements. According to *Donahue* and its progeny, any minority shareholder in a close corporation may find itself violating fiduciary duties regardless of the size of its ownership. From the case law above, a minority shareholder that attempts to use his power negotiated from the majority to frustrate legitimate business goals will probably violate fiduciary duties to the majority. However, it is unclear whether a minority with insignificant holdings in the close corporation will be liable for other fiduciary duties.

III. Recommendations for the Planner

Investing in a close corporation is risky especially if a particular investor is in the minority. Obviously understanding one's rights when investing or founding a corporation makes for better legal and business decisions. Including discussion about fiduciary duties will give the investor the complete picture about his investment. The following are simple recommendations for making sure this issue will not come back to haunt the uninformed.

A. Be aware of both statutory and common law governing close corporations in your jurisdiction. Delaware does not recognize close corporation fiduciary duties among shareholders in common law or statutorily. Massachusetts has a judicially created doctrine and Minnesota has codified enhanced fiduciary duties. The primary reason for these doctrines as applied to close corporations is to protect shareholders and release administrative burden. However, as discussed above, application to the close corporation is inconsistent. At its best, courts will prevent truly egregious behavior on the part of a shareholder or group of shareholders. At its worst, a result may be imposed that was never contracted for when the founders dreamed up their business.

B. Lawyers advising multi-owner founders need to add fiduciary duties to the discussion. While these duties may not affect the tax treatment or liability of the entity, it may affect the manner in which an owner wishes to manage his investment. The advantage of these duties is that all shareholders are accountable to each other; the transaction cost of managing one's investment is low. Loyalty and careful management is expected. The disadvantage, however, is that these duties may restrict the behavior of all the shareholders equally regardless of the size of their investment. For example, a minority investor may not be able to invest in other businesses if they are remotely related to the close corporation. Additionally, "compliance" with fiduciary duties may increase the cost of managing the corporation. Justification of riskier business decisions may mean initiating more discovery than would be required if fiduciary duties were waived. So, it is possible the disadvantages may outweigh the advantages.

C. Disclose the owners' intentions with respect to fiduciary duties in the incorporation or shareholder agreement. State simply whether the owners want fiduciary duties, including which ones, or not. Unless the breaching behavior becomes especially egregious, the courts appear to follow the intention of the parties to these contracts. It is possible that some portion of the duties cannot be waived, however if the choice of entity is seen as choosing the set of rules one wishes to be governed under, at least the "breaching party" can point to the original intention of the parties.

IV. Conclusion

Investing is a risky business. Investing is a close corporation is riskier. Being a minority investor in a close corporation keeps you up at night. To manage this risk, a number of contractual and statutory provisions have been used to level the playing field. While the minority investor gets some relief, this power equalization creates another problem: fiduciary duties being imposed on the minority for unduly exercising its power gained from negotiating with the majority. This paper has attempted to inform a minority stockholder where these duties came from and where they could be applied. Hopefully armed with this information, minority shareholders can negotiate and craft contractual provisions that still protect their investment, but do not place themselves in a position of being sued for simply exercising their rights.