

because they are the complete owners of the corporation, cannot be invoked here." That was because all the stockholders were not parties to the agreement there in question. So, where the public was not affected, "the parties in interest, might, by their original agreement of incorporation, limit their respective rights and powers," even where there was a conflicting statutory standard. *Ripin v. United States Woven Label Co.*, 205 N.Y. 442, 448, 98 N.E. 855, 857. . . .

Except for the broad dicta in the McQuade opinion, we think there can be no doubt that the agreement here in question was legal and that the complaint states a cause of action. There was no attempt to sterilize the board of directors, as in the Manson and McQuade Cases. The only restrictions on Dodge were (a) that as a stockholder he should vote for Clark as a director—a perfectly legal contract; (b) that as director he should continue Clark as general manager, so long as he proved faithful, efficient, and competent—an agreement which could harm nobody; (c) that Clark should always receive as salary or dividends one-fourth of the "net income." For the purposes of this motion, it is only just to construe that phrase as meaning whatever was left for distribution after the directors had in good faith set aside whatever they deemed wise; (d) that no salaries to other officers should be paid, unreasonable in amount or incommensurate with services rendered—a beneficial and not a harmful agreement.

If there was any invasion of the powers of the directorate under that agreement, it is so slight as to be negligible; and certainly there is no damage suffered by or threatened to anybody. The broad statements in the McQuade opinion, applicable to the facts there, should be confined to those facts.

ANALYSIS AND PLANNING

1. In *McQuade v. Stoneham*, the court says that it is a matter of "public policy" that "stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries." What, if any, are the goals or criteria of good government that underlie that public policy?

2. Was McQuade assured of representation on the board of directors? What legal devices are available to provide assurance of a seat on the board?

3. If McQuade had been assured of representation on the board of directors, how might he have been assured of continuation in his role as treasurer of the corporation?

4. Subsequent to the decisions in these cases, the New York Business Corporation Law was changed. It now provides, in § 620:

(a) An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in

exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them.

(b) A provision in the certificate of incorporation otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one of more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter, shall nevertheless be valid: (1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certificate of incorporation or an amendment thereof; and (2) If, subsequent to the adoption of such provision, shares are transferred or issued only to persons who had knowledge or notice thereof or consented in writing to such provision.

Under this provision, how might you have protected McQuade's interests?

5. Section 141(a) of the Delaware General Corporation Law provides:

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Section 142(b) provides, in part:

(b) Officers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the by-laws or determined by the board of directors or other governing body.

With these provisions to rely upon, how might you have protected McQuade's interests?*

6. In *Clark v. Dodge* the court in effect granted specific performance of the agreement. Do you agree that this is the appropriate remedy?

* Compare New York Business Corporation Law, § 715(b) ("The certificate of incorporation may provide that all officers or that specified officers shall be elected by the shareholders instead of by the board."); California Corporations Code, § 312(b) ("Except as otherwise provided by the articles or bylaws, officers shall be chosen by the board and serve at the pleasure of the board, . . .").

7. Dodge and Clark agreed, according to the court, that Clark "should continue as [the corporation's] general manager so long as he should be 'faithful, efficient and competent.'" What do you think about the wisdom and efficacy of this agreement?

CORPORATE PLANNING BY USE OF EMPLOYMENT CONTRACTS

One way to give McQuade, in *McQuade v. Stoneham*, or Clark, in *Clark v. Dodge*, what he seemed to have wanted might have been to have the corporation enter into an employment contract with him. Here, in outline form, is a list of some issues that are presented by employment contracts.

I. Duration

- A. Number of years. Then what?
- B. Termination for cause
 - 1. By whom?
 - 2. What is "cause"?
- C. Effect of illness, incapacity, etc.

II. Compensation

- A. Salary
- B. Adjustments (e.g., for inflation)
- C. Bonuses, stock options, etc.
- D. Benefits
- E. Travel and other expenses
- F. Perquisites

III. Duties and status

- A. Job description
- B. Other duties
- C. Amount of time; vacation
- D. Outside activities

IV. Competition and Trade Secrets

V. Consequences of termination

- A. Liquidated damages
- B. Duty to mitigate

VI. Parties

- A. Mergers, etc.
- B. Guarantee by majority shareholder

Assume that you represent McQuade, except that the time is now, and that he is about to invest a substantial amount of money in a major league baseball team and become its treasurer and chief financial officer. He wants to sit down with you and have you explain to him what the issues are and what he might reasonably seek in an employment contract and in any related agreements that you think important. What would you be prepared to ask him and tell him?

What if it were Clark, rather than McQuade, whom you were about to advise?

Do you think that the interests of the parties in the two cases would have been better served by the use of employment contracts than by the use of voting agreements? What other legal device should have been recommended?

NOTE ON SHAREHOLDER AGREEMENTS, VOTING TRUSTS, STATUTORY CLOSE CORPORATIONS, AND INVOLUNTARY DISSOLUTION

Shareholder agreements (sometimes called "pooling" agreements), designed to achieve objectives such as those reflected in *McQuade v. Stoneham* and in *Clark v. Dodge*, have often been used. Agreements by which the shareholders simply commit to electing themselves, or their representatives, as directors, are generally considered unobjectionable, and are now expressly validated in many jurisdictions (see, e.g., New York Bus. Corp. Law, § 620(a), validating shareholder voting agreements with other objectives as well). They do not interfere with the obligations of the directors to exercise their sound judgment in managing the affairs of the corporation.

The courts have had more difficulty with shareholder agreements requiring the appointment of particular individuals as officers or employees of the corporation, since such agreements do deprive the directors of one of their most important functions. The modern view, reflected in the next case (*Galler v. Galler*) and in the Note following it (summarizing *Zion v. Kurtz*), is that such agreements are enforceable, at least for closely held corporations, as long as they are signed by all shareholders (and, perhaps, in situations in which any nonsigning minority shareholders cannot or do not object).

Another device that can be used for control is the voting trust, a device specifically authorized by the corporation laws of most states. With a voting trust, shareholders who wish to act in concert turn their shares over to a trustee. The trustee then votes all the shares, in accordance with instructions in the document establishing the trust. Voting trusts are often used to maintain control of a corporation by a family or group, when there is a fear that some members of the family or group might form a coalition with minority shareholders to shift control. For example, suppose that five members of a family own 60 percent of

the voting shares of the corporation. They can create a voting trust and instruct the trustee to vote all the shares for directors, and on other matters submitted to shareholder vote, in accordance with decisions reached by the five members by majority vote. Voting trusts generally must be made public. See Del.Gen.Corp. Law § 218.

Many states now have special statutory provisions for closely held corporations. These provisions vary widely from state to state. Generally they allow certain corporations to elect (it's voluntary) close corporation status (whereupon the corporation is said to be a statutory close corporation). For example, under the Delaware General Corporation Law close corporation status may be elected by corporations with not more than 30 shareholders. § 342(1). Under § 351, "The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors." Thus, one advantage of close corporation status is avoidance of any need to provide for certain corporate formalities (where otherwise the failure to do so might give rise to personal liability of shareholders for corporate debts). In many situations, however, electing close corporation status may be more trouble than it is worth. Most of what investors should have to protect their interests and ensure the effective control of their venture can be accomplished by adaptations of the articles of incorporation and bylaws, together with ancillary agreements such as voting agreements, employment agreements, and buy-sell agreements.

Of more current relevance is the recent innovation in small-business organization, the Limited Liability Company (LLC). With an LLC, issues of control are left largely to individual choice, reflected in a document, drafted by (or for) the investors (the "members") and called "regulations" or "operating agreement" or something of the sort. Broadly speaking, an LLC may be "member managed" (like a partnership) or "manager managed" (like a corporation), with virtually infinite variety available. Additional flexibility in organization and control is provided by the availability in most states of a Limited Liability Partnership (LLP) or Limited Liability Limited Partnership (LLLP).

A final aspect of corporate law affecting closely held corporations is the development of provisions in corporations codes allowing for involuntary dissolution by court order. These provisions can operate, in certain circumstances, as a bail-out remedy for shareholders who have failed to enter into effective control or buy-sell agreements. These agreements are examined in Section 5 of this Chapter.

Galler v. Galler

32 Ill.2d 16, 203 N.E.2d 577 (1964).

There is no substantial dispute as to the facts in this case. From 1919 to 1924, Benjamin and Isadore Galler, brothers, were equal partners in

the Galler Drug Company, a wholesale drug concern. In 1924 the business was incorporated under the Illinois Business Corporation Act, each owning one half of the outstanding 220 shares of stock. In 1945 each contracted to sell 6 shares to an employee, Rosenberg, at a price of \$10,500 for each block of 6 shares, payable within 10 years. . . . Rosenberg was not involved in this litigation either as a party or as a witness, and in July of 1961, prior to the time that the master in chancery hearings were concluded, defendants Isadore and Rose Galler purchased the 12 shares from Rosenberg. A supplemental complaint was filed by the plaintiff, Emma Galler, asserting an equitable right to have 6 of the 12 shares transferred to her and offering to pay the defendants one half of the amount that the defendants paid Rosenberg. The parties have stipulated that pending disposition of the instant case, these shares will not be voted or transferred. For approximately one year prior to the entry of the decree by the chancellor in July of 1962, there were no outstanding minority shareholder interests.

In March, 1954, Benjamin and Isadore, on the advice of their accountant, decided to enter into an agreement for the financial protection of their immediate families and to assure their families, after the death of either brother, equal control of the corporation. In June, 1954, while the agreement was in the process of preparation by an attorney-associate of the accountant, Benjamin suffered a heart attack. Although he resumed his business duties some months later, he was again stricken in February, 1955, and thereafter was unable to return to work. During his brother's illness, Isadore asked the accountant to have the shareholders' agreement put in final form in order to protect Benjamin's wife, and this was done by another attorney employed in the accountant's office. On a Saturday night in July, 1955, the accountant brought the agreement to Benjamin's home, and 6 copies of it were executed there by the two brothers and their wives. . . . Between the execution of the agreement in July, 1955, and Benjamin's death in December, 1957, the agreement was not modified. Benjamin suffered a stroke late in July, 1955. . . . Because of the state of Benjamin's health, nothing further was said to him by any of the parties concerning the agreement. It appears from the evidence that some months after the agreement was signed, the defendants Isadore and Rose Galler and their son, the defendant, Aaron Galler sought to have the agreements destroyed. The evidence is undisputed that defendants had decided prior to Benjamin's death they would not honor the agreement, but never disclosed their intention to plaintiff [Emma] or her husband [Benjamin].

On July 21, 1956, Benjamin executed an instrument creating a trust naming his wife as trustee. The trust covered, among other things, the 104 shares of Galler Drug Company stock and the stock certificates were endorsed by Benjamin and delivered to Emma. When Emma presented the certificates to defendants for transfer into her name as trustee, they sought to have Emma abandon the 1955 agreement or enter into some

kind of a noninterference agreement as a price for the transfer of the shares. Finally, in September, 1956, after Emma had refused to abandon the shareholders' agreement, she did agree to permit defendant Aaron to become president for one year and agreed that she would not interfere with the business during that year. The stock was then reissued in her name as trustee. During the year 1957 while Benjamin was still alive, Emma tried many times to arrange a meeting with Isadore to discuss business matters but he refused to see her.

Shortly after Benjamin's death, Emma went to the office and demanded the terms of the 1955 agreement be carried out. Isadore told her that anything she had to say could be said to Aaron, who then told her that his father would not abide by the agreement. He offered a modification of the agreement by proposing the salary continuation payment but without her becoming a director. When Emma refused to modify the agreement and sought enforcement of its terms, defendants refused and this suit followed.

During the last few years of Benjamin's life both brothers drew an annual salary of \$42,000. Aaron, whose salary was \$15,000 as manager of the warehouse prior to September, 1956, has since the time that Emma agreed to his acting as president drawn an annual salary of \$20,000. In 1957, 1958, and 1959 a \$40,000 annual dividend was paid. Plaintiff has received her proportionate share of the dividend.

The July, 1955, agreement in question here, entered into between Benjamin, Emma, Isadore and Rose, recites that Benjamin and Isadore each own 47½% of the issued and outstanding shares of the Galler Drug Company, an Illinois corporation, and that Benjamin and Isadore desired to provide income for the support and maintenance of their immediate families. No reference is made to the shares then being purchased by Rosenberg. The essential features of the contested portions of the agreement are substantially as set forth in the opinion of the Appellate Court: (2) that the bylaws of the corporation will be amended to provide for a board of four directors; that the necessary quorum shall be three directors; and that no directors' meeting shall be held without giving ten days notice to all directors. (3) The shareholders will cast their votes for the above named persons (Isadore, Rose, Benjamin and Emma) as directors at said special meeting and at any other meeting held for the purpose of electing directors. (4, 5) In the event of the death of either brother his wife shall have the right to nominate a director in place of the decedent. (6) Certain annual dividends will be declared by the corporation. The dividend shall be \$50,000 payable out of the accumulated earned surplus in excess of \$500,000. If 50% of the annual net profits after taxes exceeds the minimum \$50,000, then the directors shall have discretion to declare a dividend up to 50% of the annual net profits. If the net profits are less than \$50,000, nevertheless the minimum \$50,000 annual dividend shall be declared, providing the \$500,000 surplus is maintained. Earned surplus is defined. (9) The

certificates evidencing the said shares of Benjamin Galler and Isadore Galler shall bear a legend that the shares are subject to the terms of this agreement. (10) A salary continuation agreement shall be entered into by the corporation which shall authorize the corporation upon the death of Benjamin Galler or Isadore Galler, or both, to pay a sum equal to twice the salary of such officer, payable monthly over a five-year period. Said sum shall be paid to the widow during her widowhood, but should be paid to such widow's children if the widow remarries within the five-year period. . . .

The Appellate Court found the 1955 agreement void because "the undue duration, stated purpose and substantial disregard of the provisions of the Corporation Act outweigh any considerations which might call for divisibility" and held that "the public policy of this state demands voiding this entire agreement."

While the conduct of defendants towards plaintiff was clearly inequitable, the basically controlling factor is the absence of an objecting minority interest, together with the absence of public detriment. . . .

At this juncture it should be emphasized that we deal here with a so-called close corporation. . . . For our purposes, a close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling. . . . Moreover, it should be recognized that shareholder agreements similar to that in question here are often, as a practical consideration, quite necessary for the protection of those financially interested in the close corporation. While the shareholder of a public-issue corporation may readily sell his shares on the open market should management fail to use, in his opinion, sound business judgment, his counterpart of the close corporation often has a large total of his entire capital invested in the business and has no ready market for his shares should he desire to sell. He feels, understandably, that he is more than a mere investor and that his voice should be heard concerning all corporate activity. Without a shareholder agreement, specifically enforceable by the courts, insuring him a modicum of control, a large minority shareholder might find himself at the mercy of an oppressive or unknowledgeable majority. Moreover, as in the case at bar, the shareholders of a close corporation are often also the directors and officers thereof. With substantial shareholding interests abiding in each member of the board of directors, it is often quite impossible to secure, as in the large public-issue corporation, independent board judgment free from personal motivations concerning corporate policy. For these and other reasons too voluminous to enumerate here, often the only sound basis for protection is afforded by a lengthy, detailed shareholder agreement securing the rights and obligations of all concerned.

As the preceding review of the applicable decisions of this court points out, there has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*.

Several shareholder-director agreements that have technically "violated" the letter of the Business Corporation Act have nevertheless been upheld in the light of the existing practical circumstances, i.e., no apparent public injury, the absence of a complaining minority interest, and no apparent prejudice to creditors. However, we have thus far not attempted to limit these decisions as applicable only to close corporations and have seemingly implied that general considerations regarding judicial supervision of all corporate behavior apply. . . .

. . . "New needs compel fresh formulation of corporate 'norms.' There is no reason why mature men should not be able to adapt the statutory form to the structure they want, so long as they do not endanger other stockholders, creditors, or the public, or violate a clearly mandatory provision of the corporation laws. In a typical close corporation the stockholders' agreement is usually the result of careful deliberation among all initial investors. In the large public-issue corporation, on the other hand, the 'agreement' represented by the corporate charter is not consciously agreed to by the investors; they have no voice in its formulation, and very few ever read the certificate of incorporation. Preservation of the corporate norms may there be necessary for the protection of the public investors." Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 *Yale L. Journal*, 1040, 1056.

This court has recognized, albeit *sub silentio*, the significant conceptual differences between the close corporation and its public-issue counterpart in, among other cases, *Kantzler v. Benzinger*, 214 Ill. 589, where an agreement quite similar to the one under attack here was upheld. Where, as in *Kantzler* and here, no complaining minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all. . . .

We now, in the light of the foregoing, turn to specific provisions of the 1955 agreement.

The Appellate Court correctly found many of the contractual provisions free from serious objection, and we need not prolong this opinion with a discussion of them here. That court did, however, find difficulties in the stated purpose of the agreement as it relates to its duration, the election of certain persons to specific offices for a number of years, the requirement for the mandatory declaration of stated dividends (which the Appellate Court held invalid), and the salary continuation agreement.

Since the question as to the duration of the agreement is a principal source of controversy, we shall consider it first. The parties provided no specific termination date, and while the agreement concludes with a paragraph that its terms "shall be binding upon and shall inure to the benefits of" the legal representatives, heirs and assigns of the parties,

this clause is, we believe, intended to be operative only as long as one of the parties is living. It further provides that it shall be so construed as to carry out its purposes, and we believe these must be determined from a consideration of the agreement as a whole. Thus viewed, a fair construction is that its purposes were accomplished at the death of the survivor of the parties. While these life spans are not precisely ascertainable, and the Appellate Court noted Emma Galler's life expectancy at her husband's death was 26.9 years, we are aware of no statutory or public policy provision against stockholder's agreements which would invalidate this agreement on that ground. . . .

The clause that provides for the election of certain persons to specified offices for a period of years likewise does not require invalidation. In *Kantzler v. Benzinger*, 214 Ill. 589, this court upheld an agreement entered into by all the stockholders providing that certain parties would be elected to the offices of the corporation for a fixed period. In *Faulds v. Yates*, 57 Ill. 416, we upheld a similar agreement among the majority stockholders of a corporation, notwithstanding the existence of a minority which was not before the court complaining thereof. See also Hornstein, "Judicial Tolerance of the Incorporated Partnership," 18 *Law and Contemporary Problems* 435 at page 444.

We turn next to a consideration of the effect of the stated purpose of the agreement upon its validity. The pertinent provision is: "The said Benjamin A. Galler and Isadore A. Galler desire to provide income for the support and maintenance of their immediate families." Obviously, there is no evil inherent in a contract entered into for the reason that the persons originating the terms desired to so arrange their property as to provide post-death support for those dependent upon them. Nor does the fact that the subject property is corporate stock alter the situation so long as there exists no detriment to minority stock interests, creditors or other public injury. It is, however, contended by defendants that the methods provided by the agreement for implementation of the stated purpose are, as a whole, violative of the Business Corporation Act . . . to such an extent as to render it void *in toto*.

The terms of the dividend agreement require a minimum annual dividend of \$50,000, but this duty is limited by the subsequent provision that it shall be operative only so long as an earned surplus of \$500,000 is maintained. It may be noted that in 1958, the year prior to commencement of this litigation, the corporation's net earnings after taxes amounted to \$202,759 while its earned surplus was \$1,543,270, and this was increased in 1958 to \$1,680,079 while earnings were \$172,964. The minimum earned surplus requirement is designed for the protection of the corporation and its creditors, and we take no exception to the contractual dividend requirements as thus restricted. . . .

The salary continuation agreement is a common feature, in one form or another, of corporate executive employment. It requires that the widow should receive a total benefit, payable monthly over a five-year

period, aggregating twice the amount paid her deceased husband in one year. This requirement was likewise limited for the protection of the corporation by being contingent upon the payments being income tax-deductible by the corporation. The charge made in those cases which have considered the validity of payments to the widow of an officer and shareholder in a corporation is that a gift of its property by a noncharitable corporation is in violation of the rights of its shareholders and *ultra vires*. Since there are no shareholders here other than the parties to the contract, this objection is not here applicable, and its effect, as limited, upon the corporation is not so prejudicial as to require its invalidation. . . .

We hold defendants must account for all monies received by them from the corporation since September 25, 1956, in excess of that theretofore authorized.

ANALYSIS

1. In *Galler v. Galler*, as in *Clark v. Dodge*, the court in effect ordered specific performance. Is there a better remedy? If you think there is, what does that suggest about whether there was a better form of agreement available to the parties at the outset?
2. Under the court's order, what is the likelihood of a change in the salaries paid to Isadore and to Aaron as long as Emma lives?
3. Was there anything in the agreement about which Rosenberg might reasonably have complained? If he had complained, and had sided with the defendants in the litigation that resulted in the decision of the Illinois Supreme Court, what would the outcome have been?
4. The court in *Galler v. Galler* says, "Without a shareholder agreement, specifically enforceable by the courts, insuring him a modicum of control, a large minority shareholder might find himself at the mercy of an oppressive or unknowledgeable majority." Later the court says, "often the only sound basis for protection is afforded by a lengthy, detailed shareholder agreement securing the rights and obligations of all concerned." Does it follow that a lawyer who is asked to form a corporation for people about to embark on a business venture and who fails to urge the adoption of various protective agreements is guilty of malpractice?
5. At the time this case arose the use of the corporate form could produce some federal income tax advantages. Under the current tax regime those tax advantages have largely disappeared. Most closely held corporations are eligible to be treated for tax purposes as so-called S corporations, which are taxed much the same as partnerships. Moreover, closely held businesses can achieve desired tax outcomes by organizing as Limited Liability Companies, Limited Liability Partnerships, Limited Partnerships, or Limited Liability Limited Partnerships. Thus, tax considerations do not play an important role in crafting the substantive

elements of a business organization. Do you think that in the Gallers' family business the partnership form would have been better than the corporate form? In answering this question think of the basic rules of partnership and corporate law relating to control, duration and termination, and share of profit and loss, and about how those rules need to be modified.

Ramos v. Estrada

8 Cal.App.4th 1070 10 Cal.Rptr.2d 833 (1992).

[Two groups of people separately sought from the Federal Communications Commission a permit to form a Spanish language television station in Ventura County. One group was called the Broadcast Group and included Leopoldo Ramos and his wife and Tila Estrada and her husband. The Ramoses owned 50 percent of the Broadcast Group and the Estradas and four other couples each owned 10 percent. The other group seeking the permit was called Ventura 41. Ultimately the two groups combined in a corporation called Television, Inc. and at some time in 1986 the shares of this corporation were issued to the individual members of each group. Initially, 5,000 shares of Television, Inc. were issued to the members of the Broadcast Group and 5,000 to the members of Ventura 41. The board of directors was to have eight members, four from each group. After the station was operated at full power for six months, however, two additional shares were to go to the Broadcast Group and the membership of the board of directors was to be increased to nine, of whom five would be elected by the Broadcast Group.

In June 1987, the members of Broadcast Group entered into an agreement to vote all their shares of Television, Inc. in a manner determined by a majority of them. The agreement also restricted transfer of the shares and provided that if any member of the group failed to abide by the voting provision, that member's shares would be sold to the other members at cost plus 8 percent per year.

The initial eight-member board of Television, Inc. elected Leopoldo Ramos as president. Tila Estrada was a member of the board. Thereafter, however, Estrada defected from the Broadcast Group, as described by the court below.]

At a special directors' meeting held on October 8, 1988, Tila Estrada voted with the Ventura 41 group block to remove Ramos as president and to replace him with Walter Ulloa, a member of Ventura 41. She also joined Ventura 41 in voting to remove Romualdo Ochoa, a Broadcast Group member, as secretary and to replace him with herself.

Under the June Broadcast Agreement and the Merger Agreement, each of the groups were required to vote for the directors upon whom a majority of each respective group had agreed. The terms of that agreement expressly state that failure to adhere to the agreement constitutes an election by the shareholder to sell his or her shares

pursuant to buy/sell provisions of the agreement. The agreement also calls for specific enforcement of such buy/sell provisions.

On October 15, 1988, the Broadcast Group noticed another meeting to decide how its members would vote their shares for directors at the annual meeting. All members attended except the Estradas. The group agreed to nominate *another* slate of directors which did not include either of the Estradas. The Estradas were notified of the results of this meeting.

The Estradas unilaterally declared the June Broadcast Agreement null and void as of October 15, 1988, in a letter dictated for them by Paul Zevnik, the attorney for Ventura 41. Tila Estrada refused to recognize the October 15 vote of the majority of the Broadcast Group to replace her as a director of Television Inc. Ramos et al. sued the Estradas for breach of the June Broadcast Agreement, among other things.

The court ruled that the Estradas materially breached the valid June Broadcast Agreement, and it ordered their shares sold in accordance with the specific enforcement provisions of the June Broadcast Agreement. The court restrained the Estradas from voting their shares other than as provided in the June Broadcast Agreement.

Discussion

The Estradas contend that the June Broadcast Agreement is void because it constitutes an expired proxy which the Estradas validly revoked. . . .

Corporations Code [California] section 178 defines a proxy to be "a written authorization signed . . . by a shareholder . . . giving another person or persons power to vote with respect to the shares of such shareholder."

Section 7.1 of the June Broadcast Agreement details the voting arrangement among the shareholders. It states, in pertinent part: "The Stockholders agree that they shall consult with each other prior to voting their shares in the Company. They shall attempt in good faith to reach a consensus as to the outcome of any such vote. In the case of a vote for directors, they agree that no director shall be selected who is not acceptable to at least one member (i.e., spousal unit) of each of Group A and Group B. (See P 1.2(b)(1) above [which states that "The Stockholders shall be divided into two groups, Group "A" being composed of Leopoldo Ramos and Cecilia Morris, and Group "B" being composed of all the other Stockholders"].) In the case of all *votes of Stockholders* they agree that, following consultation and compliance with the other provisions of this paragraph, *they will all vote their stock in the manner voted by a majority of the Stockholders.*" (Second emphasis in original.)

No proxies are created by this agreement. The agreement has the characteristics of a shareholders' voting agreement expressly authorized by section 706, subdivision (a) for close corporations. . . . Although the articles of incorporation do not contain the talismanic statement that "This corporation is a close corporation," the arrangements of this

corporation, and in particular this voting agreement, are strikingly similar to ones authorized by the Code for close corporations.

Section 706, subdivision (a) states, in pertinent part: "an agreement between two or more shareholders of a close corporation, if in writing and signed by the parties thereto, may provide that in exercising any voting rights the shares held by them shall be voted as provided by the agreement, or as the parties may agree or as determined in accordance with a procedure agreed upon by them. . . ."

Here, the members of this corporation executed a written agreement providing that they shall try to reach a consensus on all votes and that they shall consult with one another and vote their own stock in accordance with the majority of the stockholders. They entered into this agreement because they "mutually desired" to limit the transferability of their stock to ensure "the Company does not pass into the control of persons whose interests might be incompatible with the interests of the Company and of the Stockholders, establishing their mutual rights and obligations in the event of death, and establishing a mechanism for determining how the Stockholders' voting rights in the Company shall be exercised. . . ."

Even though this corporation does not qualify as a close corporation, this agreement is valid and binding on the Estradas. Section 706, subdivision (d) states: "This section shall not invalidate any voting or other agreement among shareholders . . . which agreement . . . is not otherwise illegal."

The Legislative Committee comment regarding section 706, subdivision (d) states that "this subdivision is intended to preserve any agreements which would be upheld under court decisions *even though they do not comply with one or more of the requirements of this section, including voting agreements of corporations other than close corporations.*" (West's Ann. Corp. Code, § 706 (1990) p. 330, emphasis added.)

The California Practice Guide indicates that such "pooling" agreements are valid not only for close corporations, but also "among any number of shareholders of other corporations as well." (Friedman, Cal. Practice Guide Corporations (1992) § 3:159.2, p. 3-31.)

The instant agreement is valid, enforceable and supported by consideration. It states, in pertinent part, that the stockholders entered into the agreement for the purposes of "limiting the transferability of . . . stock in the Company, ensuring that the Company does not pass into the control of persons whose interests might be incompatible with the interests of the Company and of the Stockholders, establishing their mutual rights and obligations in the event of death, and establishing a mechanism for determining how the Stockholders' voting rights . . . shall be exercised. . . ."

Section 7.2 of the agreement states that "the Stockholders understand and acknowledge that the purpose of the foregoing arrangement is to preserve their relative voting power in the Company. . . . Accordingly, in the event that a Stockholder fails to abide by this arrangement for whatever reason, that failure shall constitute on [sic] irrevocable election by the Stockholder to sell his stock in the Company, triggering the same rights of purchase provided in Article IV above."

The agreement calls for enforcement by specific performance of its terms because the stock is not readily marketable. [Corporations Code] Section 709, subdivision (c) expressly permits enforcement of shareholder voting agreements by such equitable remedies. It states, in pertinent part: "The court may determine the person entitled to the office of director or may order a new election to be held or appointment to be made, may determine the validity, effectiveness and construction of voting agreements . . . and the right of persons to vote and may direct such other relief as may be just and proper."

The Estradas contend that the forced sale provision is unconscionable and oppressive. They portray themselves as naive, small-town business people who were forced to sign an adhesion agreement without reviewing its contents.

Substantial evidence supports the findings that Tila Estrada has been a licensed real estate broker. She is an astute businesswoman experienced with contracts concerning real property. The consent and signatures of the Estradas to the agreement were not procured by fraud, duress or other wrongful conduct of Ramos. The Estradas read and discussed with other members of Broadcast Group, and with their own counsel, the voting, buy/sell and other provisions of the agreement and the January Broadcast Agreement, as well as various drafts of these documents, and they freely signed these agreements.

On direct examination, under Evidence Code section 776, Tila Estrada admitted she owns and operates a real estate brokerage business; she regularly reviews a broad variety of real estate documents; she and her husband own and manage investment property; and she has considered herself "to be an astute business woman" since 1985. Tila Estrada also has been a participant and owner in another application before the FCC, for an FM radio station, before the instant suit was filed.

Ms. Estrada stated she got copies "of all the drafts and all the Shareholders Agreements." She discussed these agreements with other members of Broadcast Group and with its counsel, Mr. Howard Weiss.

The June Broadcast Agreement, including its voting and buy/sell provisions, was unanimously executed after the Estradas had a full and fair opportunity to consider it in its entirety. As the trial court found, the buy-out provisions at issue here are valid, favored by courts and enforceable by specific performance. . . .

The Estradas breached the agreement by their written repudiation of it. Their breach constituted an election to sell their Television Inc. shares in accordance with the terms of the buy/sell provisions in the agreement. This election does not constitute a forfeiture—they violated the agreement voluntarily, aware of the consequences of their acts and they are provided full compensation, per their agreement.

The judgment is affirmed. Costs to Ramos.

ANALYSIS

1. If you had been consulted by Tila Estrada before she signed the June Broadcast Agreement, what advice would you have given her?
2. If Tila Estrada had consulted you after she formed the intent to defect from the Broadcast Group and vote with the Ventura 41 Group, what advice would you have given her (assuming you did not have the decision in the case as an authority on which to rely)?

NOTE ON THE LAW IN OTHER STATES

In *Zion v. Kurtz*, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681 (1980), the Court of Appeals of New York, applying a basic choice-of-law rule, decided a shareholder-agreement case under Delaware law, but stated that the result would be the same under New York law. The facts in the case were complex and unusual. There were essentially two shareholders, with Kurtz holding the majority interest and Zion the minority. An agreement between them narrowly defined the intended activities of the corporation and provided that no other activities could be engaged in without the minority shareholder's consent.* In supporting its view that the agreement did not violate the public policy of Delaware, the court cited the Delaware provisions relating to statutory close corporations, although the corporation involved in the case was not a statutory close corporation and the restriction in the agreement was not made part of the articles of incorporation, as might be required in the case of a statutory close corporation (under Del.Gen.Corp.Law § 351). See also N.Y.Bus.Corp.Law § 620(b), set forth following *Clark v. Dodge*.

* Note that the shareholders' objective could have been achieved by use of a narrow statement of purposes in the articles of incorporation. Such a limitation might not have been enforceable as against a third party (see, e.g., Del.Gen.Corp.Law § 124), but the same would be true of the limitation in the contract in *Zion v. Kurtz*. A limitation in the articles might have created problems in selling shares to others, but again the problem also seems to arise with the use of a contract. Some shares were in fact sold to others, but subject to the terms of the agreement of the two original shareholders. Presumably the two could have abandoned their agreement without the consent of the new shareholders. Amendment of the articles of incorporation requires a vote of the shareholders, which might or might not have been a problem.

PROBLEM

Curlie, Moe, and Larry incorporate a restaurant. They each receive one-third of the stock.

1. If they agree to exercise their best efforts to ensure that each is elected to the board of directors, is the agreement enforceable? If they agree that they will, as directors, elect each other officers of the corporation, is the agreement enforceable?

2. Suppose Curlie and Moe (but not Larry) agree to exercise their best efforts to ensure that each is elected to the board and agree that they will, as directors, elect each other as officers. Is either agreement enforceable? Does the result change if they agree to elect each other as officers, "so long as each shall remain faithful, efficient and competent to manage and control the restaurant"?

NOTE AND QUESTIONS ON LIMITED LIABILITY COMPANIES

Under the Delaware Limited Liability Company Act, § 18-704(a),

An assignee of a limited liability company interest may become a member:

(1) As provided in the limited liability company agreement;

(2) Unless otherwise provided in the limited liability company agreement, upon the vote or consent of all of the members of the limited liability company; . . .

Notwithstanding the permissive language of (a)(1), do you think that most LLCs would be well advised to provide in their organizational documents for freely transferrable membership interests? What are the sensible alternatives?

4. ABUSE OF CONTROL**Wilkes v. Springside Nursing Home, Inc.**

370 Mass. 842, 353 N.E.2d 657 (1976).

In 1951 Wilkes acquired an option to purchase a building and lot located on the corner of Springside Avenue and North Street in Pittsfield, Massachusetts, the building having previously housed the Hillcrest Hospital. Though Wilkes was principally engaged in the roofing and siding business, he had gained a reputation locally for profitable dealings in real estate. Riche, an acquaintance of Wilkes, learned of the option, and interested Quinn (who was known to Wilkes through membership on the draft board in Pittsfield) and Pipkin (an acquaintance of both Wilkes and Riche) in joining Wilkes in his investment. The four men met and decided to participate jointly in the purchase of the building and lot as a

real estate investment which, they believed, had good profit potential on resale or rental.

The parties later determined that the property would have its greatest potential for profit if it were operated by them as a nursing home. Wilkes consulted his attorney, who advised him that if the four men were to operate the contemplated nursing home as planned, they would be partners and would be liable for any debts incurred by the partnership and by each other. On the attorney's suggestion, and after consultation among themselves, ownership of the property was vested in Springside, a corporation organized under Massachusetts law.

Each of the four men invested \$1,000 and subscribed to ten shares of \$100 par value stock in Springside. At the time of incorporation it was understood by all of the parties that each would be a director of Springside and each would participate actively in the management and decision making involved in operating the corporation.⁷ It was, further, the understanding and intention of all the parties that, corporate resources permitting, each would receive money from the corporation in equal amounts as long as each assumed an active and ongoing responsibility for carrying a portion of the burdens necessary to operate the business.

The work involved in establishing and operating a nursing home was roughly apportioned, and each of the four men undertook his respective tasks.⁸ Initially, Riche was elected president of Springside, Wilkes was elected treasurer, and Quinn was elected clerk.⁹ Each of the four was listed in the articles of organization as a director of the corporation.

At some time in 1952, it became apparent that the operational income and cash flow from the business were sufficient to permit the four stockholders to draw money from the corporation on a regular basis. Each of the four original parties initially received \$35 a week from the corporation. As time went on the weekly return to each was increased until, in 1955, it totalled \$100.

In 1959, after a long illness, Pipkin sold his shares in the corporation to Connor, who was known to Wilkes, Riche and Quinn through past

⁷ Wilkes testified before the master that, when the corporate officers were elected, all four men "were . . . guaranteed directorships." Riche's understanding of the parties' intentions was that they all wanted to play a part in the management of the corporation and wanted to have some "say" in the risks involved; that, to this end, they all would be directors; and that "unless you [were] a director and officer you could not participate in the decisions of [the] enterprise."

⁸ Wilkes took charge of the repair, upkeep and maintenance of the physical plant and grounds; Riche assumed supervision over the kitchen facilities and dietary and food aspects of the home; Pipkin was to make himself available if and when medical problems arose; and Quinn dealt with the personnel and administrative aspects of the nursing home, serving informally as a managing director. Quinn further coordinated the activities of the other parties and served as a communication link among them when matters had to be discussed and decisions had to be made without a formal meeting.

⁹ Riche held the office of president from 1951 to 1963; Quinn served as president from 1963 on, as clerk from 1951 to 1967, and as treasurer from 1967 on; Wilkes was treasurer from 1951 to 1967.

transactions with Springside in his capacity as president of the First Agricultural National Bank of Berkshire County. Connor received a weekly stipend from the corporation equal to that received by Wilkes, Riche and Quinn. He was elected a director of the corporation but never held any other office. He was assigned no specific area of responsibility in the operation of the nursing home but did participate in business discussions and decisions as a director and served additionally as financial adviser to the corporation.

In 1965 the stockholders decided to sell a portion of the corporate property to Quinn who, in addition to being a stockholder in Springside, possessed an interest in another corporation which desired to operate a rest home on the property. Wilkes was successful in prevailing on the other stockholders of Springside to procure a higher sale price for the property than Quinn apparently anticipated paying or desired to pay. After the sale was consummated, the relationship between Quinn and Wilkes began to deteriorate.

The bad blood between Quinn and Wilkes affected the attitudes of both Riche and Connor. As a consequence of the strained relations among the parties, Wilkes, in January of 1967, gave notice of his intention to sell his shares for an amount based on an appraisal of their value. In February of 1967 a directors' meeting was held and the board exercised its right to establish the salaries of its officers and employees.¹⁰ A schedule of payments was established whereby Quinn was to receive a substantial weekly increase and Riche and Connor were to continue receiving \$100 a week. Wilkes, however, was left off the list of those to whom a salary was to be paid. The directors also set the annual meeting of the stockholders for March, 1967.

At the annual meeting in March, Wilkes was not reelected as a director, nor was he reelected as an officer of the corporation. He was further informed that neither his services nor his presence at the nursing home was wanted by his associates.

The meetings of the directors and stockholders in early 1967, the master found, were used as a vehicle to force Wilkes out of active participation in the management and operation of the corporation and to cut off all corporate payments to him. Though the board of directors had the power to dismiss any officers or employees for misconduct or neglect of duties, there was no indication in the minutes of the board of directors' meeting of February, 1967, that the failure to establish a salary for Wilkes was based on either ground. The severance of Wilkes from the payroll resulted not from misconduct or neglect of duties, but because of the personal desire of Quinn, Riche and Connor to prevent him from

¹⁰ The by-laws of the corporation provided that the directors, subject to the approval of the stockholders, had the power to fix the salaries of all officers and employees. This power, however, up until February, 1967, had not been exercised formally; all payments made to the four participants in the venture had resulted from the informal but unanimous approval of all the parties concerned.

continuing to receive money from the corporation. Despite a continuing deterioration in his personal relationship with his associates, Wilkes had consistently endeavored to carry on his responsibilities to the corporation in the same satisfactory manner and with the same degree of competence he had previously shown. Wilkes was at all times willing to carry on his responsibilities and participation if permitted so to do and provided that he receive his weekly stipend.

1. We turn to Wilkes's claim for damages based on a breach of the fiduciary duty owed to him by the other participants in this venture. In light of the theory underlying this claim, we do not consider it vital to our approach to this case whether the claim is governed by partnership law or the law applicable to business corporations. This is so because, as all the parties agree, Springside was at all times relevant to this action, a close corporation as we have recently defined such an entity in *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 367 Mass. 578, 585-586 (1975).

In *Donahue*, we held that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another." *Id.* at 593 (footnotes omitted), 328 N.E.2d at 515. As determined in previous decisions of this court, the standard of duty owed by partners to one another is one of "utmost good faith and loyalty." *Cardullo v. Landau*, 329 Mass. 5, 8, 105 N.E.2d 843 (1952), and cases cited. . . .

Thus, we concluded in *Donahue*, with regard to "their actions relative to the operations of the enterprise and the effects of that operation on the rights and investments of other stockholders," "[s]tockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." 367 Mass. at 593, n. 18.

In the *Donahue* case we recognized that one peculiar aspect of close corporations was the opportunity afforded to majority stockholders to oppress, disadvantage or "freeze out" minority stockholders. In *Donahue* itself, for example, the majority refused the minority an equal opportunity to sell a ratable number of shares to the corporation at the same price available to the majority. The net result of this refusal, we said, was that the minority could be forced to "sell out at less than fair value," 367 Mass. at 593, since there is by definition no ready market for minority stock in a close corporation.

"Freeze outs," however, may be accomplished by the use of other devices. One such device which has proved to be particularly effective in accomplishing the purpose of the majority is to deprive minority stockholders of corporate offices and of employment with the corporation. . . . This "freeze-out" technique has been successful because courts fairly consistently have been disinclined to interfere in those facets

of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control. . . . As one authoritative source has said, "[M]any courts apparently feel that there is a legitimate sphere in which the controlling [directors or] shareholders can act in their own interest even if the minority suffers." F.H. O'Neal, ["Squeeze-Outs" of Minority Shareholders 59 (1975)] (footnote omitted). . . .

The denial of employment to the minority at the hands of the majority is especially pernicious in some instances. A guaranty of employment with the corporation may have been one of the "basic reason[s] why a minority owner has invested capital in the firm." Symposium—The Close Corporation, 52 Nw.U.L.Rev. 345, 392 (1957).

...

The minority stockholder typically depends on his salary as the principal return on his investment, since the "earnings of a close corporation . . . are distributed in major part in salaries, bonuses and retirement benefits." 1 F.H. O'Neal, Close Corporations § 1.07 (1971). Other noneconomic interests of the minority stockholder are likewise injuriously affected by barring him from corporate office. . . . Such action severely restricts his participation in the management of the enterprise, and he is relegated to enjoying those benefits incident to his status as a stockholder. . . . In sum, by terminating a minority stockholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment.

The *Donahue* decision acknowledged, as a "natural outgrowth" of the case law of this Commonwealth, a strict obligation on the part of majority stockholders in a close corporation to deal with the minority with the utmost good faith and loyalty. On its face, this strict standard is applicable in the instant case. The distinction between the majority action in *Donahue* and the majority action in this case is more one of form than of substance. Nevertheless, we are concerned that untempered application of the strict good faith standard enunciated in *Donahue* to cases such as the one before us will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned. The majority, concededly, have certain rights to what has been termed "selfish ownership" in the corporation which should be balanced against the concept of their fiduciary obligation to the minority. . . .

Therefore, when minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority, we must carefully analyze the action taken by the controlling stockholders in the individual case. It must be asked

whether the controlling group can demonstrate a legitimate business purpose for its action. . . . In asking this question, we acknowledge the fact that the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation. It must have a large measure of discretion, for example, in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.

When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest. . . . If called on to settle a dispute, our courts must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.

Applying this approach to the instant case it is apparent that the majority stockholders in Springside have not shown a legitimate business purpose for severing Wilkes from the payroll of the corporation or for refusing to reelect him as a salaried officer and director. The master's subsidiary findings relating to the purpose of the meetings of the directors and stockholders in February and March, 1967, are supported by the evidence. There was no showing of misconduct on Wilkes's part as a director, officer or employee of the corporation which would lead us to approve the majority action as a legitimate response to the disruptive nature of an undesirable individual bent on injuring or destroying the corporation. On the contrary, it appears that Wilkes had always accomplished his assigned share of the duties competently, and that he had never indicated an unwillingness to continue to do so.

It is an inescapable conclusion from all the evidence that the action of the majority stockholders here was a designed "freeze out" for which no legitimate business purpose has been suggested. Furthermore, we may infer that a design to pressure Wilkes into selling his shares to the corporation at a price below their value well may have been at the heart of the majority's plan.¹⁴

In the context of this case, several factors bear directly on the duty owed to Wilkes by his associates. At a minimum, the duty of utmost good faith and loyalty would demand that the majority consider that their action was in disregard of a long-standing policy of the stockholders that each would be a director of the corporation and that employment with the corporation would go hand in hand with stock ownership; that Wilkes was one of the four originators of the nursing home venture; and that Wilkes, like the others, had invested his capital and time for more than fifteen years with the expectation that he would continue to participate

¹⁴ This inference arises from the fact that Connor, acting on behalf of the three controlling stockholders, offered to purchase Wilkes's shares for a price Connor admittedly would not have accepted for his own shares.

in corporate decisions. Most important is the plain fact that the cutting off of Wilkes's salary, together with the fact that the corporation never declared a dividend . . . assured that Wilkes would receive no return at all from the corporation.

2. The question of Wilkes's damages at the hands of the majority has not been thoroughly explored on the record before us. Wilkes, in his original complaint, sought damages in the amount of the \$100 a week he believed he was entitled to from the time his salary was terminated up until the time this action was commenced. However, the record shows that, after Wilkes was severed from the corporate payroll, the schedule of salaries and payments made to the other stockholders varied from time to time. In addition, the duties assumed by the other stockholders after Wilkes was deprived of his share of the corporate earnings appear to have changed in significant respects.¹⁵ Any resolution of this question must take into account whether the corporation was dissolved during the pendency of this litigation.

Therefore our order is as follows: So much of the judgment as dismisses Wilkes's complaint and awards costs to the defendants is reversed. The case is remanded to the Probate Court for Berkshire County for further proceedings concerning the issue of damages. Thereafter a judgment shall be entered declaring that Quinn, Riche and Connor breached their fiduciary duty to Wilkes as a minority stockholder in Springside, and awarding money damages therefor. Wilkes shall be allowed to recover from Riche, the estate of T. Edward Quinn and the estate of Lawrence R. Connor, ratably, according to the inequitable enrichment of each, the salary he would have received had he remained an officer and director of Springside. In considering the issue of damages the judge on remand shall take into account the extent to which any remaining corporate funds of Springside may be diverted to satisfy Wilkes's claim.

So ordered.

ANALYSIS

1. According to normal, fundamental rules of corporate law, the board of directors appoints officers and sets their salaries. The earlier cases in this section reveal the difficulties that courts generally have with deviations from the corporate norm of management by the board of directors. In the present case, the parties did not, by written shareholder agreement, attempt to "sterilize" the board. Why is it, then, that the plaintiff in this case, Wilkes, was not required to cast his argument in terms of abuse of discretion by the board?

¹⁵ In fairness to Wilkes, who, as the master found, was at all times ready and willing to work for the corporation, it should be noted that neither the other stockholders nor their representatives may be heard to say that Wilkes's duties were performed by them and that Wilkes's damages should, for that reason, be diminished.

2. Suppose that the Springside Nursing Home board in 1967 had declared a dividend of \$1,000 payable to each of Connor, Riche, and Quinn, with no dividend payable to Wilkes. Would Wilkes have had a legal entitlement to object? How would you frame the objection? Does this line of inquiry suggest another approach to the actual case?

3. Suppose there had been evidence in the case that the board had found another person to perform the duties that were being performed by Wilkes, but at a lower salary, and, after due deliberation, had fired Wilkes and hired the other person. Would Wilkes still have prevailed?

4. If the venture had been operated as a partnership, relying on the basic rules of the Uniform Partnership Act, what would Wilkes's position have been? Could the other partners have fired him? If they refused to pay him a salary, could they continue to pay themselves salaries?

5. The court refers to a right of "selfish ownership" in a close corporation. Suppose that Connor, Quinn, and Riche had decided on a substantial expansion of the nursing home; that this expansion would require suspension of the payment of salaries or dividends and would require considerable borrowing; and that there would, as a result, be a substantial risk of failure and loss of the entire investment. Suppose that Connor, Quinn, and Riche were all wealthy and could afford the loss, but that Wilkes was a man of modest means and could not afford the loss. Would Wilkes have been legally entitled to block the action of the majority? Should he have been? Would your answer be different if the majority had offered to buy out Wilkes's interest at a price about 40 percent below its existing market value? How would your answers to these questions change, if at all, if the venture had been organized as a partnership?

6. What is the appropriate remedy in this case? If Wilkes is entitled to damages, what about the duty to mitigate? Assuming that the corporation is to continue in existence, and that Connor, Quinn, and Riche are willing to forgo salary payments, must they pay dividends?

7. What planning techniques were available to the investors that would have allowed them to avoid litigation? If the lawyer who assisted in the formation of the corporation failed to discuss those planning techniques, is she or he guilty of malpractice? How does the decision in this case affect the obligations of lawyers in similar situations in the future?

8. Could the outcome in this case have been reached by applying ordinary principles of contract, rather than principles of fiduciary obligation? If so, would that have been a better approach? If you had been Wilkes's lawyer, which approach would you have emphasized?

Ingle v. Glamore Motor Sales, Inc.

73 N.Y.2d 183, 538 N.Y.S.2d 771, 535 N.E.2d 1311 (1989).

■ BELLACOSA, JUDGE.

...

In 1964, plaintiff-appellant Ingle sought to purchase an equity interest in respondent Glamore Motor Sales, Inc. from its then sole shareholder, respondent James Glamore. Ingle was not sold an interest in the corporation initially, but he was hired as sales manager. There was no express agreement between the parties establishing either the duration or conditions of employment.

In 1966, Glamore and Ingle entered into a written shareholders' agreement which provided that Ingle would purchase 22 of Glamore's 100 shares in the corporation, that Ingle would have a five-year option to purchase an additional 18 shares, and that Glamore would nominate and vote Ingle as a director and secretary of the corporation. The agreement also gave Glamore the right to repurchase all of Ingle's stock if "Ingle shall cease to be an employee of the Corporation *for any reason*" (emphasis added). Ingle later purchased the 18 additional shares and the parties executed a new shareholders' agreement, which updated some facets and eliminated outdated ones. The repurchase provision of the 1973 agreement tracked identically the 1966 version.

On January 1, 1982, the corporation issued 60 additional shares of stock. Glamore purchased 22 shares of the new issue and his two sons (respondents William and Robert Glamore) each purchased 19 shares. The three Glamores and Ingle, the only four shareholders, entered into a third agreement reflecting the corporate relationship. The repurchase provision pertinent to this litigation is: "(b) *Termination of employment.* In the event that any Stockholder shall *cease to be an employee of the Corporation for any reason*, Glamore shall have the option, for a period of 30 days after such termination of employment, to purchase all of the shares of stock then owned by such Stockholder" (emphasis supplied).

At a special meeting of the board of directors held on May 9, 1983, Ingle was voted out of his corporate posts and fired from his employment as operating manager of the business. The termination was effective May 31, 1983. On June 1, Glamore notified Ingle that he was exercising the repurchase-upon-termination-of-employment option and in due course paid Ingle \$96,000 for his 40 shares in the corporation.

Plaintiff argues that as a minority shareholder of a closely held corporation, employed without the benefit of a contract containing a durational employment protection and without any limitation on the employer's right to discharge, he is nevertheless entitled by reason of his minority shareholder status to a fiduciary-rooted protection against being fired. His theory is that his employment status should not be governed by the employment at-will doctrine but, rather, that as a

minority shareholder in a close corporation he should be treated as a co-owner, equivalent to a partner, whose employment rights flow from a special duty of loyalty and good faith. He next urges that an implicit covenant of good faith and fair dealing under the shareholders' agreement precluded his termination without cause, despite the express language and nature of the agreement in that regard. He concludes that even if he is an at-will employee, an action properly lies for the respondents' breach of fiduciary duties and for wrongful interference with his employment. Ingle started two separate actions seeking damages via seven causes of action alleging breach of fiduciary duty and of contract. Eventually all causes of action were dismissed—we believe correctly.

A minority shareholder in a close corporation, by that status alone, who contractually agrees to the repurchase of his shares upon termination of his employment for any reason, acquires no right from the corporation or majority shareholders against at-will discharge. There is nothing in law, in the agreement, or in the relationship of the parties to warrant such a contradictory and judicial alteration of the employment relationship or the express agreement. It is necessary in this case to appreciate and keep distinct the duty a corporation owes to a minority shareholder *as a shareholder* from any duty it might owe him as an employee.

Both lower courts agree, as do we, that Ingle did not sufficiently present facts raising a triable issue regarding the existence of either an oral or written employment contract fixing employment of a definite duration. . . . Under the established common-law rule—and without any reference to the shareholders' agreement—the corporation had the right to discharge plaintiff at will. . . .

The twist in this fact pattern is an asserted liability based on allegations that the corporate officers breached fiduciary duties of good faith and fair dealing arising from the shareholders' agreement and on tortious interference with Ingle's employment. The twist does not support a deviation from the governing principle in this case.

In *Murphy v. American Home Prods. Corp.*, 58 N.Y.2d 293, 461 N.Y.S.2d 232, 448 N.E.2d 86, we concluded that there is no implied obligation of good faith and fair dealing in an employment at will, as that would be incongruous to the legally recognized jural relationship in that kind of employment relationship. . . .

Plaintiff confuses and tries to avoid the sequential relationship of his employment status to his shareholders' agreement by extracting an obligation from the agreement to manufacture a legally unrecognized employment security. Divestiture of his status as a shareholder, by operation of the repurchase provision, is a contractually agreed to consequence flowing directly from the firing, not vice versa. The dissent similarly confuses and inverts the Appellate Division's and our holding. . . .

As noted, Ingle argued that the corporation discharged him because James Glamore would then have a right to repurchase his shares under the terms of the shareholders' agreement. Notably, however, Ingle never asserted that the \$2,400 per share paid to him upon termination was not fairly representative of his equity interest in the corporation. He does not contend that the corporation undervalued his shares, and he accepted payment from Glamore without reservation. Indeed, that, too, was fixed by the parties' buy-out agreement. . . .

Ingle's and the dissent's reliance on *Fender v. Prescott*, 101 A.D.2d 418, 422, 476 N.Y.S.2d 128, *expressly affirmed on grounds other than the corporate relationship discussion*, 64 N.Y.2d 1077, 1078-1079, 489 N.Y.S.2d 880, 479 N.E.2d 225, for an exception based on the close corporate form in which this employer and employee find themselves is unavailing. No duty of loyalty and good faith akin to that between partners, precluding termination except for cause, arises among those operating a business in the corporate form who "have only the rights, duties and obligations of stockholders" and not those of partners. . . .

Finally, the dissent essentially invokes an equity appeal. While we have no quarrel whatsoever with that magnificent juridical jewel applied in its proper setting, this lawsuit does not qualify. Here, fair principles of well-settled law, affecting employment and contractual relationships between private parties, govern and are entitled to respect and efficacy from this court. We cannot merely substitute our preferred notions for those of the parties themselves in such matters.

. . .

If there was no protection against discharge of an at-will employee in *Murphy* (supra) . . . , where there was no contractual arrangement at all, there surely can be none here where the related contract expressly confirms the unavailability of that protection. Moreover, to hold otherwise on the facts and pleadings of this case would confuse our recent holdings in an area of the law where certainty, predictability and reliability are highly prized common-law goals.

. . .

Accordingly, the order of the Appellate Division, 140 A.D.2d 493, 528 N.Y.S.2d 602, should be affirmed, with costs.

■ HANCOCK, JUDGE (dissenting).

This appeal presents a clear-cut legal question: whether plaintiff's status as an officer, director, substantial part owner and active participant in the affairs and management of Glamore Motor Sales, a close corporation, gives him equitable rights and remedies which are not subject to the ordinary legal rules of master and servant? The majority answers "no" and writes off the case as a routine application of New York's employment at-will rule. Because this produces a result which is egregiously unfair and one which, I am convinced, is not warranted under existing case law, I respectfully dissent.

By treating the essence of plaintiff's complaints as a claimed breach of a hiring contract by the employer rather than an unfair squeeze-out of a minority shareholder in a close corporation by the majority, the court simply concludes that plaintiff has no rights at all. . . .

The majority's decision summarily rejects, without discussion, plaintiff's underlying theory which is rooted in his equitable rights as a minority shareholder and principal in a close corporation and the fiduciary duty of fair dealing owed him by the majority shareholders—rights and duties which have been widely recognized in statutory and decisional law in this and other jurisdictions (*see, e.g., . . . Wilkes v. Springside Nursing Home*, 370 Mass. 842, 353 N.E.2d 657 [1976], . . .).

. . .

What is remarkable about the majority opinion is that it appears to treat the employment at-will rule as a sort of categorical imperative which necessarily dictates the result in this case. There can be no question about the harshness of the outcome—assuming plaintiff's allegations to be true: the controlling shareholders are permitted to have the corporation fire plaintiff arbitrarily and in bad faith solely for the purpose of getting rid of him as a 25% stock owner.¹ . . .

The Appellate Division, in dismissing plaintiff's complaints, and the majority of the court, in its affirmance, have adopted defendants' literal interpretation of the phrase in paragraph 7(b) of the stockholders' agreement—"cease to be an employee of the Corporation for any reason"—as giving defendants the unfettered right to repurchase plaintiff's shares by firing him, even if arbitrarily or in bad faith.

The plain wording of the buy-back provision and its sense, when read in the context of the entire agreement and the circumstances surrounding its execution, by no means unequivocally support this interpretation. Plaintiff states that the purpose and intent of paragraph 7(b) was to protect James Glamore in case *plaintiff chose* to leave the

¹ The notion that plaintiff's loss must somehow be viewed as less onerous because he is not contesting the \$2,400 per share cash-out price misses the point of the lawsuit. Plaintiff wants to *keep his stock*—not to sell it. The injury to plaintiff is that he is being involuntarily cashed out as a stockholder through the buy-back agreement and forced out of his investment and participation in Glamore Motor Sales, Inc. Obviously, if the buy-back agreement is held to be enforceable against plaintiff, he is precluded from complaining about the amount. He has agreed to it.

Moreover, it cannot seriously be suggested that plaintiff should be pleased with being repaid a total of \$96,000 in 1983 for his \$75,000 cash outlay made 17 to 15 years earlier, particularly in light of the high risk he assumed in guaranteeing the corporation's loans up to \$1,000,000. That he agreed to such buy-back figure, of course, supports his contention that he thought the buy-back agreement was intended to protect Glamore's control over plaintiff's stock by giving Glamore the right to repurchase the stock in the event that plaintiff died, wished to sell or transfer his shares, or voluntarily decided to quit; and that it was never in plaintiff's contemplation that the clause was to apply as the price for his shares in the event that he was involuntarily terminated. . . .

William Glamore and Robert Glamore, sons of James H. Glamore, were elected vice-president and secretary-treasurer, respectively; and . . . , thereafter, upon exercise of the purchase option in the shareholders' agreement, plaintiff was compelled to deliver his shares for the sum of \$2,400 per share. About these facts there is no dispute.

business, not to give Glamore the right—at any time, for any reason or for no reason—to deprive plaintiff of all expectancies as coprincipal in the agency. He points to the other two contingencies giving Glamore the right to repurchase his shares: plaintiff's decision to sell his stock (para. 7[a]) and plaintiff's death (para. 7[c]); he argues that the purpose of paragraph 7(b) like that of the other provisions was solely to protect Glamore by giving him the right to repurchase upon the happening of a contingency beyond Glamore's control—i.e., in paragraph 7(b), plaintiff's voluntary decision to leave. The very choice of the wording to describe the contingency of plaintiff's leaving—i.e., “ceases to be an employee” rather than “is terminated”—tends to support plaintiff's argument. The word “ceases” suggests that it was action by plaintiff not by the employer in ending the relationship which was contemplated. Thus, in my opinion the repurchase option of 7(b) is not free from ambiguity. . . .

There is no employment agreement between plaintiff and the corporation. Nothing in the original stockholders' agreement between plaintiff and James Glamore or in the subsequent agreement between plaintiff and the additional members of the Glamore family as stockholders purports to set the terms of plaintiff's relationship with the corporation or to state when or under what circumstances it may be terminated. . . . Upholding the corporation's right to discharge plaintiff here, therefore, must rest squarely on the application of the employment at-will doctrine, “that where an employment is for an indefinite term it is presumed to be a hiring at will which may be freely terminated by either party at any time for any reason or even for no reason” (*Murphy v. American Home Prods. Corp.*, 58 N.Y.2d [293,] 300, 461 N.Y.S.2d 232, 448 N.E.2d 86). Whether this rule may be properly and fairly applied in this case is the central issue on which we disagree.

II

New York, like many other States, unquestionably recognizes that the status of a minority shareholder in a close corporation requires special protection from the courts. . . .

Thus, for purposes of asserting rights as a minority shareholder under Business Corporation Law § 1104-a, we have held that a shareholder “who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment” (*Matter of Kemp & Beatley* [*Gardstein*], 64 N.Y.2d supra, at 72–73, 484 N.Y.S.2d 799, 473 N.E.2d 1173).

A person who, like plaintiff, buys a minority interest in a close corporation does so not only in the hope of enjoying an increase in value of his stake in the business but for the assurance of employment in the business in a managerial position. . . .

Thus, the relationship of a minority shareholder to a close corporation, if fairly viewed, cannot possibly be equated with an ordinary hiring and, in the absence of a contract, regarded as nothing more than an employment at will. But this is exactly how the majority of the court has treated plaintiff's association with Glamore Motor Sales. And it has done so by not addressing the multiple relationships and the expectancies and vulnerabilities peculiar to the status of a minority shareholder in plaintiff's position—those very considerations which call for the relief that only a court of equity can give. . . .

ANALYSIS

1. Is it possible to reconcile the result in *Ingle* with the result in *Wilkes*?
2. What should Ingle have done to protect the rights he claimed he had? What should Glamore have done to make clear that Ingle had no such rights?
3. On what basis did the dissent conclude that the result was unfair to Ingle? What do you imagine is the story behind the termination of Ingle?
4. If Ingle had convinced the court of the correctness of his claim of unfair treatment, what would the appropriate remedy have been? Would Ingle have a job for life? What if the Glamores wanted to sell their interest in the corporation?

Brodie v. Jordan

447 Mass. 866, 857 N.E.2d 1076 (2006).

...

1. *Background.* Malden is a Massachusetts corporation that operates a small machine shop and produces metal objects such as ball bearings. The plaintiff's now deceased husband, Walter S. Brodie (Walter), was one of the founding members of the company and served as its president from 1979 to 1992. Barbuto has been a shareholder, a director, and the treasurer of the company since its formation. Jordan has been an employee of the company since 1975 and a shareholder, director, and officer since 1984; he is the one responsible for the day-to-day operation of the business. Beginning in 1984, Walter, Barbuto, and Jordan each held one-third of the shares of the corporation and all three served as directors. By 1988, however, Walter was no longer involved in the company's day-to-day operation and only met with Barbuto and Jordan two to three times each year. After Walter and the defendants began to disagree over various management issues, Walter made a number of requests that the company purchase his shares, but those requests were rejected. Neither the articles of organization nor any

corporate bylaw obligated Malden or the defendants to purchase the stock of a shareholder.

The corporation has not paid any dividends to shareholders since 1989. As an employee, Jordan receives a salary at a rate set by the board of directors (Barbuto and himself). Jordan participates in a profit-sharing plan made available by the corporation and has the use of a company vehicle. Barbuto received director's fees from the corporation until 1998. He owns the building that houses Malden's corporate offices and receives rent from the corporation. Barbuto also owns a separate corporation, Barco Engineering, Inc., which is a customer of Malden and for which Malden regularly performs services on an open credit account. Walter received compensation from the company prior to 1992, and was paid a consultant's fee in 1994 and 1995. However, neither Walter nor the plaintiff [Mary Brodie, Walter's wife] appears to have received any compensation or other money from the corporation since 1995.

In 1992, Walter was voted out as president and director of Malden, and Jordan was elected president. Walter died in 1997. The plaintiff was appointed Walter's executrix and inherited his one-third interest in Malden. She attended a Malden shareholders' meeting in July, 1997, at which she nominated herself, through counsel, as a director, but Barbuto and Jordan voted against her election. At this same meeting, the plaintiff asked Jordan and Barbuto to perform a valuation of the company so that she could ascertain the value of her shares, but such a valuation was never performed.

In 1998, the plaintiff filed the instant suit. Prior to and since that time, the defendants failed to provide her with various financial and operational company information that she requested. At the time of trial, the defendants had failed to hold an annual shareholder's meeting for the previous five years, and the plaintiff had not participated in any company decision-making.

2. *Discussion.* The parties do not dispute that Malden is a close corporation . . . "[S]tockholders in [a] close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another" (footnotes omitted), [Donahue v. Rodd Electrotpe Co. of New England, Inc., 328 N.E.2d 505 (1975)] . . . , that is, a duty of "utmost good faith and loyalty," *id.*, quoting *Cardullo v. Landau*, 329 Mass. 5, 8, 105 N.E.2d 843 (1952).

Majority shareholders in a close corporation violate this duty when they act to "freeze out" the minority. We have defined freeze-outs by way of example:

The squeezers [those who employ the freeze-out techniques] may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for

property leased from majority shareholders . . . ; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders. . . .

Donahue v. Rodd Electrottype Co. of New England, Inc., supra at 588–589, 328 N.E.2d 505, quoting *F.H. O’Neal & J. Derwin, Expulsion or Oppression of Business Associates* 42 (1961). What these examples have in common is that, in each, the majority frustrates the minority’s reasonable expectations of benefit from their ownership of shares.

We have previously analyzed freeze-outs in terms of shareholders’ “reasonable expectations” both explicitly and implicitly. . . . A number of other jurisdictions, either by judicial decision or by statute, also look to shareholders’ “reasonable expectations” in determining whether to grant relief to an aggrieved minority shareholder in a close corporation.

In the present case, the Superior Court judge properly analyzed the defendants’ liability in terms of the plaintiff’s reasonable expectations of benefit. The judge found that the defendants had interfered with the plaintiff’s reasonable expectations by excluding her from corporate decision-making, denying her access to company information, and hindering her ability to sell her shares in the open market. In addition, the judge’s findings reflect a state of affairs in which the defendants were the only ones receiving any financial benefit from the corporation. The Appeals Court determined that the findings were warranted, and the defendants have not sought further appellate review with respect to liability. Thus, the only question before us is whether, on this record, the plaintiff was entitled to the remedy of a forced buyout of her shares by the majority. We conclude that she was not so entitled.

a. *Remedies for freeze-out of minority shareholder.* The proper remedy for a freeze-out is “to restore [the minority shareholder] as nearly as possible to the position [s]he would have been in had there been no wrongdoing.” *Zimmerman v. Bogoff*, 402 Mass. 650, 661, 524 N.E.2d 849 (1988). Because the wrongdoing in a freeze-out is the denial by the majority of the minority’s reasonable expectations of benefit, it follows that the remedy should, to the extent possible, restore to the minority shareholder those benefits which she reasonably expected, but has not received because of the fiduciary breach.

If, for example, a minority shareholder had a reasonable expectation of employment by the corporation and was terminated wrongfully, the remedy may be reinstatement, back pay, or both. See *Wilkes v. Springside Nursing Home, Inc.*, . . . 353 N.E.2d 657. . . . Similarly, if a minority shareholder has a reasonable expectation of sharing in company profits and has been denied this opportunity, she may be “entitled to participate in the favorable results of operations to the extent that those results have been wrongly appropriated by the majority.” *Crowley v.*

Communications for Hosps., Inc., 30 Mass. App. Ct. 751, 768, 573 N.E.2d 996 (1991). . . .

b. *The Superior Court judge's remedy.* Courts have broad equitable powers to fashion remedies for breaches of fiduciary duty in a close corporation, . . . and their choice of a particular remedy is reviewed for abuse of discretion. . . . Here, the Superior Court judge ordered the defendants to buy out the plaintiff at the price of an expert's estimate of her share of the corporation, a remedy that no Massachusetts appellate court has previously authorized. The problem with this remedy is that it placed the plaintiff in a significantly better position than she would have enjoyed absent the wrongdoing, and well exceeded her reasonable expectations of benefit from her shares.

. . . In this case, it is undisputed that neither the articles of organization nor any corporate bylaw obligates Malden or the defendants to purchase the plaintiff's shares. Thus, there is nothing in the background law, the governing rules of this particular close corporation, or any other circumstance that could have given the plaintiff a reasonable expectation of having her shares bought out.

In ordering the defendants to purchase the plaintiff's stock at the price of her share of the company, the judge created an artificial market for the plaintiff's minority share of a close corporation—an asset that, by definition, has little or no market value. . . . Thus, the remedy had the perverse effect of placing the plaintiff in a position superior to that which she would have enjoyed had there been no wrongdoing. . . .

c. *Considerations on remand.* As we have indicated, the remedy for the defendants' breach of fiduciary duty is one that protects the plaintiff's reasonable expectations of benefit from the corporation and that compensates her for their denial in the past. An evidentiary hearing is appropriate to determine her reasonable expectations of ownership; whether such expectations have been frustrated; and, if so, the means by which to vindicate the plaintiff's interests. For breaches visited upon the plaintiff resulting in deprivations that can be quantified, money damages will be the appropriate remedy. Prospective injunctive relief may be granted to ensure that the plaintiff is allowed to participate in company governance, and to enjoy financial or other benefits from the business, to the extent that her ownership interest justifies.

In devising a remedy that grants the plaintiff her reasonable expectations of benefit from stock ownership in Malden, the judge may consider the fact that the plaintiff has received no economic benefit from her shares. If the defendants have denied the plaintiff any return on her investment while "drain[ing] off the corporation's earnings" for themselves, *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, . . . 328 N.E.2d 505, the judge may consider, among other possibilities the propriety, of compelling the declaration of dividends.

So ordered.

ANALYSIS

1. What might the defendants have done, beginning around 1990, to deprive Ms. Brodie of basis for a suit against them or the corporation—without giving up much of substance? In other words, what was the minimum “fiduciary obligation” of the defendants toward Ms. Brodie?
2. On remand, whose “reasonable expectations” are to be determined? What evidence might each of the parties offer as to their expectations?
3. Does the *Brodie* reasonable expectations standard replace the *Wilkes* three-step test? If not, what does the relationship between the two appear to be?
4. Who won, Ms. Brodie or the defendants? What is the likely effect of the decision on settlement negotiations?

Smith v. Atlantic Properties, Inc.

12 Mass.App.Ct. 201, 422 N.E.2d 798 (1981).

In December, 1951, Dr. Louis E. Wolfson agreed to purchase land in Norwood for \$350,000, with an initial cash payment of \$50,000 and a mortgage note of \$300,000 payable in thirty-three months. Dr. Wolfson offered a quarter interest each in the land to Mr. Paul T. Smith, Mr. Abraham Zimble, and William H. Burke. Each paid to Dr. Wolfson \$12,500, one quarter of the initial payment. Mr. Smith, an attorney, organized the defendant corporation (Atlantic) in 1951 to operate the real estate. Each of the four subscribers received twenty-five shares of stock. Mr. Smith included, both in the corporation's articles of organization and in its by-laws, a provision reading, “No election, appointment or resolution by the Stockholders and no election, appointment, resolution, purchase, sale, lease, contract, contribution, compensation, proceeding or act by the Board of Directors or by any officer or officers shall be valid or binding upon the corporation until effected, passed, approved or ratified by an affirmative vote of eighty (80%) per cent of the capital stock issued outstanding and entitled to vote.” This provision (hereafter referred to as the 80% provision) was included at Dr. Wolfson's request and had the effect of giving to any one of the four original shareholders a veto in corporate decisions.

Atlantic purchased the Norwood land. Some of the land and other assets were sold for about \$220,000. Atlantic retained twenty-eight acres on which stood about twenty old brick or wood mill-type structures, which required expensive and constant repairs. After the first year, Atlantic became profitable and showed a profit every year prior to 1969, ranging from a low of \$7,683 in 1953 to a high of \$44,358 in 1954. The mortgage was paid by 1958 and Atlantic has incurred no long-term debt thereafter. Salaries of about \$25,000 were paid only in 1959 and 1960. Dividends in the total amount of \$10,000 each were paid in 1964 and

1970. By 1961, Atlantic had about \$172,000 in retained earnings, more than half in cash.

For various reasons, which need not be stated in detail, disagreements and ill will soon arose between Dr. Wolfson, on the one hand, and the other stockholders as a group.³ Dr. Wolfson wished to see Atlantic's earnings devoted to repairs and possibly some improvements in its existing buildings and adjacent facilities. The other stockholders desired the declaration of dividends. Dr. Wolfson fairly steadily refused to vote for any dividends. Although it was pointed out to him that failure to declare dividends might result in the imposition by the Internal Revenue Service of a penalty under the Internal Revenue Code, I.R.C. § 531 et seq. (relating to unreasonable accumulation of corporate earnings and profits), Dr. Wolfson persisted in his refusal to declare dividends. The other shareholders did agree over the years to making at least the most urgent repairs to Atlantic's buildings, but did not agree to make all repairs and improvements which were recommended in a 1962 report by an engineering firm retained by Atlantic to make a complete estimate of all repairs and improvements which might be beneficial.

The fears of an Internal Revenue Service assessment of a penalty tax were soon realized. Penalty assessments were made in 1962, 1963, and 1964. These were settled by Dr. Wolfson for \$11,767.71 in taxes and interest. Despite this settlement, Dr. Wolfson continued his opposition to declaring dividends. The record does not indicate that he developed any specific and definitive schedule or plan for a series of necessary or desirable repairs and improvements to Atlantic's properties. At least none was proposed which would have had a reasonable chance of satisfying the Internal Revenue Service that expenditures for such repairs and improvements constituted "reasonable needs of the business," I.R.C. § 534(c), a term which includes (see I.R.C. § 537) "the reasonably anticipated needs of the business." Predictably, despite further warnings by Dr. Wolfson's shareholder colleagues, the Internal Revenue Service assessed further penalty taxes for the years 1965, 1966, 1967, and 1968. These taxes were upheld by the United States Tax Court in *Atlantic Properties, Inc. v. Commissioner of Int. Rev.*, 62 T.C. 644 (1974), and on appeal in 519 F.2d 1233 (1st Cir.1975). . . .

An examination of these decisions makes it apparent that Atlantic has incurred substantial penalty taxes and legal expense largely because of Dr. Wolfson's refusal to vote for the declaration of sufficient dividends to avoid the penalty, a refusal which was (in the Tax Court and upon appeal) attributed in some measure to a tax avoidance purpose on Dr. Wolfson's part.

On January 30, 1967, the shareholders, other than Dr. Wolfson, initiated this proceeding in the Superior Court, later supplemented to

³ At least one cause of ill will on Dr. Wolfson's part may have been the refusal of the other shareholders to consent to his transferring his shares in Atlantic to the Louis E. Wolfson Foundation, a charitable foundation created by Dr. Wolfson.

reflect developments after the original complaint. The plaintiffs sought a court determination of the dividends to be paid by Atlantic, the removal of Dr. Wolfson as a director, and an order that Atlantic be reimbursed by him for the penalty taxes assessed against it and related expenses. . . .

The trial judge made findings (but in more detail) of essentially the facts outlined above and concluded that Dr. "Wolfson's obstinate refusal to vote in favor of . . . dividends was . . . caused more by his dislike for other stockholders and his desire to avoid additional tax payments than . . . by any genuine desire to undertake a program for improving . . . [Atlantic] property." She also determined that Dr. Wolfson was liable to Atlantic for taxes and interest amounting to "\$11,767.11 plus interest from the commencement of this action, plus \$35,646.14 plus interest from August 11, 1975," the date of the First Circuit decision affirming the second penalty tax assessment. The latter amount includes an attorney's fee of \$7,500 in the Federal tax cases. She also ordered the directors of Atlantic to declare "a reasonable dividend at the earliest practical date and reasonable dividends annually thereafter consistent with good business practice." In addition, the trial judge directed that jurisdiction of the case be retained in the Superior Court "for a period of five years to [e]nsure compliance." Judgment was entered pursuant to the trial judge's order. . . .

After the entry of judgment, Dr. Wolfson and Atlantic filed a motion for a new trial and to amend the judge's findings. This motion, after hearing, was denied, and Dr. Wolfson and Atlantic claimed an appeal from the judgment and the former from the denial of the motion. The plaintiffs . . . requested payment of their attorneys' fees in this proceeding and filed supporting affidavits. The motion was denied, and the plaintiffs appealed.

1. The trial judge, in deciding that Dr. Wolfson had committed a breach of his fiduciary duty to other stockholders, relied greatly on broad language in *Donahue v. Rodd Electrotape Co.*, 367 Mass. 578, 586-597 (1975), in which the Supreme Judicial Court afforded to a minority stockholder in a close corporation equality of treatment (with members of a controlling group of shareholders) in the matter of the redemption of shares. The court (at 592-593) relied on the resemblance of a close corporation to a partnership and held that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another" (footnotes omitted). That standard of duty, the court said, was the "utmost good faith and loyalty." The court went on to say that such stockholders "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." Similar principles were stated in *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 848-852 (1976), but with some modifications . . . of the sweeping language of the *Donahue* case. . . .

In the *Donahue* case, 367 Mass. at 593 n. 17, the court recognized that cases may arise in which, in a close corporation, majority stockholders may ask protection from a minority stockholder. Such an instance arises in the present case because Dr. Wolfson has been able to exercise a veto concerning corporate action on dividends by the 80% provision (in Atlantic's articles of organization and by-laws) already quoted. The 80% provision may have substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest.⁶

... In the present case, Dr. Wolfson testified that he requested the inclusion of the 80% provision "in case the people [the other shareholders] whom I knew, but not very well, ganged up on me." The possibilities of shareholder disagreement on policy made the provision seem a sensible precaution.⁸ A question is presented, however, concerning the extent to which such a veto power possessed by a minority stockholder may be exercised as its holder may wish, without a violation of the "fiduciary duty" referred to in the *Donahue* case, 367 Mass. at 593, 328 N.E.2d 505, as modified in the *Wilkes* case. ...

2. With respect to the past damage to Atlantic caused by Dr. Wolfson's refusal to vote in favor of any dividends, the trial judge was justified in finding that his conduct went beyond what was reasonable. The other stockholders shared to some extent responsibility for what occurred by failing to accept Dr. Wolfson's proposals with much sympathy, but the inaction on dividends seems the principal cause of the tax penalties. Dr. Wolfson had been warned of the dangers of an assessment under the Internal Revenue Code, I.R.C. § 531 et seq. He had refused to vote dividends in any amount adequate to minimize that danger and had failed to bring forward, within the relevant taxable years, a convincing, definitive program of appropriate improvements which could withstand scrutiny by the Internal Revenue Service. Whatever may have been the reason for Dr. Wolfson's refusal to declare dividends (and even if in any particular year he may have gained slight, if any, tax advantage from withholding dividends) we think that he recklessly ran serious and unjustified risks of precisely the penalty taxes eventually assessed, risks which were inconsistent with any reasonable interpretation of a duty of "utmost good faith and loyalty." The trial judge

⁶ The majority shareholders, in the event of a deadlock, at least may seek dissolution of the corporation if forty percent of the voting power can be mustered, whereas a single stockholder with only twenty-five percent of the stock may not do so. See G.L. c. 156B, § 99(b), as amended by St.1969, c. 392, § 23.

⁸ ... It was reasonably foreseeable that there might be differences of opinion between Dr. Wolfson, a man with substantial income likely to be in a high income tax bracket, and less affluent shareholders on such matters of policy as dividend declarations, salaries, and investment in improvements in the property. The other shareholders, two of whom were attorneys, should have known that it was as open to Dr. Wolfson reasonably to exercise the veto provided to him by the 80% provision in favor of a policy of reinvestment of earnings in Atlantic's properties, which would probably avoid taxes and increase the value of the corporate assets, as it was for them (possessed of the same veto) to use reasonably their voting power in favor of a more generous dividend and salary policy.

(despite the fact that the other shareholders helped to create the voting deadlock and despite the novelty of the situation) was justified in charging Dr. Wolfson with the out-of-pocket expenditure incurred by Atlantic for the penalty taxes and related counsel fees of the tax cases.¹⁰

ANALYSIS

1. What is the logic of the case? Why is the problem Wolfson's fault?

2. If you had been Wolfson's lawyer and he had told you he was adamant in his intention to use earnings for rehabilitation, what would you have advised him to do? What does your answer tell you about the legal doctrine of the decision and about the effect of that doctrine on behavior and on economic entitlements?

PLANNING

How could the problems encountered by the investors in this case have been avoided by adoption of appropriate provisions at the time of formation of the enterprise?

NOTE AND QUESTIONS

In *Nixon v. Blackwell*, 626 A.2d 1366, 1379–81 (Del.1993) (en banc), the Delaware Supreme Court offered the following comments (which were not necessary to analysis of the legal issues raised by the case):

The case at bar points up the basic dilemma of minority stockholders in receiving fair value for their stock as to which there is no market and no market valuation. It is not difficult to be sympathetic, in the abstract, to a stockholder who finds himself or herself in that position. A stockholder who bargains for stock in a closely held corporation . . . can make a business judgment whether to buy into such a minority position, and if so on what terms. One could bargain for definitive provisions of self-ordering permitted to a Delaware corporation through the certificate of incorporation or by-laws by reason of the provisions in 8 Del.C. §§ 102, 109, and 141(a). Moreover, in addition to such mechanisms, a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive stockholder agreements, and such agreements may provide for elaborate earnings tests, buy-out provisions, voting trusts, or other voting agreements. . . .

The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for

¹⁰ We do not now suggest that the standard of "utmost good faith and loyalty" may require some relaxation when applied to a minority ad hoc controlling interest, created by some device, similar to the 80% provision, designed in part to protect the selfish interests of a minority shareholder. This seems to us a difficult area of the law best developed on a case by case basis.

protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted. . . .

It would . . . be inappropriate judicial legislation for this Court to fashion a special judicially created rule for minority investors when . . . there are no negotiated special provisions in the certificate of incorporation, by-laws, or stockholder agreements.

1. How would *Wilkes* have been decided under Delaware law?
2. Which approach do you prefer—Delaware's (you made your bed and you must lie in it) or Massachusetts's (the Golden Rule)? Why? What are the likely consequences of each approach?

Jordan v. Duff and Phelps, Inc.

815 F.2d 429 (7th Cir.1987), cert. dismissed, 485 U.S. 901 (1988).

- BEFORE CUDAHY, POSNER, and EASTERBROOK, CIRCUIT JUDGES.
- EASTERBROOK, CIRCUIT JUDGE.

. . .

I

The case is here following a grant of summary judgment for the defendants [in an action founded on § 10(b) and Rule 10b-5, common law fraud, and breach of fiduciary duty].

Duff and Phelps, Inc., evaluates the risk and worth of firms and their securities. It sells credit ratings, investment research, and financial consulting services to both the firms under scrutiny and potential investors in them. Jordan started work at Duff & Phelps in May 1977 and was viewed as a successful securities analyst. In 1981 the firm offered Jordan the opportunity to buy some stock. By November 1983 Jordan had purchased 188 of the 20,100 shares outstanding. He was making installment payments on another 62 shares. Forty people other than Jordan held stock in Duff & Phelps.

Jordan purchased his stock at its "book value" (the accounting net worth of Duff & Phelps, divided by the number of shares outstanding). Before selling him any stock, Duff & Phelps required Jordan to sign a "Stock Restriction and Purchase Agreement" (the Agreement). This provided in part:

Upon the termination of any employment with the Corporation . . . for any reason, including resignation, discharge, death, disability or retirement, the individual whose employment is terminated or his estate shall sell to the Corporation, and the Corporation shall buy, all Shares of the Corporation then owned

by such individual or his estate. The price to be paid for such Shares shall be equal to the adjusted book value (as hereinafter defined) of the Shares on the December 31 which coincides with, or immediately precedes, the date of termination of such individual's employment.

Duff & Phelps enforced this restriction with but a single exception. During 1983 the board of directors of Duff & Phelps adopted a resolution—of which Jordan did not learn until 1984—allowing employees fired by the firm to keep their stock for five years. The resolution followed the discharge of Carol Franchik, with whom Claire Hansen, the (married) chairman of the board, had been having an affair. When Franchik threatened suit, the board allowed her to keep her stock.

While Jordan was accumulating stock, Hansen, the chairman of the board, was exploring the possibility of selling the firm. Between May and August 1983 Hansen and Francis Jeffries, another officer of Duff & Phelps, negotiated with Security Pacific Corp., a bank holding company. The negotiators reached agreement on a merger, in which Duff & Phelps would be valued at \$50 million, but a higher official within Security Pacific vetoed the deal on August 11, 1983. As of that date, Duff & Phelps had no irons in the fire.

Jordan, however, was conducting a search of his own—for a new job. Jordan's family lived near Chicago, the headquarters of Duff & Phelps, and Jordan's wife did not get along with Jordan's mother. The strain between the two occasionally left his wife in tears. He asked Duff & Phelps about the possibility of a transfer to the firm's only branch office, in Cleveland, but the firm did not need Jordan's services there. Concluding that it was time to choose between his job and his wife, Jordan chose his wife and started looking for employment far away from Chicago. His search took him to Houston, where Underwood Neuhaus & Co., a broker-dealer in securities, offered him a job at a salary (\$110,000 per year) substantially greater than his compensation (\$67,000) at Duff & Phelps. Jordan took the offer on the spot during an interview in Houston, but Underwood would have allowed Jordan to withdraw this oral acceptance.

On November 16, 1983, Jordan told Hansen that he was going to resign and accept employment with Underwood. Jordan did not ask Hansen about potential mergers; Hansen did not volunteer anything. Jordan delivered a letter of resignation, which Duff & Phelps accepted the same day. By mutual agreement, Jordan worked the rest of the year for Duff & Phelps even though his loyalties had shifted. He did this so that he could receive the book value of the stock as of December 31, 1983—for under the Agreement a departure in November would have meant valuation as of December 31, 1982. Jordan delivered his certificates on December 30, 1983, and the firm mailed him a check for \$23,225, the book value (at \$123.54 per share) of the 188 shares of stock.

Jordan surrendered, as worthless under the circumstances, the right to buy the remaining 62 shares.

Before Jordan cashed the check, however, he was startled by the announcement on January 10, 1984, of a merger between Duff & Phelps and a subsidiary of Security Pacific. Under the terms of the merger Duff & Phelps would be valued at \$50 million. If Jordan had been an employee on January 10, had quickly paid for the other 62 shares, and the merger had closed that day, he would have received \$452,000 in cash and the opportunity to obtain as much as \$194,000 more in "earn out" (a percentage of Duff & Phelps's profits to be paid to the former investors—an arrangement that keeps the employees' interest in the firm keen and reduces the buyer's risk if profits fall short). Jordan refused to cash the check and demanded his stock back; Duff & Phelps told him to get lost. He filed this suit in March 1984, asking for damages measured by the value his stock would have had under the terms of the acquisition.

The public announcement on January 10 explained that the boards of the two firms had reached an agreement in principle on January 6. The definitive agreement was signed on March 23. Because Security Pacific is a bank holding company, the acquisition required the approval of the Board of Governors of the Federal Reserve. The Fed granted approval, but with a condition so onerous that the firms abandoned the transaction. The Fed objected to Security Pacific's acquisition of Duff & Phelps's credit rating business. 71 Fed. Res. Bull. 118 (1985). The agreement was formally cancelled on January 9, 1985. Duff & Phelps quickly asked the district court to dismiss Jordan's suit, on the ground that he could not establish damages. Jordan responded by amending his complaint, with Judge Hart's permission, to ask for rescission rather than damages.

Throughout 1985 Duff & Phelps continued looking for a partner; finding none, it decided to dance with itself. The firm's management formed an "Employee Stock Ownership Trust", which was able to borrow \$40 million against the security of the firm's assets and business. The Trust acquired Duff & Phelps through a new firm, Duff Research, Inc. This transaction occurred in December 1985. The employees at the time, together with Carol Franchik, received cash, notes, and beneficial interests in the Trust. Jordan asserts that the package was worth almost \$2000 per share, or \$497,000 if he had held 250 shares in December 1985.

...

II

Michaels [v. *Michaels*, 767 F.2d 1185, 1194-97 (7th Cir.1985)] holds that close corporations that purchase their own stock must disclose to the sellers all information that meets the standard of "materiality" set out in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 48 L.Ed. 2d 757, 96 S.Ct. 2126 (1976). . . . A jury would be free under *Michaels* to conclude that the board's decision of November 14 to seek a buyer for

Duff & Phelps—coupled with the fact that at least one putative buyer thought Duff & Phelps worth \$50 million, which casts an important light on the prospect of a profitable conclusion to the search—was “material” under the standard of TSC Industries. That is, there is a “substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder” and “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” 426 U.S. at 449 (footnote omitted.)

...

[T]his supposes that Duff & Phelps had a duty to disclose anything to Jordan. Most people are free to buy and sell stock on the basis of valuable private knowledge without informing their trading partners. Strangers transact in markets all the time using private information that might be called “material” and, unless one has a duty to disclose, both may keep their counsel. *Dirks v. SEC*, 463 U.S. 646, 653–64, 77 L.Ed. 2d 911, 103 S.Ct. 3255 (1983); *Chiarella v. United States*, 445 U.S. 222, 227–35, 63 L.Ed. 2d 348, 100 S.Ct. 1108 (1980); . . . The ability to make profits from the possession of information is the principal spur to create the information, which the parties and the market as a whole may find valuable. The absence of a duty to disclose may not justify a lie about a material fact, but Duff & Phelps did not lie to Jordan. It simply remained silent when Jordan quit and tendered the stock, and it offered the payment required by the Agreement.

This argument is unavailing on the facts as we know them. The “duty” in question is the fiduciary duty of corporate law. Close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts. . . . The “special facts” doctrine developed by several courts at the turn of the century is based on the principle that insiders in closely held firms may not buy stock from outsiders in person-to-person transactions without informing them of new events that substantially affect the value of the stock. . . .

Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements. It is a violation of duty to steal from the corporate treasury; it is not a violation to write oneself a check that the board has approved as a bonus. . . . The obligation to break silence is itself based on state law, . . . and so may be redefined to the extent state law permits. . . . But we need not decide how far contracts can redefine obligations to disclose. Jordan was an employee at will; he signed no contract.

The stock was designed to bind Duff & Phelps’s employees loyally to the firm. The buy-sell agreement tied ownership to employment. Understandably Duff & Phelps did not want a viper in its nest, a disgruntled employee remaining only in the hope of appreciation of his

stock. So there could have been reason to divorce the employment decision from the value of the stock. Perhaps it would have been rational for each employee to agree with Duff & Phelps to look to salary alone in deciding whether to stay. A contractual agreement that the firm had no duty to disclose would have uncoupled the investment decision from the employment decision, leaving whoever was in the firm on the day of a merger to receive a surprise appreciation. . . .

Yet an explicit agreement to make all employment decisions in ignorance of the value of the stock might not have been in the interests of the firm or its employees. Duff & Phelps was trying to purchase loyalty by offering stock to its principal employees. The package of compensation contained salary and the prospect of appreciation of the stock. Perhaps it paid a lower salary than, say, Underwood Neuhaus & Co., because its package contained a higher component of gain from anticipated appreciation in the stock. It is therefore unwarranted to say that the implicit understanding between Jordan and Duff & Phelps should be treated as if it had such a no-duty clause; we are not confident that this is the clause firms and their employees regularly would prefer. . . .

The course of dealing between Jordan and Duff & Phelps suggests that the firm did not demand that employees decide whether to stay or go without regard to the value of the stock. It apparently informed Jordan what the book value was expected to be on December 31, 1983, so that Jordan could decide whether to leave in November (receiving the value as of December 31, 1982) or stay for another six weeks. The firm did not demand that Jordan depart as soon as it learned he had switched loyalties; it allowed employees to time their departures to obtain the maximum advantage from their stock. The Agreement did not ensure that employees disregard the value of the stock when deciding what to do, and neither did the usual practice at Duff & Phelps. So the possibility that a firm could negotiate around the fiduciary duty does not assist Duff & Phelps; it did not obtain such an agreement, express or implied.

The closest Duff & Phelps came is the provision in the Agreement fixing the price of the stock at book value. Yet although the Agreement fixed the price to be paid those who quit, it did not establish the terms on which anyone would leave. Thus cases such as *Toledo Trust* [Co. v. Nye, 588 F.2d 202, 206 (6th Cir.1978)] and *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir.1977), do not assist Duff & Phelps. These cases dealt with agreements calling for valuation at a formula price on a fixed date. In *St. Louis Union Trust* the date was the death of the employee, the formula was book value. The court of appeals held that there was no need to pay the employee's estate a different price, just because a few weeks later Merrill Lynch went public at a higher price. The employee presumably did not take the possibility of a merger into account in deciding whether to die, and the formula price made "disclosure" irrelevant. *Toledo Trust*, too, discussed a buy back triggered by death. . . . Jordan, though, exercised choice about

the date on which the formula would be triggered. He could have remained at Duff & Phelps; his decision to depart was affected by his wife's distress, his salary, his working conditions, the enjoyment he received from the job, and the value of his stock. The departure of such an employee is an investment decision as much as it is an employment decision. It is not fanciful to suppose that Mrs. Jordan would have found her mother in law a whole lot more tolerable if she had known that Jordan's stock might shortly be worth 20 times book value.

...

Our dissenting colleague concludes that all of this is beside the point because Hansen could have said, on receiving Jordan's letter on November 16: "In a few weeks we will pull off a merger that would have made your stock 20 times more valuable. It's a shame you so foolishly resigned. But even if you hadn't resigned, we would have fired you, the better to engross the profits of the merger for ourselves. So long, sucker." This would have been permissible, under our colleague's interpretation, because Jordan was an employee at will and therefore could have been fired at any time, even the day before the merger, for any reason—including the desire to deprive Jordan of a share of the profits. The ability to fire Jordan enabled the firm to "call" his shares, at book value, on whim. On this view, it is foolish to say that Duff & Phelps had a duty to disclose, because disclosure would have been no use to Jordan. (Perhaps this is really an argument about "causation" rather than "duty," but the terminology is unimportant.) But Duff & Phelps itself does not press this argument, and in civil litigation an appellate court ought not put words in a party's mouth and use them as the grounds on which to decide. . . . Perhaps Duff & Phelps does not want to establish a reputation for shoddy dealing; as our dissenting brother observes, a firm's desire to preserve its reputation is a powerful inducement to treat its contractual partners well. To attribute to a litigant an argument that it will take every possible advantage is to assume that the party wishes to dissipate its reputation, and the assumption is unwarranted.

More than that, a person's status as an employee "at will" does not imply that the employer may discharge him for every reason. Illinois, where Jordan was employed, has placed some limits on the discharge of at-will employees. . . . But employment at will is still a contractual relation, one in which a particular duration ("at will") is implied in the absence of a contrary expression. . . . One term implied in every unwritten contract and therefore, we suppose, every written one, is that neither party will try to take opportunistic advantage of the other. "[T]he fundamental function of contract law (and recognized as such at least since Hobbes's day) is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and to make costly self-protective measures unnecessary." Richard A. Posner, *Economic Analysis of Law* 81 (3d ed. 1986). . . .

Employment creates occasions for opportunism. . . . The difficulties of separating opportunistic conduct from honest differences of opinion about an employee's performance on the job may lead firms and their employees to transact on terms that keep such disputes out of court—which employment at will usually does. But no one . . . doubts that an avowedly opportunistic discharge is a breach of contract, although the employment is at-will. . . .

. . . We do not suppose for a second that if Jordan had not resigned on November 16, the firm could have fired him on January 9 with a little note saying: "Dear Mr. Jordan: There will be a lucrative merger tomorrow. You have been a wonderful employee, but in order to keep the proceeds of the merger for ourselves, we are letting you go, effective this instant. Here is the \$23,000 for your shares." Had the firm fired Jordan for this stated reason, it would have broken an implied pledge to avoid opportunistic conduct. . . .

The timing of the sale and the materiality of the information Duff & Phelps withheld on November 16 are for the jury to determine. Our dissenting colleague stresses that businesses would be shocked to learn that they must disclose valuable corporate information to fickle employees. If disclosure is unthinkable, however, Jordan may have trouble establishing that Duff & Phelps acted with intent to defraud, a necessary element of a case under Rule 10b-5. . . .

III

. . . Jordan is entitled only to damages, as his initial complaint requested. . . . But what might the damages be? Judge Leinenweber held that there are none, as a matter of law, because the merger with Security Pacific fell through. Doubtless the news of the deal with Security Pacific was the reason Jordan filed this suit. Yet the rationale of finding a securities violation—if there was one, a qualification we will not repeat—is that Jordan sold his stock in ignorance of facts that would have established a higher value. The relevance of the fact does not depend on how things turn out. Just as a lie that overstates a firm's prospects is a violation even if, against all odds, every fantasy comes true, . . . so a failure to disclose an important beneficent event is a violation even if things later go sour. The news, here that some firm was willing to pay \$50 million for Duff & Phelps in an arms' length transaction, allows investors to assess the worth of the stock. If one deal for \$50 million falls through, another may be possible at a similar price. Investors will either hold the stock or demand a price that reflects the value of that information. The conclusion that because the first deal collapsed there are no damages must reflect a belief that if the firm was not worth \$50 million, then it was worth only \$2.5 million (its book value). That is implausible. Security Pacific was willing to pay \$50 million because, it concluded, Duff & Phelps was worth that much. If it was worth that much to Security Pacific, it was worth that much to someone else. Some value may be produced by interactions unique to Security Pacific, but there is

no reason to think that Security Pacific would pay the investors of Duff & Phelps for the elements of value Security Pacific brought to the deal. The price of an asset usually is what the second-highest bidder will pay. So if Security Pacific bid \$50 million, it believed that someone else would pay that much too (or that Duff & Phelps would hold out as part of a risky gaming strategy); otherwise Security Pacific would have bid less. The end of Security Pacific's bid—for reasons unrelated to a reassessment of the value of Duff & Phelps—therefore does not show that Jordan was uninjured. And less than a year later Duff & Phelps sold the firm to a trust (which is to say, to the syndicate of banks that loaned the money to the trust) for about \$40 million.

The sticky problem is not whether Jordan can show some damages in principle but whether he can establish causation. . . . Because of the Agreement, employment and ownership of the shares were tied. Jordan could sell his stock in two ways: by leaving the firm and receiving book value, or by holding the stock until a merger or LBO [that is, leveraged buyout, which is the type of transaction that was ultimately concluded] and receiving the offered price. Even if the stock was worth more than book value, Jordan could not receive that price without holding on. So it seems that to recover, Jordan must establish that on learning of the negotiations with Security Pacific he would have dropped plans to go to Houston, and that even after the disappointment of the Fed's action that scuttled the deal with Security Pacific Jordan would have stuck around until the end of 1985, finally receiving the payment from the LBO. Judge Hart denied defendants' motion for summary judgment, holding that causation is a question for the jury. We think that right. Because a reasonable investor would not conclude that the withdrawal of one bid implies that there will be no others—and because Jordan would have known of the board's decision to sell the firm—a jury would be entitled to conclude that Jordan would have stuck around. Difficulties with a mother-in-law are a strain, but families bear strains greater than that for the prospect of financial gain.

...

REVERSED AND REMANDED

[The short concurring opinion of Judge Cudahy is omitted.]

■ POSNER, CIRCUIT JUDGE, dissenting. A corporate employee at will quit, owning shares that he had agreed to sell back to the corporation at book value. The agreement was explicit that his status as a shareholder conferred no job rights on him. Nevertheless the court holds that the corporation had, as a matter of law, a duty, enforceable by proceedings under Rule 10b-5 of the Securities Exchange Act, to volunteer to the employee information about the corporation's prospects that might have led him to change his mind about quitting, although as an employee at will he had no right to change his mind. I disagree with this holding. The terms of the stockholder agreement show that there was no duty of

disclosure, and since there was no duty there was no violation of Rule 10b-5.

...
We should ask why liability for failing to disclose, as distinct from liability for outright misrepresentation, depends on proof of duty. The reason is that information is a valuable commodity, and its production is discouraged if the producer must share it with the whole world. Hence an investor is not required to blurt out his secrets, and a skilled investor is not required to disclose the results of his research and insights before he is able to profit from them. . . . But one who makes a contract, express or implied, to disclose information to another acts wrongfully if he then withholds the information. The question is whether Duff and Phelps made an undertaking, and therefore assumed a duty, to disclose to any stockholding employee who announced his resignation information regarding the prospects for a profitable sale of the company.

My brethren find such a duty implicit in the fiduciary relationship between a closely held corporation and its shareholders. By this approach, what should be the beginning of analysis becomes its end. . . . [T]he mere existence of a fiduciary relationship between a corporation and its shareholders does not require disclosure of material information to the shareholders. A further inquiry is necessary, and here must focus on the particulars of Jordan's relationship with Duff and Phelps.

. . . The contingent nature of Jordan's status as a shareholder [that is, he could remain a shareholder only if he also remained an employee] has a twofold significance. First, it raises a question about the applicability of the majority's rule requiring disclosure "in the course of negotiating to purchase stock." One may doubt whether there was any real negotiation in this case, for once Jordan resigned he was contractually obligated to sell back his stock at a predetermined price. Second, and more important, the contingent nature of Jordan's status as a shareholder negates the existence of a right to be informed and hence a duty to disclose. This point is central to my dissent and has now to be explained.

Jordan's deal with Duff and Phelps required him to surrender his stock at book value if he left the company. It didn't matter whether he quit or was fired, retired or died; the agreement is explicit on these matters. My brethren hypothesize "implicit parts of the relations between Duff & Phelps and its employees." But those relations are totally defined by (1) the absence of an employment contract, which made Jordan an employee at will; (2) the shareholder agreement, which has no "implicit parts" that bear on Duff and Phelps' duty to Jordan, and explicitly ties his rights as a shareholder to his status as an employee at will; (3) a provision in the stock purchase agreement between Jordan and Duff and Phelps (signed at the same time as the shareholder agreement) that "nothing herein contained shall confer on the Employee any right to be continued in the employment of the Corporation." There is no occasion

to speculate about "the implicit understanding" between Jordan and Duff and Phelps. The parties left nothing to the judicial imagination. The effect of the shareholder and stock purchase agreements (which for simplicity I shall treat as a single "stockholder agreement"), against a background of employment at will, was to strip Jordan of any contractual protection against what happened to him, and indeed against worse that might have happened to him. Duff and Phelps points out that it would not have had to let Jordan withdraw his resignation had he gotten wind of the negotiations with Security Pacific and wanted to withdraw it. On November 14 Hansen could have said to Jordan, "I accept your resignation effective today; we hope to sell Duff and Phelps for \$50 million but have no desire to see you participate in the resulting bonanza. You will receive the paltry book value of your shares as of December 31, 1982." The "nothing herein contained" provision in the stockholder agreement shows that this tactic is permitted. Equally, on November 14, at the board meeting before Hansen knew that Jordan wanted to quit, the board could have decided to fire Jordan in order to increase the value of the deal with Security Pacific to the remaining shareholders.

...

My brethren correctly observe that, "Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements." But, they add, "we need not decide how far contracts can redefine obligations to disclose. Jordan was an employee at will; he signed no contract." It is true that he signed no contract of employment, but he signed a stockholder agreement that defined his rights as a shareholder "with greater specificity." The agreement entitled Duff and Phelps to terminate Jordan as shareholder, subject only to a duty to buy back his shares at book value. The arrangement that resulted (call it "shareholder at will") is incompatible with an inference that Duff and Phelps undertook to keep him abreast of developments affecting the value of the firm.

...

Since receipt of the information would have conferred no right on Jordan to benefit from the information, how can the parties be thought to have intended Duff and Phelps to have an enforceable duty to disclose the information to him? There is no duty to give shareholders information that they have no right to benefit from. . . . By signing the stockholder agreement Jordan gave Duff and Phelps in effect an option . . . to buy back his stock at any time at a fixed price. The grant of the option denied Jordan the right to profit from any information that the company might have about its prospects but prefer not to give him. If Hansen had known of the rule of law that my brethren adopt today, he could have avoided liability simply by telling Jordan that, come what may, December 30 would be Jordan's last day working for Duff and Phelps. Failure to disclose would be immaterial because Jordan could not act on the

disclosure. Only because Hansen failed to make Jordan's resignation effective immediately (a generous gesture, which we have given Hansen cause to regret), as he could have done without violating any contractual obligation, is he held to have violated a duty of disclosure.

...

Was Jordan a fool to have become a shareholder of Duff and Phelps on such disadvantageous terms as I believe he agreed to? (If so, that might be a reason for doubting whether those were the real terms.) He was not. Few business executives in this country have contractual entitlements to earnings, bonuses, or even retention of their jobs. They would rather take their chances on their employer's good will and interest in reputation, and on their own bargaining power and value to the firm, than pay for contract rights that are difficult and costly to enforce. . . . If Jordan had had greater rights as a shareholder he would have had a lower salary; when he went to work for a new employer in Houston and received no stock rights he got a higher salary.

I go further: Jordan was protected by Duff and Phelps' own self-interest from being exploited. The principal asset of a service company such as Duff and Phelps is good will. It is a product largely of its employees' efforts and skills. If Jordan were a particularly valuable employee, so that the firm would be worth less without him, Hansen, desiring as he did to sell the firm for the highest possible price, would have told him about the prospects for selling the company. If Jordan was not a particularly valuable employee—if his departure would not reduce the value of the firm—there was no reason why he should participate in the profits from the sale of the firm, unless perhaps he had once been a particularly valuable employee but had ceased to be so. That possibility might, but did not, lead him to negotiate for an employment contract, or for stock rights that would outlast his employment. By the type of agreement that he made with Duff and Phelps, Jordan gambled that he was and would continue to be such a good employee that he would be encouraged to stay long enough to profit from the firm's growth. The relationship that the parties created aligned their respective self-interests better than the legal protections that the court devises today.

My brethren are well aware that Duff and Phelps faced market constraints against exploiting its employee shareholders, but seem to believe that this implies that the company also assumed contractual duties. Businessmen, however, are less enthusiastic about contractual duties than lawyers are, . . . so it is incorrect to infer from the existence of market constraints against exploitation that the parties also imposed a contractual duty against exploitation. Contractual obligation is a source of uncertainty and cost, and is therefore an expensive way of backstopping market forces. That is why employment at will is such a common form of employment relationship. It is strange to infer that firms invariably assume a legal obligation not to do what is not in their self-interest to do, and stranger to suppose—in the face of an explicit

disclaimer—that by “allowing employees to time their departures to obtain the maximum advantage from their stock,” Duff and Phelps obligated itself to allow them to do this.

Having earlier in its opinion tried to get mileage out of the fact that Jordan “signed no [employment] contract,” the majority later tries to get additional mileage from the observation that employment at will is a “contractual relation.” This is the kind of legal half-truth that should make us thankful that our opinions are not subject to Rule 10b-5. Employment at will is a voluntary relationship, and thus contractual in the sense in which the word contract is used in the expression “freedom of contract.” And the relationship can provide a framework for contracting: if Duff and Phelps had not paid Jordan his agreed-on wage after he had earned it, he could have sued the company for breach of contract. But the only element of employment at will that is relevant to this case is that employment at will is terminable at will, meaning that the employer can fire the employee without worrying about legal sanctions and likewise the employee can quit without worrying about them. Freedom of contract includes freedom not to contract.

...

The inroads that the majority opinion makes on freedom of contract are not justified by its quotation from my academic writings concerning the purpose of contract law (which presupposes an agreement that the parties regard as legally enforceable) or by the possibility that corporations will exploit their junior executives, which may well be the least urgent problem facing our nation. The majority’s statement that “one term implied in every written contract and therefore, we suppose, every unwritten one, is that neither party will try to take opportunistic advantage of the other” confuses the underlying rationale of contract law with the actual requirements of that law, and is anyway irrelevant since the parties decided not to subject the relevant parts of their relationship to the law of contracts and not to give Jordan any contractual protections against being fired. There was no “implied pledge to avoid opportunistic conduct” any more than there were “implicit parts of the relations” giving rise to contractual obligations. . . .

...

ANALYSIS

1. What relationship should be the focus of attention in this case: employer and employee, corporation and shareholder, or majority shareholder and minority shareholder? In other words, is this an employee-compensation case or a shareholder-oppression case? Or is it just an old-fashioned contract case, with the terms incompletely specified?
2. What is the relevance, if any, of fraud or fiduciary obligation? How do these questions bear on the question whether the plaintiff is

entitled to relief under § 10(b) and Rule 10b-5? Is it possible to ignore all the linguistic frameworks, the legal “cubbyholes,” and examine the case in some other, more fundamental way? One possibility is to describe the facts as objectively as possible and then to examine various possible outcomes in light of the goals or criteria of a good system of rules of law for such situations. What are those goals or criteria? What are the implicit criteria applied by Judge Easterbrook? By Judge Posner?

3. Judge Easterbrook asserts, “Duff & Phelps was trying to purchase loyalty by offering stock to its principal employees.” Is that statement accurate? Helpful?

4. Suppose Jordan’s contract with Duff & Phelps made clear that his employment could be terminated at any time, even if termination meant that he would lose out on an expected appreciation in the value of his shares, and that Duff & Phelps had no obligation to provide him with any information regarding the value of his shares. Or suppose that the contract had provided clearly that all that Jordan could ever expect was the book value of his shares; that he would never be entitled to the benefit of a sale of the entire corporation. Would Jordan have been foolish to accept employment on those terms? Would enforcement of such a term in the contract be “opportunistic”? A violation of Rule 10b-5?

5. How would Jordan have fared (without benefit of litigation) if his contract with Duff & Phelps had provided for a buyout at “fair market value” rather than book value? Why did the parties use book value?

5. CONTROL, DURATION, AND STATUTORY DISSOLUTION

In this section, as in the preceding section, we examine situations in which minority shareholders of closely held corporations claim that they have been treated unfairly by the majority. In the cases in this section, however, the minority shareholders have invoked special statutory provisions allowing the courts to order dissolution in certain circumstances and the general equitable powers of the courts. We will now focus our attention on those statutory provisions and equitable powers, on the remedies available under them, and on the strategies both majority and minority shareholders should consider.

Alaska Plastics, Inc. v. Coppock

621 P.2d 270 (Alaska 1980).

The issue in this case involves the rights of a minority shareholder in a close corporation who allegedly has been deprived of benefits accorded other shareholders. The trial judge concluded that the corporation was obligated to buy the minority shareholder’s stock at its fair value. We have concluded that this remedy is not available on the present record as a matter of law. Accordingly, we remand to the superior court to determine whether, based upon adequate findings of fact and

Pedro v. Pedro

489 N.W.2d 798 (Minn.App.1992).

After a request for dissolution of The Pedro Companies by respondent, Alfred Pedro, appellants, Carl and Eugene Pedro and The Pedro Companies, moved that the action proceed as a buyout pursuant to Minn. Stat. § 302A.751 (1990).*

After a jury awarded damages, this court determined the jury's verdict was merely advisory and remanded the case to the trial court to make findings. *Pedro v. Pedro*, 463 N.W.2d 285 (Minn.App.1990) (*Pedro 1*), pet. for rev. denied (Minn. Jan. 24, 1991). On remand, the trial court awarded damages for breach of fiduciary duty and for wrongful termination of lifetime employment. In addition to other issues, appellants challenge the propriety of the trial court's rulings on these matters.

Facts

Alfred, Carl, and Eugene Pedro are brothers who each owned a one-third interest in The Pedro Companies ("TPC"), a closely held Minnesota corporation, which manufactures and sells luggage and leather products. All three brothers worked in the business for all or most of their adult lives. TPC has annual sales of approximately \$6 million. Carl has worked for TPC since 1940 and he is currently employed by the company. Eugene has worked for TPC since 1939 and is also currently employed by the company. Alfred worked for TPC for 45 years and was fired in 1987 at the age of 62. Each brother, as an equal shareholder, received the same benefit and compensation as the others. Each shareholder had an equal vote in the management of the company.

In 1968, all of the company's shareholders (the three brothers and their father) entered into a stock retirement agreement ("SRA") which was designed to facilitate the purchase of the shareholder's stock upon death, or when a living shareholder wished to sell his stock. In 1975, the father died and the company purchased his stock from his estate, pursuant to the terms of the SRA.

* [Eds.—This section of the Minnesota Business Corporations law provides for judicial dissolution at the request of a shareholder on a finding of deadlock among directors or shareholders, or waste of assets, or if "those in control have acted fraudulently, illegally, or in a manner unfairly prejudicial toward one or more shareholders," etc. As a remedy, in the case of a "closely held corporation," the court may order a buy-out of the shares of either party, at "fair value," with the purchase price payable in installments, but with the purchaser required to post a bond for the purchase price. A "closely held corporation" is one with not more than 35 shareholders. Minn. Stat. § 302A.011, subd. 6a.

In its earlier opinion in this case, the court described this provision as follows:

[I]t provides the courts with equitable authority to protect the rights and *reasonable expectations* of minority shareholders. . . . [T]he primary expectations of minority shareholders include *an active voice in management* of the corporation and *input as an employee*.

463 N.W.2d at 289 (emphasis supplied.)]

In 1979, the remaining shareholders (the three brothers) modified and re-executed the SRA, reducing the purchase price of the shares. The agreement provided in part:

Until and unless changed the value of each share of stock shall be as follows: 75% of net book value at the end of the preceding calendar year. It is the intent of the parties that the value of a Stockholder's interest as herein determined does include good will.

The relationship between respondent and the other two shareholders deteriorated through 1987 and 1988, after Alfred discovered an apparent discrepancy of almost \$330,000 between the internal accounting records and the TPC checking account. Approximately \$40,000 was discovered in an emergency investigation, yet about \$270,000 of the discrepancy remained unexplained.

Alfred was very concerned and insisted that an independent accountant be retained to locate the source of the discrepancy. In May 1987, Carl and Eugene agreed to retain an accountant to investigate the cash shortage. After a month with no results, TPC dismissed the accountant. Alfred testified that soon afterwards, the corporate accountant admitted in a meeting with all three brothers that there was a \$140,000 to \$147,000 discrepancy which was unexplainable.

Alfred testified that during this time, Eugene would interfere with his area of responsibility in the TPC plant and undermine his management authority. Alfred testified that he was told to cooperate, resign or be fired. He was told if he did not forget about the apparent discrepancy, his brothers would fire him. Alfred again repeated his demand that the corporation hire an independent accountant to investigate the situation.

In October 1987, a second independent accountant was hired to investigate the shortage. After concluding his investigation, the accountant issued a report identifying a \$140,000 discrepancy which could not be reconciled. He testified that throughout his investigation, he was refused access to numerous documents. He also stated there were over 20 leads never followed up before he ended his investigation.

Alfred was placed on a mandatory leave of absence from TPC on October 27, 1987. In December 1987, Alfred received a written notice that he was fired and all of his pay and benefits were discontinued. Employees were informed that Alfred had a nervous breakdown.

Alfred commenced this action in February 1988. Upon remand from this court on the earlier appeal, the trial court made the following findings of fact and conclusions of law. The court awarded Alfred \$766,582.33 as damages for his one-third ownership in TPC which was

determined by the terms of the SRA.* Alfred was awarded \$58,260.69 for prejudgment interest on this award.

The trial court also awarded Alfred \$563,417.67 based on its finding that the individual defendants had breached their fiduciary duties to Alfred. The award represented the difference between the fair market value of Alfred Pedro's stock as determined by the trial court and the value provided by the SRA. In addition, the trial court awarded \$68,690.05 for prejudgment interest on this award.

The trial court further found that Alfred had a contract of lifetime employment with TPC. The court found wrongful termination and awarded him \$256,740 as compensation for lost wages. Because the contract was for lifetime employment, the award represented lost wages until he reached the age of 72. The court reduced this award by payments made to Alfred since December 1989. Moreover, the court awarded prejudgment interest in the sum of \$31,750.37 on this award.

The trial court also awarded Alfred \$200,000 for attorney fees and expenses incurred by him. This award was based on the trial court's finding that appellants had acted in a manner which was "arbitrary, vexatious and otherwise not in good faith . . . prior to and during this action." The court awarded Alfred an additional \$6,063 for attorney fees for having to respond to appellants' motion to recuse the trial judge and for the preparation of Findings of Fact, Conclusions of Law and Order for Judgment.

Issues

1. Was the evidence sufficient to support the trial court's finding of breach of fiduciary duty?
2. Did the trial court properly determine Alfred Pedro had a reasonable expectation of lifetime employment, thereby awarding him damages for lost wages following the buyout until he reached age 72?
3. Did the trial court make proper determinations regarding joint and several liability, prejudgment interest, recusal of the trial judge, and attorney fees?

Analysis

I.

...

The relationship among shareholders in closely held corporations is analogous to that of partners.... Shareholders in closely held corporations owe one another a fiduciary duty. . . . Owing a fiduciary duty includes dealing "openly, honestly and fairly with other shareholders." *Evans [v. Blesi, 345 N.W.2d 775, 779 (Minn.App.1984)]*.

* [Eds.—In its earlier (1990) opinion in the case, the court had held, "Inasmuch as appellants' breaches of fiduciary duty forced the buyout, they cannot benefit from wrongful treatment of their fellow shareholder and must disgorge any such gain." 463 N.W.2d at 288.]

The court's findings of fact contain many examples where appellants did not act openly, honestly, and fairly with respondent Alfred Pedro. The trial court found that at no time since the action was commenced, did appellants ever implement payments admittedly due under the SRA. Appellants interfered with respondent's responsibilities in TPC and hired a private investigator to follow him when he was not in the office. The court found appellants fabricated accusations of neglect and malfeasance which were not substantiated during the trial.

Moreover, an employee testified that after respondent was terminated, employees were informed that he had a nervous breakdown. Also, respondent testified he was told if he did not forget about the discrepancies in the financial records, his brothers would fire him. Finally, appellants admitted in their motion requesting a buyout, that they were acting "in a manner unfairly prejudicial" toward respondent pursuant to Minn. Stat. § 302A.751, subd. 1(b)(2) (1990). This admission supports a finding of breach of fiduciary duty.

Appellants claim no breach of fiduciary duty can exist because there has been no diminution in the value of the corporation or the stock value of respondent's shares. In support of this assertion, appellants cite several cases where actions by an officer or director did reduce the value of the corporation, constituting a breach of fiduciary duty. . . .

However, an action depleting a corporation's value is not the exclusive method of breaching one's fiduciary duties. See *Evans*, 345 N.W.2d at 779–80 (majority shareholders breached fiduciary duty to minority shareholder by forcing his resignation). Moreover, loss in value of a shareholder's stock is not the only measure of damages. See *Pavlidis v. New England Patriots Football Club, Inc.*, 675 F.Supp. 701, 703 (D.Mass.1987) (damages for corporate director's breach of fiduciary duty was either profits made by director or value of property at time of breach plus interest).

Moreover, the measure of damages for the buyout was proper. In *Pedro 1* [*Pedro v. Pedro*, 463 N.W.2d 285 (Minn.App.1990) (an earlier decision in this case)], this court stated:

If the fair value of the shares is greater than the purchase price for the buyout as calculated from the formula in the SRA, the difference is the measure of respondent's damage resulting from having been forced to sell his shares in the company.

Pedro, 463 N.W.2d at 288. Here there was evidence in the record that the fair market value of respondent's shares equalled \$1,330,000. After subtracting the undisputed purchase price set forth under the SRA of \$766,582.33, the trial court properly awarded damages for breach of fiduciary duty of \$563,417.67.

II.

Appellants claim the evidence was insufficient for the court to find a contract for lifetime employment. They also assert damages for lost

wages following the buyout were improper. Again, we are unable to set aside findings of fact unless they are clearly erroneous. . . . Based upon the unique facts in this case, we affirm the trial court's award of damages for lost wages.

Trial courts have broad equitable powers in fashioning relief for the buyout of shareholders in a closely held corporation. Minn. Stat. § 302A.751, subd. 3a provides:

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

This section allows courts to look to respondent's reasonable expectations when awarding damages. In addition to an ownership interest,

the reasonable expectations of such a shareholder are a job, salary, a significant place in management, and economic security for his family.

Joseph E. Olson, *A Statutory Elixir for the Oppression Malady*, 36 Mercer L. Rev. 627, 629 (1985) (footnote omitted).

In *Pine River State Bank v. Mettille*, 333 N.W.2d 622 (Minn.1983), the supreme court explained that the court must ascertain the intent of the parties to the employment contract. *Id.* at 628. When ascertaining the intent, trial courts must consider the written and oral negotiations of the parties as well as the parties' situation, the type of employment and the particular circumstances of the case. *Eklund v. Vincent Brass and Aluminum Co.*, 351 N.W.2d 371, 376 (Minn.App.1984), *pet. for rev. denied* (Minn. Nov. 1, 1984).

In a closely held corporation the nature of the employment of a shareholder may create a reasonable expectation by the employee-owner that his employment is not terminable at will. *Pedro*, 463 N.W.2d at 289.

The unique facts in the record support the trial court's finding of an agreement to provide lifetime employment to respondent. Carl Pedro, Sr. worked at the corporation until his death. Eugene Pedro, who worked for over 50 years at TPC, testified that he intended to always work for the company. Carl Pedro, Jr. worked at TPC for over 34 years. Alfred Pedro testified of his expectation of a lifetime job like his father. He had already been employed by TPC for 45 years. Even the corporate accountant testified regarding Carl's and Eugene's expectations that they would work for the corporation as long as they wanted. Based upon this

evidence it was reasonable for the trial court to determine that the parties did in fact have a contract that was not terminable at will.

Appellants claim a grant of damages for both lost wages and breach of fiduciary duty under § 302A.751, subd. 3a allows respondent a double recovery. . . . Even appellants concede respondent has two separate interests, as owner and employee. Thus, allowing recovery for each interest is appropriate and will not be considered a double recovery.

Finally, appellants dispute the trial court's award of damages for lost wages following the buyout. They claim once respondent's ownership interest is severed, he has no right to damages for lost wages. We believe the trial court's award of future damages for lost wages is wholly consistent with the court's broad equitable powers found in § 302A.751, subd. 3a and is warranted based upon its finding of a contract for lifetime employment.

III.

...

[A]ppellants challenge the trial court's award of attorney fees. Under section 302A.751, subd. 4, if the court finds a party to a proceeding brought under this section has acted arbitrarily, vexatiously or otherwise not in good faith, it may, in its discretion, award reasonable expenses, including attorneys fees and disbursements to any of the other parties. Here, the trial court made specific findings that appellants both breached fiduciary duties and acted arbitrarily, vexatiously or otherwise not in good faith. Once this has been done, the trial court has discretion to award attorney fees. . . .

Decision

The facts of this case support the trial court's findings that appellants breached their fiduciary duties to respondent and wrongfully terminated his contract for lifetime employment.

Affirmed.

ANALYSIS

1. How would you have drafted the SRA?
2. Could the parties have avoided the court's result by drafting the contract differently? Would they have wanted to do so? Does the court interpret the SRA or does it impose mandatory contractual terms?
3. Does the Minnesota statute, with its interpretation in *Pedro*, reduce the need for buy/sell agreements in closely held corporations? Eliminate them? Suppose you are about to invest in such a corporation. If you tell the other investors that you do not like the state's "default" rule and want to hammer out a control agreement, employment agreements, and a buy/sell agreement, what adverse message might you be conveying?

PLANNING ISSUE

How do the rules encountered in this section affect your judgment about the need for a buy-sell agreement in closely held corporations?

Stuparich v. Harbor Furniture Mfg., Inc.

83 Cal.App.4th 1268, 100 Cal.Rptr.2d 313 (2000).

This is a dispute concerning a closely held family corporation. Plaintiffs and appellants, Ann Stuparich and Candi Tuttleton, appeal from judgment entered in favor of the corporation after the trial court granted summary judgment against them. The sole issue on appeal is whether plaintiffs raised a triable issue of material fact regarding their claim that dissolution was appropriate under Corporations Code § 1800(b)(5). . . . That statute provides for the involuntary dissolution of a corporation where "In the case of any corporation with 35 or fewer shareholders . . . liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders."

We conclude that plaintiffs did not raise a triable issue of material fact that dissolution of the corporation was reasonably necessary to protect their rights, and interests, and affirm the judgment.

FACTUAL AND PROCEDURAL SUMMARY

Plaintiffs are sisters. Harbor Furniture was founded by their grandfather in 1929 as a furniture manufacturing business. A short time later, ownership of the company was divided between the grandfather and his wife (50 percent) and their son, Malcolm Tuttleton, Sr. and his wife, Ilo Tuttleton (50 percent). In 1946, Harbor Furniture purchased land in Los Angeles County as an investment. Harbor Furniture was incorporated in 1957. In 1965, the Los Angeles County land was developed into a mobile home park named "The Californian," which continues to be owned and operated by Harbor Furniture. The corporation also continues to manufacture furniture.

It is undisputed that Malcolm, Jr. worked with his father, Malcolm, Sr., in the day-to-day operation of Harbor Furniture beginning in 1961. Malcolm, Jr. is the plaintiffs' brother. In 1982, Malcolm, Sr. turned over the position of Chief Executive Officer to Malcolm, Jr. Malcolm, Jr. received an annual salary of \$153,000 plus bonuses. His wife, Jocelle, is employed by Harbor Furniture as an office manager and she also oversees production. Her annual salary is \$49,000. Malcolm, Jr.'s son, Brent, is employed by Harbor Furniture as a salesman. He receives a guaranteed annual salary of \$27,000 plus commissions. Other than by attendance at board meetings, neither plaintiff has been involved in the operation of the company.

Plaintiffs obtained shares in Harbor Furniture through gifts and inheritance. When they filed the dissolution proceeding on December 17, 1996, they each held 19.05 percent of voting shares and 33.33 percent of

non-voting shares in the corporation. In March 1996, their father, Malcolm, Sr., sold his voting stock to his son, Malcolm, Jr. This transaction gave Malcolm, Jr. 51.56 percent of the voting shares and 33.33 percent of the non-voting shares. (Plaintiffs characterize this transaction as "clandestine" and assert that they first learned of it through discovery conducted in this action.) The remaining 10.34 percent of shares are held by unidentified others. It is undisputed that the total number of shareholders is less than 35.

Plaintiffs became dissatisfied with the failure of the company to observe various formalities. At Ann Stuparich's insistence, the corporation began holding annual meetings in 1990. She served as chairman of the board of directors between 1990 and 1996. Both plaintiffs were on the board of directors for that period. The other members of the board included Malcolm Jr., Malcolm Sr., and his wife, Ilo. Candi Tuttleton became secretary of the board of directors in 1993. Malcolm, Sr. was president and Malcolm, Jr. was vice-president.

Confusion and a dispute arose in late 1995 when the company's certified public accountant, John Rohm, circulated a proposal regarding disposition of Ilo Tuttleton's stock following her death. Plaintiffs believed that they had acquired a controlling share of the stock in the corporation. They proposed formally separating the mobile home park operation from the furniture manufacturing operation by creating separate divisions. This was because the furniture business was incurring financial losses each year while the mobile home park was very profitable. Ann Stuparich intended to insulate the profits of the mobile home park from the furniture losses through this reorganization. Candi Tuttleton concurred in her sister's proposal.

According to Ann Stuparich's declaration, "Shortly thereafter, I was notified by John Rohm that his initial communication had been in error. The stock [distribution] had not given voting control to my sister and I. At approximately the same time I was notified by my brother [Malcolm, Jr.] that my meeting notice was defective and that no meeting would be held to discuss my restructuring proposal. When I was unable to obtain a satisfactory explanation as to how the voting/non-voting ... discrepancy had arisen, I threw up my hands in frustration."

Plaintiffs' separate statement of disputed facts, which is supported by their declarations, states: "Although given titles of authority, Plaintiffs never had any real power or role in the corporation. Plaintiffs in 1996 realized that their efforts were futile, and that there never would be meaningful discussion of subjects of concern to them. Rather than continue efforts in frustration and futility, Plaintiffs stopped attending annual meetings." Malcolm, Jr. refused plaintiffs' request to buy out their shares.

It is undisputed that plaintiffs received monthly dividends from corporate profits from 1984 to 1996. The dividend payments tripled during this period from \$1,000 per month to \$3,000 per month. With

additional quarterly payments, each plaintiff has received more than \$800,000 in dividends since 1984. Harbor Furniture has distributed in excess of \$2,700,000 in dividends to its shareholders since 1984, although the furniture portion of the business suffered losses of \$2,577,682 in the fiscal years from 1990 through 1998.

Plaintiffs filed a verified complaint against Harbor Furniture Manufacturing, Inc., Malcolm, Jr., Malcolm, Sr., Malcolm, Jr.'s wife, Jocelle and son, Brent. They sought involuntary dissolution of the corporation under § 1800(b)(4) and (5); declaratory relief; and damages for fraud, conspiracy and negligence. The individual defendants and all causes of action other than that for dissolution under § 1800(b)(5) subsequently were dismissed by stipulation of the parties. After the action was filed, there was a serious argument between Candi Tuttleton and Malcolm, Jr. which resulted in physical injuries to Ms. Tuttleton.

Harbor Manufacturing moved for summary judgment. . . . The trial court granted the motion for summary judgment. In its minute order, the court found, "Plaintiff [sic] seek involuntary dissolution on the ground that the animosity between them and their brother makes it impossible to participate in corporate activities. However, as the moving papers indicate, plaintiffs could pursue a representative on the board of directors to represent their interests in the corporation. Further, plaintiff's [sic] rights are not in need of protection as they have consistently received the dividends owed them as shareholders."

DISCUSSION

...

The sole issue in this appeal is whether plaintiffs raised a triable issue of material fact as to their right to involuntary dissolution of the corporation under § 1800(b)(5) which applies where "liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders." The Legislative Committee Comment to § 1800 notes that the enacting legislation was intended to expand the authority to initiate an involuntary dissolution in specified situations. (Assem. Legis. Com. com., reprinted at 23E West's Ann. Corp.Code (1990 ed.) foll. § 1800, p. 481 (Legislative Committee comment)). The Legislative Committee comment specifically addresses involuntary dissolution in a close corporation. "The new law specifically authorizes the formation of 'close corporations' and the agreements necessary to 'close' the corporation. To provide close corporation shareholders with a remedy, this section permits any shareholder of a close corporation to initiate involuntary dissolution. . . . Since this section permits a going concern to be involuntarily terminated, the application of such a drastic remedy should be appropriately limited. Subdivision (b)(5) of this section states a relatively broad ground for involuntary dissolution proceedings and, in light of the expansion of authority to bring such an action, this provision is limited to corporations with 35 or fewer shareholders."

There are two cases addressing the right of minority shareholders to force dissolution of a corporation because their interests and rights cannot be protected. The first, *Stumpf v. C.E. Stumpf & Sons, Inc.* (1975) 47 Cal.App.3d 230, 120 Cal.Rptr. 671, was decided under former § 4651, the predecessor to § 1800. Former § 4651(f) allowed involuntary dissolution where "The liquidation is reasonably necessary for the protection of the rights or interests of any substantial number of the shareholders, or of the complaining shareholders. (Id. at p. 233, fn. 2, 120 Cal.Rptr. 671.) The corporation in *Stumpf* was wholly owned in equal shares by C.G. Stumpf, Sr. and his two sons. One of the sons, Donald Stumpf, left employment with the corporation after a managerial dispute. He was removed as an officer of the corporation. He did not seek to participate in the family business after that, and was not asked to do so. The trial court granted his request for involuntary dissolution of the corporation. On appeal, the corporation argued that dissolution was inappropriate absent some finding of deadlock, mismanagement, or unfairness toward Donald. Deadlock and mismanagement were other grounds for dissolution set out in former § 4651. The trial court specifically found there had been no mismanagement or unfairness and there was no evidence of a corporate deadlock.

The *Stumpf* court affirmed the order of dissolution. It concluded that subdivision (f) of section 4651 was not limited to situations of the kind specified in the other subdivisions of the section. . . . It read former § 4658, which allowed a majority to preserve the corporation by buying out the minority, with former § 4651, as demonstrating a legislative intent "to empower the courts to order dissolution when required to assure fairness to minority shareholders and at the same time to lessen the danger of minority abuse." . . .

Based on evidence of the extreme hostility between the two brothers—which had forced Donald Stumpf to sever contact with the family and had shown that Donald had no say in the operation of the business and that he received no salary, dividends, or other revenue from his investment in the corporation after he withdrew from the business—the court concluded that the trial court's judgment granting dissolution was supported by substantial evidence. It found no abuse of discretion.

The second case is *Bauer v. Bauer*, [1996] 46 Cal.App.4th 1106, 54 Cal.Rptr.2d 377. In that case, minority shareholders of West Coast, a closely held corporation, sought involuntary dissolution. The minority shareholders went into business in direct competition with West Coast and had been ousted as employees of West Coast. Following trial, the court refused to grant dissolution. On appeal, the minority shareholders argued that dissolution was appropriate both under § 1800(b)(4) (persistent fraud, mismanagement, abuse of authority or persistent unfairness toward shareholders) and (b)(5) (dissolution necessary to protect rights or interests of complaining shareholders). The Court of Appeal held that in enacting subdivisions (b)(4) and (b)(5) of § 1800, "the

Legislature clearly distinguished between a cause of action for involuntary dissolution based on the controlling shareholders' misconduct, and one based specifically on protection of the rights, interests and expectations of complaining minority shareholders. . . . The Bauer court concluded that the grounds for dissolution under subdivision (b)(5) are considerably broader than those in subdivision (b)(4). . . .

The *Bauer* court applied an abuse of discretion standard. . . . It concluded that in light of the bad faith conduct of the minority shareholders in setting up a competing business and soliciting West Coast's customers, the trial court did not abuse its discretion in concluding that the "drastic relief of involuntary liquidation" was not "reasonably necessary" to protect the minority shareholders' interests. The appellate court also found that nonpayment of corporate dividends was not a basis for granting dissolution because of evidence that there were no profits from which dividends could be paid. Finally, it found that under the circumstances, the minority shareholders did not have a reasonable expectation of receiving either dividends or salaries from West Coast. It affirmed the trial court's judgment denying involuntary dissolution because involuntary dissolution was not "reasonably necessary" to protect the minority shareholders' rights and interests. . . . With these decisions in mind, we turn to plaintiffs' arguments on appeal.

The issue is whether plaintiffs raised a triable issue of material fact as to whether dissolution is "reasonably necessary" to protect their rights or interests. Plaintiffs point to the following evidence, presented in opposition to the motion for summary judgment: (1) their brother, Malcolm, Jr., has voting control of the corporation; (2) plaintiffs are not allowed meaningful participation in the corporation; (3) the dispute with their brother gave rise to a violent confrontation between Malcolm, Jr. and Candi Tuttleton; and (4) plaintiffs have an economic interest in reducing or ending the significant losses the furniture manufacturing business has suffered over the last 10 years, but Malcolm, Jr. and his family draw benefits from the furniture operation in the form of salaries and bonuses.

First, it is undisputed that Malcolm, Jr., with 51.56 percent of the voting shares, can outvote plaintiffs on any issue. California law allows corporations to issue both voting and nonvoting stock. (§ 400, subd. (a).) . . .

It is also undisputed that Malcolm, Sr. turned over the operation of Harbor Furniture to Malcolm, Jr. and that plaintiffs have played no part in the daily operation of either the furniture manufacturing or mobile home park operations of the corporation. In addition, while characterizing Malcolm, Sr.'s sale of his voting stock to his son as "clandestine," plaintiffs do not dispute his right to make the sale.

Thus, the distribution of voting shares in the corporation is consistent with California law, and does not, in itself, present a "reasonable" necessity for dissolution. The other issues briefed by

plaintiffs are related. They cite their inability to play a meaningful role in the operation of the corporation, the complete breakdown of their relationship with their brother, and the continuing losses incurred by the furniture manufacturing operation, which reduced profits. Plaintiffs rely on their declarations, in which they describe their efforts to participate in corporate operations or policy as frustrating and futile. As evidence of their treatment as "second class" shareholders, plaintiffs cite Malcolm, Jr.'s concealment of his acquisition of a controlling share of voting stock. As we have discussed, plaintiffs do not challenge Malcolm, Sr.'s right to sell these shares to his son. Plaintiffs contend that the sale was made at steeply discounted values, arguing "the entire secretive transaction is merely one more example of actions that disadvantage and disregard the sisters, who after all do in fact own the majority of all shares in the corporation. But Malcolm, Sr. was privileged to sell his shares to his son at whatever price he chose.

In essence, the corporation argues that as minority shareholders, plaintiffs' only right and interest is in continuing to receive dividends. It points to undisputed evidence that plaintiffs, as well as the other shareholders, were paid significant dividends in the period preceding the filing of the dissolution action. It invokes the business judgment rule of deference to corporate directors in making decisions regarding the operation of the company. . . . In response to plaintiffs' argument that the corporation would make more money if the furniture manufacturing operation were eliminated, Harbor Furniture argues that this does not raise a triable issue of material fact because it can always be argued that more profits could be made. It contends that courts should not be involved "in the tweaking of corporate performance. Such is the reason for the 'business judgment' rule." The corporation also suggests that plaintiffs elect someone other than themselves to represent their interests on the board of directors. It argues "An opportunity to participate and speak is all a minority shareholder is entitled to and may expect." . . .

On this undisputed record, we cannot say that the trial court erred in finding as a matter of law that the drastic remedy of liquidation is not reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders. . . . As holders of a minority of the voting shares, plaintiffs are not entitled to substitute their business judgment for their brother's with respect to viability of the furniture operations. . . .

The judgment is affirmed.

ANALYSIS

1. What is the relevance of the altercation between Candi Tuttleton and Malcolm Tuttleton, Jr., that led to "physical injuries" to Candi?

2. What is the relevance of the fact that Malcolm, Jr., and his wife and son received salaries and the sisters did not?
3. How can the outcome in this case be reconciled with the outcomes in *Alaska Plastics* and *Pedro v. Pedro*?
4. What happens next? The dueling family factions seem to be stuck with one another. Suppose Malcolm, Jr. asks for your advice. He suggests that he might want to reduce dividends, using the money to modernize the furniture factory, and that he might offer to buy out his sisters if they are willing to sell at a low enough price. What advice do you offer?

6. TRANSFER OF CONTROL

Frandsen v. Jensen-Sundquist Agency, Inc.

802 F.2d 941 (7th Cir.1986).

■ POSNER, CIRCUIT JUDGE.

The appeals in this diversity suit require us to consider issues of Wisconsin contract and tort law in the settling of a dispute over the rights of a minority shareholder in a closely held corporation. The facts are as follows. In 1975 Walter Jensen owned all the stock of Jensen-Sundquist Agency, Inc., a holding company whose principal asset was a majority of the stock of the First Bank of Grantsburg; Jensen-Sundquist also owned a small insurance company. That year Jensen sold 52 percent of his stock in the holding company to members of his family—the “majority bloc,” as we shall call them and the interest they acquired; 8 percent to Dennis Frandsen, a substantial businessman who was not a member of Jensen’s family and who paid Jensen \$97,000 for the stock; and the rest, in smaller chunks, to other non-family members. By a stockholder agreement drafted by Jensen and a lawyer representing the bank and Jensen’s family, the majority bloc agreed “that should they at any time offer to sell their stock in Jensen-Sundquist, Inc., . . . they will first offer their stock to [Frandsen and six other minority shareholders who had negotiated for this provision] at the same price as may be offered to [the majority bloc] . . . and . . . they will not sell their stock to any other person, firm, or organization without first offering said stock” to these minority shareholders “at the same price and upon the same terms.” The majority bloc also agreed not to “sell any of their shares to anyone without at the same time offering to purchase all the shares of” these minority shareholders “at the same price.” Thus if the majority bloc offered to sell its shares it had to give Frandsen a right to buy the shares at the offer price. If Frandsen declined, the second protective provision came into play: the majority bloc had to offer to buy his shares at the same price at which it sold its own shares.

In 1984 the president of Jensen-Sundquist began discussions with First Wisconsin Corporation, Wisconsin’s largest bank holding company,

open market for \$7.38 per share. It is undisputed that the 44.4% acquired by Flintkote represented effective control of Gable.

Recognizing that those who invest the capital necessary to acquire a dominant position in the ownership of a corporation have the right of controlling that corporation, it has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price. . . .

Certainly, minority shareholders are entitled to protection against such abuse by controlling shareholders. They are not entitled, however, to inhibit the legitimate interests of the other stockholders. It is for this reason that control shares usually command a premium price. The premium is the added amount an investor is willing to pay for the privilege of directly influencing the corporation's affairs.

In this action plaintiff Zetlin contends that minority stockholders are entitled to an opportunity to share equally in any premium paid for a controlling interest in the corporation. This rule would profoundly affect the manner in which controlling stock interests are now transferred. It would require, essentially, that a controlling interest be transferred only by means of an offer to all stockholders, i.e., a tender offer. This would be contrary to existing law and if so radical a change is to be effected it would best be done by the Legislature.

Order affirmed.

NOTE AND QUESTIONS ON CONTROL PREMIUMS

The underlying issue in sale-of-control cases can be reflected by two paradigms. For the *first paradigm*, suppose there is a business firm that produces earnings of \$200,000 per year before any payment of salary to its manager and suppose that a reasonable salary for the manager is \$50,000 per year, so the net earnings are \$150,000 per year. Suppose further that the market value of the firm is a multiple of five times the net earnings, or \$750,000; that the firm is incorporated, with 1,500 common shares outstanding; that 1,000 (or 2/3) of these shares are owned by C (the controlling shareholder) and 500 by M (the minority shareholder); and that C has been acting as manager and taking a salary of \$50,000 per year. Thus, the financial picture looks like this:

Gross earnings	\$200,000
Reasonable salary	\$ 50,000
Net earnings	\$150,000
Market value of firm (5 times net earnings)	\$750,000
C's shares	1,000

M's shares	500
Earnings allocable to C	\$100,000
Earnings allocable to M	\$ 50,000
Market value of C's shares	\$500,000
Market value of M's shares	\$250,000

Now suppose C's shares are bought by B, who elects his representatives to the board of directors, and that the board installs B's son, S, as manager; that S, as a manager, is competent but has no special qualities that add value to the business; that the board sets S's salary at \$110,000 per year; and that, given the traditional judicial deference to decisions of boards of directors, there is no realistic prospect that a legal attack on this salary would be successful. The financial picture now looks like this:

Gross earnings	\$200,000
S's salary	\$110,000
Net earnings	\$ 90,000
B's shares	1,000
M's shares	500
Earnings allocable to B	\$ 60,000

Additional value to B from S's excess salary (yearly)	\$ 60,000
Total annual return to B	\$120,000
Market value of B's shares	\$600,000
Earnings allocable to M	\$ 30,000
Market value of M's shares	\$150,000

On these assumed facts, which are extreme but may fairly depict reality in some situations, B has been able to shift \$100,000 of the value of the firm from M to himself.* Thus, B might have been willing to pay C a premium (that is, an amount in excess of C's allocable share of the total fair market value of the firm) for his shares. If, for example, B had paid

* A thoughtful reader may detect a problem with the assumed facts. If it is so easy to increase the salary of the controlling shareholder or his son, why would M's shares initially be worth \$250,000? Why would there not be at least some discount to reflect the prospect that the controlling shareholder would extract benefits not shared with the minority shareholder? The answer is that the initially assumed facts may in fact be unrealistic to some degree, but the observations generated by the facts assumed are nonetheless interesting and useful. The implications of the thoughtful reader's concern with the realism of the assumed facts might be explored by starting with the firm under B's ownership, with B's shares worth \$600,000 and M's shares worth \$150,000, and asking how one's reactions to sale of control shares for a premium price change if it is now B, rather than C, who is selling the shares.

\$550,000 for C's 1,000 shares, C and B each would profit by \$50,000—at the expense of M. On this view of control premiums, the premium is paid for control because the buyer intends to milk, or (a more extreme version) loot, the corporation. In thinking about this view of reality, however, one must wonder why (returning to our hypothetical facts) C had been paying himself a salary of only \$50,000. If C had been paying himself \$110,000, then C's shares would have been worth more than M's, but the sale of those shares to B, at a price in excess of the value of M's shares, would not have harmed M. The question left by this paradigm is, why not, by some legal rule or device, provide that a buyer such as B, who is willing to pay a premium for a controlling number of shares, must buy pro rata from all shareholders?

For the *second paradigm*, assume that we begin with the same facts as in the first paradigm, with the firm earning net revenues of \$150,000 (after the \$50,000 salary to C), and with C owning 1,000 shares worth \$500,000 and M owning 500 shares worth \$250,000. Along comes E, a successful entrepreneur, who examines the firm's methods of operations and concludes that by making some changes and by replacing C, as manager, with her own person (who will be willing to accept the same \$50,000 salary), she can increase the net earnings to \$200,000.* If E is right, she can increase the value of the firm from \$750,000 to \$1,000,000. Suppose E buys C's shares for \$600,000. Everyone has an increase in wealth. C has sold shares worth \$500,000 for \$600,000, for a gain of \$100,000. E has paid \$600,000 for shares that should now be worth \$666,667 ($\frac{2}{3}$ of the \$1,000,000 total value). And M's shares should increase in value from \$250,000 to \$333,333 ($\frac{1}{3}$ of \$1,000,000), a gain of \$83,333. The total gain is \$250,000, which, of course, is the total increase in the value of the firm. It is difficult to see any basis for objection to the sale from C to E. But is this a realistic paradigm? In challenging the realism, a person might ask why, since E expected to make a profit from the purchase of C's shares at a 20 percent premium,** was she not also willing to offer the same premium for M's shares? Does the failure to do so necessarily establish that E does not genuinely expect to increase the firm's earnings, but rather intends to exploit the firm for her own personal advantage, as in the first paradigm?

* Again the thoughtful reader might wonder why the initial value of the shares was not at least slightly greater than \$750,000, to reflect the prospect that the earnings might be increased through better strategies and management, or to reflect the probability that C was gaining intangible benefits from managing the firm in his own relatively inefficient way. Changing the facts to reflect this possibility would add complexity without altering the important implications.

** It was assumed that C's shares were initially worth \$500,000. E paid \$600,000, which includes a premium of \$100,000 over the initial worth. \$100,000 is 20 percent of \$500,000.

PLANNING PROBLEM

Recall that in the *Frandsen* case, a minority shareholder bargained for a "take-me-along" or "equal-opportunity" provision. It was described by the court as follows:

[I]f the majority bloc offered to sell its shares it had to give Frandsen a right to buy the shares at the offer price. If Frandsen declined, the second protective provision came into play: the majority bloc had to offer to buy his shares at the same price at which it sold its own shares.

Suppose that you are practicing law and that three people come to you and ask you to advise and assist them in forming a business organization to manufacture and sell computer components. The three individuals are Ida, Sally, and Maria. Ida has the product ideas and technical competence and will supervise production. Sally will be in charge of sales and promotion. Maria will supply the money for the start-up phase; she will play no active role in the business. The three principals tell you that if all goes well they expect to become rich from this venture (or, in Maria's case, richer). What advice would you give them about adopting an equal-opportunity provision? Would your advice change if you knew that Ida and Sally were sisters and always acted together, as if they were one person? (By the way, do you have a problem with advising all three?)

Perlman v. Feldmann

219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955).

■ CLARK, CHIEF JUDGE.

This is a derivative action brought by minority stockholders of Newport Steel Corporation to compel accounting for, and restitution of, allegedly illegal gains which accrued to defendants as a result of the sale in August, 1950, of their controlling interest in the corporation. The principal defendant, C. Russell Feldmann, who represented and acted for the others, members of his family,¹ was at that time not only the dominant stockholder, but also the chairman of the board of directors and the president of the corporation. Newport, an Indiana corporation, operated mills for the production of steel sheets for sale to manufacturers of steel products, first at Newport, Kentucky, and later also at other places in Kentucky and Ohio. The buyers, a syndicate organized as Wilport Company, a Delaware corporation, consisted of end-users of steel who were interested in securing a source of supply in a market becoming ever tighter in the Korean War. Plaintiffs contend that the consideration

¹ The stock was not held personally by Feldmann in his own name, but was held by the members of his family and by personal corporations. The aggregate of stock thus had amounted to 33% of the outstanding Newport stock and gave working control to the holder. The actual sale included 55,552 additional shares held by friends and associates of Feldmann, so that a total of 37% of the Newport stock was transferred.

paid for the stock included compensation for the sale of a corporate asset, a power held in trust for the corporation by Feldmann as its fiduciary. This power was the ability to control the allocation of the corporate product in a time of short supply, through control of the board of directors; and it was effectively transferred in this sale by having Feldmann procure the resignation of his own board and the election of Wilport's nominees immediately upon consummation of the sale.

...

Newport was a relative newcomer in the steel industry with predominantly old installations which were in the process of being supplemented by more modern facilities. Except in times of extreme shortage Newport was not in a position to compete profitably with other steel mills for customers not in its immediate geographical area. Wilport, the purchasing syndicate, consisted of geographically remote end-users of steel who were interested in buying more steel from Newport than they had been able to obtain during recent periods of tight supply. The price of \$20 per share was found by Judge Hincks to be a fair one for a control block of stock, although the over-the-counter market price had not exceeded \$12 and the book value per share was \$17.03. . . .

Both as director and as dominant stockholder, Feldmann stood in a fiduciary relationship to the corporation and to the minority stockholders as beneficiaries thereof. . . .

It is true, as defendants have been at pains to point out, that this is not the ordinary case of breach of fiduciary duty. We have here no fraud, no misuse of confidential information, no outright looting of a helpless corporation. But on the other hand, we do not find compliance with that high standard which we have just stated and which we and other courts have come to expect and demand of corporate fiduciaries. . . . The actions of defendants in siphoning off for personal gain corporate advantages to be derived from a favorable market situation do not betoken the necessary undivided loyalty owed by the fiduciary to his principal.

The corporate opportunities of whose misappropriation the minority stockholders complain need not have been an absolute certainty in order to support this action against Feldmann. . . . [I]n *Irving Trust Co. v. Deutsch*, 2 Cir., 73 F.2d 121, 124, an accounting was required of corporate directors who bought stock for themselves for corporate use, even though there was an affirmative showing that the corporation did not have the finances itself to acquire the stock. Judge Swan speaking for the court pointed out that "The defendants' argument, contrary to *Wing v. Dillingham* [5 Cir., 239 F. 54], that the equitable rule that fiduciaries should not be permitted to assume a position in which their individual interests might be in conflict with those of the corporation can have no application where the corporation is unable to undertake the venture, is not convincing. If directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their

strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally."

This rationale is equally appropriate to a consideration of the benefits which Newport might have derived from the steel shortage. In the past Newport had used and profited by its market leverage by operation of what the industry had come to call the "Feldmann Plan." This consisted of securing interest-free advances from prospective purchasers of steel in return for firm commitments to them from future production. The funds thus acquired were used to finance improvements in existing plants and to acquire new installations. In the summer of 1950 Newport had been negotiating for cold-rolling facilities which it needed for a more fully integrated operation and a more marketable product, and Feldmann plan funds might well have been used toward this end.

Further, as plaintiffs alternatively suggest, Newport might have used the period of short supply to build up patronage in the geographical area in which it could compete profitably even when steel was more abundant. Either of these opportunities was Newport's, to be used to its advantage only. Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed. . . .

Defendants seek to categorize the corporate opportunities which might have accrued to Newport as too unethical to warrant further consideration. It is true that reputable steel producers were not participating in the gray market brought about by the Korean War and were refraining from advancing their prices, although to do so would not have been illegal. But Feldmann plan transactions were not considered within this self-imposed interdiction; the trial court found that around the time of the Feldmann sale Jones & Laughlin Steel Corporation, Republic Steel Company, and Pittsburgh Steel Corporation were all participating in such arrangements. In any event, it ill becomes the defendants to disparage as unethical the market advantages from which they themselves reaped rich benefits.

We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do this with impunity when the buyer is an interested customer, actual or potential, for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains. So in a time of market shortage, where a call on a corporation's product commands an unusually large premium, in one form or another, we think it sound law that a fiduciary may not appropriate to himself the value of this premium. . . .

Hence to the extent that the price received by Feldmann and his co-defendants included such a bonus, he is accountable to the minority stockholders who sue here. . . . And plaintiffs, as they contend, are entitled to a recovery in their own right, instead of in right of the

corporation (as in the usual derivative actions), since neither Wilport nor their successors in interest should share in any judgment which may be rendered. . . .

■ SWAN, CIRCUIT JUDGE (dissenting).

With the general principles enunciated in the majority opinion as to the duties of fiduciaries I am, of course, in thorough accord. But, as Mr. Justice Frankfurter stated in *Securities and Exchange Comm. v. Chenery Corp.*, 318 U.S. 80, 85, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?" My brothers' opinion does not specify precisely what fiduciary duty Feldmann is held to have violated or whether it was a duty imposed upon him as the dominant stockholder or as a director of Newport. . . .

The power to control the management of a corporation, that is, to elect directors to manage its affairs, is an inseparable incident to the ownership of a majority of its stock, or sometimes, as in the present instance, to the ownership of enough shares, less than a majority, to control an election. Concededly a majority or dominant shareholder is ordinarily privileged to sell his stock at the best price obtainable from the purchaser. In so doing he acts on his own behalf, not as an agent of the corporation. If he knows or has reason to believe that the purchaser intends to exercise to the detriment of the corporation the power of management acquired by the purchase, such knowledge or reasonable suspicion will terminate the dominant shareholder's privilege to sell and will create a duty not to transfer the power of management to such purchaser. The duty seems to me to resemble the obligation which everyone is under not to assist another to commit a tort rather than the obligation of a fiduciary. But whatever the nature of the duty, a violation of it will subject the violator to liability for damages sustained by the corporation. Judge Hincks found that Feldmann had no reason to think that Wilport would use the power of management it would acquire by the purchase to injure Newport, and that there was no proof that it ever was so used. Feldmann did know, it is true, that the reason Wilport wanted the stock was to put in a board of directors who would be likely to permit Wilport's members to purchase more of Newport's steel than they might otherwise be able to get. But there is nothing illegal in a dominant shareholder purchasing from his own corporation at the same prices it offers to other customers. That is what the members of Wilport did, and there is no proof that Newport suffered any detriment therefrom.

My brothers say that "the consideration paid for the stock included compensation for the sale of a corporate asset," which they describe as "the ability to control the allocation of the corporate product in a time of short supply, through control of the board of directors; and it was effectively transferred in this sale by having Feldmann procure the resignation of his own board and the election of Wilport's nominees

immediately upon consummation of the sale." The implications of this are not clear to me. If it means that when market conditions are such as to induce users of a corporation's product to wish to buy a controlling block of stock in order to be able to purchase part of the corporation's output at the same mill list prices as are offered to other customers, the dominant stockholder is under a fiduciary duty not to sell his stock, I cannot agree. For reasons already stated, in my opinion Feldmann was not proved to be under any fiduciary duty as a stockholder not to sell the stock he controlled.

Feldmann was also a director of Newport. Perhaps the quoted statement means that as a director he violated his fiduciary duty in voting to elect Wilport's nominees to fill the vacancies created by the resignations of the former directors of Newport. As a director Feldmann was under a fiduciary duty to use an honest judgment in acting on the corporation's behalf. A director is privileged to resign, but so long as he remains a director he must be faithful to his fiduciary duties and must not make a personal gain from performing them. Consequently, if the price paid for Feldmann's stock included a payment for voting to elect the new directors, he must account to the corporation for such payment, even though he honestly believed that the men he voted to elect were well qualified to serve as directors. He can not take pay for performing his fiduciary duty. . . .

The final conclusion of my brothers is that the plaintiffs are entitled to recover in their own right instead of in the right of the corporation. This appears to be completely inconsistent with the theory advanced at the outset of the opinion, namely, that the price of the stock "included compensation for the sale of a corporate asset." If a corporate asset was sold, surely the corporation should recover the compensation received for it by the defendants. . . .

ANALYSIS

1. What did Feldmann do wrong? In what capacity?
2. How were plaintiffs harmed by the defendants' sale of their shares?
3. Why is this a derivative action?

Essex Universal Corporation v. Yates

305 F.2d 572 (2d Cir.1962).

■ BEFORE LUMBARD, CHIEF JUDGE, and CLARK and FRIENDLY, CIRCUIT JUDGES.

■ LUMBARD, CHIEF JUDGE.

...

The defendant Herbert J. Yates, a resident of California, was president and chairman of the board of directors of Republic Pictures Corporation, a New York corporation which at the time relevant to this suit had 2,004,190 shares of common stock outstanding. Republic's stock was listed and traded on the New York Stock Exchange. In August 1957, Essex Universal Corporation, a Delaware corporation owning stock in various diversified businesses, learned of the possibility of purchasing from Yates an interest in Republic. Negotiations proceeded rapidly, and on August 28 Yates and Joseph Harris, the president of Essex, signed a contract in which Essex agreed to buy, and Yates agreed "to sell or cause to be sold" at least 500,000 and not more than 600,000 shares of Republic stock. The price was set at eight dollars a share, roughly two dollars above the then market price on the Exchange. . . . In addition to other provisions not relevant to the present motion, the contract contained the following paragraph:

"6. Resignations.

Upon and as a condition to the closing of this transaction if requested by Buyer at least ten (10) days prior to the date of the closing:

(a) Seller will deliver to Buyer the resignations of the majority of the directors of Republic.

(b) Seller will cause a special meeting of the board of directors of Republic to be held, legally convened pursuant to law and the by-laws of Republic, and simultaneously with the acceptance of the directors' resignations set forth in paragraph 6(a) immediately preceding will cause nominees of Buyer to be elected directors of Republic in place of the resigned directors."

Before the date of the closing, as provided in the contract, Yates notified Essex that he would deliver 566,223 shares, or 28.3 per cent of the Republic stock then outstanding, and Essex formally requested Yates to arrange for the replacement of a majority of Republic's directors with Essex nominees pursuant to paragraph 6 of the contract. This was to be accomplished by having eight of the fourteen directors resign seriatim, each in turn being replaced by an Essex nominee elected by the others; such a procedure was in form permissible under the charter and by-laws of Republic, which empowered the board to choose the successor of any of its members who might resign.

On September 18, the parties met as arranged for the closing at Republic's office in New York City. Essex tendered bank drafts and cashier's checks totalling \$1,698,690, which was the 37½ per cent of the total price of \$4,529,784 due at this time. The drafts and checks were payable to one Benjamin C. Cohen, who was Essex' banker and had arranged for the borrowing of the necessary funds. Although Cohen was prepared to endorse these to Yates, Yates upon advice of his lawyer rejected the tender as "unsatisfactory" and said, according to his deposition testimony, "Well, there can be no deal. We can't close it."

Essex began this action in the New York Supreme Court, and it was removed to the district court on account of diversity of citizenship. Essex seeks damages of \$2,700,000, claiming that at the time of the aborted closing the stock was in actuality worth more than \$12.75 a share. Yates' answer raised a number of defenses, but the motion for summary judgment now before us was made and decided only on the theory that the provision in the contract for immediate transfer of control of the board of directors was illegal *per se* and tainted the entire contract. We have no doubt, and the parties agree, that New York law governs. . . .

Up to this point my brethren and I are in agreement. The following analysis is my own, except insofar as the separate opinions of Judges Clark and Friendly may indicate agreement.

It is established beyond question under New York law that it is illegal to sell corporate office or management control by itself (that is, accompanied by no stock or insufficient stock to carry voting control). . . . The same rule apparently applies in all jurisdictions where the question has arisen. . . . The rationale of the rule is undisputable: persons enjoying management control hold it on behalf of the corporation's stockholders, and therefore may not regard it as their own personal property to dispose of as they wish. . . .

Essex was, however, contracting with Yates for the purchase of a very substantial percentage of Republic stock. If, by virtue of the voting power carried by this stock, it could have elected a majority of the board of directors, then the contract was not a simple agreement for the sale of office to one having no ownership interest in the corporation, and the question of its legality would require further analysis. Such stock voting control would incontestably belong to the owner of a majority of the voting stock, and it is commonly known that equivalent power usually accrues to the owner of 28.3% of the stock. For the purpose of this analysis, I shall assume that Essex was contracting to acquire a majority of the Republic stock, deferring consideration of the situation where, as here, only 28.3% is to be acquired.

Republic's board of directors at the time of the aborted closing had fourteen members divided into three classes, each class being "as nearly as may be" of the same size. Directors were elected for terms of three years, one class being elected at each annual shareholder meeting on the first Tuesday in April. Thus, absent the immediate replacement of

directors provided for in this contract, Essex as the hypothetical new majority shareholder of the corporation could not have obtained managing control in the form of a majority of the board in the normal course of events until April 1959, some eighteen months after the sale of the stock. . . .

There is no question of the right of a controlling shareholder under New York law normally to derive a premium from the sale of a controlling block of stock. In other words, there was no impropriety *per se* in the fact that Yates was to receive more per share than the generally prevailing market price for Republic stock

The next question is whether it is legal to give and receive payment for the immediate transfer of management control to one who has achieved majority share control but would not otherwise be able to convert that share control into operating control for some time. I think that it is.

. . .

The easy and immediate transfer of corporate control to new interests is ordinarily beneficial to the economy and it seems inevitable that such transactions would be discouraged if the purchaser of a majority stock interest were required to wait some period before his purchase of control could become effective. Conversely it would greatly hamper the efforts of any existing majority group to dispose of its interest if it could not assure the purchaser of immediate control over corporation operations. I can see no reason why a purchaser of majority control should not ordinarily be permitted to make his control effective from the moment of the transfer of stock.

Thus if Essex had been contracting to purchase a majority of the stock of Republic, it would have been entirely proper for the contract to contain the provision for immediate replacement of directors. Although in the case at bar only 28.3 per cent of the stock was involved, it is commonly known that a person or group owning so large a percentage of the voting stock of a corporation which, like Republic, has at least the 1,500 shareholders normally requisite to listing on the New York Stock Exchange, is almost certain to have share control as a practical matter. If Essex was contracting to acquire what in reality would be equivalent to ownership of a majority of stock, i.e., if it would as a practical certainty have been guaranteed of the stock voting power to choose a majority of the directors of Republic in due course, there is no reason why the contract should not similarly be legal. Whether Essex was thus to acquire the equivalent of majority stock control would, if the issue is properly raised by the defendants, be a factual issue to be determined by the district court on remand.

Because 28.3 per cent of the voting stock of a publicly owned corporation is usually tantamount to majority control, I would place the burden of proof on this issue on Yates as the party attacking the legality

of the transaction. Thus, unless on remand Yates chooses to raise the question whether the block of stock in question carried the equivalent of majority control, it is my view that the trial court should regard the contract as legal and proceed to consider the other issues raised by the pleadings. If Yates chooses to raise the issue, it will, on my view, be necessary for him to prove the existence of circumstances which would have prevented Essex from electing a majority of the Republic board of directors in due course. . . .

■ CLARK, CIRCUIT JUDGE (concurring in the result).

Since *Barnes v. Brown*, 80 N.Y. 527, teaches us that not all contracts like the one before us are necessarily illegal, summary judgment seems definitely improper and the action should be remanded for trial. But particularly in view of our lack of knowledge of corporate realities and the current standards of business morality, I should prefer to avoid too precise instructions to the district court in the hope that if the action again comes before us the record will be generally more instructive on this important issue than it now is. . . .

. . .

■ FRIENDLY, CIRCUIT JUDGE (concurring).

I have no doubt that many contracts, drawn by competent and responsible counsel, for the purchase of blocks of stock from interests thought to "control" a corporation although owning less than a majority, have contained provisions like paragraph 6 of the contract *sub judice*. However, developments over the past decades seem to me to show that such a clause violates basic principles of corporate democracy. To be sure, stockholders who have allowed a set of directors to be placed in office, whether by their vote or their failure to vote, must recognize that death, incapacity or other hazard may prevent a director from serving a full term, and that they will have no voice as to his immediate successor. But the stockholders are entitled to expect that, in that event, the remaining directors will fill the vacancy in the exercise of their fiduciary responsibility. A mass seriatim resignation directed by a selling stockholder, and the filling of vacancies by his henchmen at the dictation of a purchaser and without any consideration of the character of the latter's nominees, are beyond what the stockholders contemplated or should have been expected to contemplate. . . .

Hence, I am inclined to think that if I were sitting on the New York Court of Appeals, I would hold a provision like paragraph 6 violative of public policy save when it was entirely plain that a new election would be a mere formality—i.e., when the seller owned more than 50% of the stock. . . . Moreover, in view of the perhaps unexpected character of such a holding, I doubt that I would give it retrospective effect.

NOTE ON WHAT IS A CONTROL BLOCK OF SHARES

In *Essex Universal Corporation v. Yates* the selling shareholder, Yates, was the incumbent—that is, Yates had control of the board of directors and of the management of the corporation. Control gave him, among other things, access to the corporation's list of shareholders and its funds (for waging a campaign to line up the votes of other shareholders in a proxy fight), and the advantage of inertia. Since he already held 28.3 percent of the voting shares, a challenger to his control would have been required to buy shares from the holders of the remaining 71.7 percent. The incumbent had a sufficiently large stake in the corporation to have a strong incentive to resist challenge. Given the likelihood of resistance, a battle for control might leave little gain for the challenger, even if the challenger did gain control. In this setting, the 28.3 percent voting block provides effective control.

Where there is an incumbent management team and board of directors that does not have a significant percentage of the voting shares, an outsider who acquires a large, but less-than-majority block of voting shares may well be unable to exert any control over the corporation. Indeed, it is not uncommon that outsiders who acquire substantial minority positions are denied any representation whatever on the board of directors, even though the incumbent directors collectively own far fewer shares than the outsider.

ANALYSIS

1. Suppose all the facts of the *Yates* case are as stated by the court except that Mr. Yates held, and sold, only 3 percent of the voting shares. What would the result have been?

2. Suppose a shareholder other than Yates had objected to the contract between Yates and Essex Universal Corporation. How might such a shareholder have challenged the contract, or its consequences, and what would have been the likelihood of success?

3. In *Yates*, the board was said to have been "classified." (Often the word used to describe the type of board encountered in the case is "staggered." A "classified" board, by contrast, is one for which different classes of stock elect different sets of directors.) How did the constitution of the board affect the strategy for the sale of the controlling block? How would the strategy have changed if the board had not been classified (that is, staggered)? In answering this question, assume that the time is now and that the applicable law is that of New York. Here are the relevant provisions:

§ 602. Meetings of shareholders

...

(b) A meeting of shareholders shall be held annually for the election of directors and the transaction of other business on a date fixed by or under the by-laws.

(c) Special meetings of the shareholders may be called by the board and by such person or persons as may be so authorized by the certificate of incorporation or the by-laws. . . .

§ 702. Number of directors

...

(b) The number of directors may be increased or decreased by amendment of the by-laws, or by action of the shareholders or of the board under specific provisions of a by-law adopted by the shareholders. . . .

§ 703. Election and term of directors

(a) At each annual meeting of shareholders, directors shall be elected to hold office until the next annual meeting except as authorized by § 704 (classification of directors). The certificate of incorporation may provide for the election of one or more directors by the holders of the shares of any class or series, . . . voting as a class.

(b) Each director shall hold office until the expiration of the term for which he is elected, and until his successor has been elected and qualified.

§ 704. Classification of directors

(a) The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide that the directors be divided into two, three, or four classes. All classes shall be as nearly equal in number as possible, and no class shall include less than three directors. The terms of office of the directors initially classified shall be as follows: that of the first class shall expire at the next annual meeting of shareholders, the second class at the succeeding annual meeting, the third class, if any, at the third succeeding annual meeting, and the fourth class, if any, at the fourth succeeding annual meeting.

(b) At each annual meeting after such initial classification, directors to replace those whose terms expire at such annual meeting shall be elected to hold office until the second succeeding annual meeting if there are two classes, the third succeeding annual meeting if there are three classes, or the fourth succeeding annual meeting if there are four classes.

(c) If directors are classified and the number of directors is thereafter changed:

(1) Any newly created directorships or any decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as possible.

(2) When the number of directors is increased by the board and any newly created directorships are filled by the board, there shall be no classification of the additional directors until the next annual meeting of shareholders.

§ 705. Newly created directorships and vacancies

(a) Newly created directorships resulting from an increase in the number of directors and vacancies occurring in the board for any reason except the removal of directors without cause may be filled by vote of the board. . . . Nothing in this paragraph shall affect any provision of the certificate of incorporation or the by-laws which provides that such newly created directorships or vacancies shall be filled by vote of the shareholders. . . .

(b) Unless the certificate of incorporation or the specific provisions of a by-law adopted by the shareholders provides that the board may fill vacancies occurring by reason of the removal of directors without cause, such vacancies may be filled only by vote of the shareholders.

...

§ 706. Removal of directors

(a) Any or all of the directors may be removed for cause by vote of the shareholders. The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide for such removal by action of the board. . . .

(b) If the certificate of incorporation or the by-laws so provide, any or all of the directors may be removed without cause by vote of the shareholders.

(c) The removal of directors, with or without cause, as provided in paragraphs (a) and (b) is subject to the following:

(1) In the case of a corporation having cumulative voting, no director may be removed when the votes cast against his removal would be sufficient to elect him. . . .

(2) When by the provisions of the certificate of incorporation the holders of the shares of any class or series . . . voting as a class, are entitled to elect one or more directors, any director so elected may be removed only by the applicable vote of the holders of that class or series, . . . voting as a class.

4. The Delaware General Corporation Law, § 141(k), provides that "any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors," with exceptions protecting cumulative

voting, and with an exception that: "Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, shareholders may effect such removal only for cause." Subsection (d) of § 141 permits the certificate or the by-laws to provide that the board may be "divided into one, two, or three classes" to achieve staggered terms and for classification of shares for the purpose of electing directors. How, if at all, does the Delaware law differ from the New York law?

Amendment of the articles of incorporation of a corporation requires, first, the adoption by the board of a resolution incorporating the amendment and, second, approval by a vote of the shareholders. See Del.Gen.Corp.Law § 242(b); N.Y.Bus.Corp.Law § 803 (following the basic two-step pattern but allowing certain minor amendments by action of the board alone).

PROBLEMS

1. Suppose Basic Press, Inc. has 100,000 shares outstanding, and is publicly held. You own 30,000 shares. The shares trade at \$5.00 per share, but you have negotiated to sell your shares to the giant East Publishing Co. at \$8.00 per share. Is there any legal impediment to the sale?

2. Suppose, instead, that Basic Press, Inc. has only four shareholders. Three of the shareholders own 30,000 shares each, and the fourth owns 10,000 shares. There is no market for the stock, and the company has issued no dividends for ten years. Suppose that the three major shareholders negotiate a sale of their stock to the East Publishing Co. Is there any legal impediment to the sale? Any ethical impediment?

3. Suppose, once again, that Basic Press is publicly held, and that you own 30,000 shares. You have negotiated a sale of your stock to the East Publishing Co.

(a) As a condition for closing the sale, East insists that Basic first replace its directors with East nominees. Is the agreement legally permissible?

(b) As a condition for closing the sale, East insists that Basic replace *one* of its directors with an East nominee. Is the agreement legally permissible?

(c) As a condition for closing the sale, East insists that the Basic directors appoint Mr. Greensmith, the CEO of East, to be the CEO of Basic. Is the agreement legally enforceable?

(d) Suppose that Basic is a closely held corporation. Would East be able to insist that Basic appoint Greensmith to be CEO of Basic?