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The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares

Charles W. Murdock*

I. Introduction

"There are 51 shares," said he, "that are worth \$250,000. There are 49 shares that are not worth a — —."¹

Such was the plight, we are told, of the minority shareholder. Since the majority, through the board of directors, ruled the company, no one would buy the minority's shares. The dilemma for the minority shareholder in the closely-held corporation was that those in control could reap the benefits of ownership through compensation and other withdrawals not available to the minority; the minority would receive no return on his or her investment, nor could the shares be sold because no prudent person would step into the shoes of the minority.

Just over thirty-five years ago, Carlos Israels, in his seminal article, *The Sacred Cow of Corporate Existence: Problems of Dead-lock and Dissolution*,² suggested that close corporations should receive judicial treatment analogous to that afforded partners in a partnership. The thrust of Professor Israels' article was that, as a result of the liberalizing of legislative and judicial attitudes with respect to close corporations, such as the acceptance of unanimous vote requirements,³ draftsmen now had a greater opportunity to protect the interests of minority shareholders through charter provisions or contractual agreements.

While freeze-outs⁴ remained a possibility, Professor Israels also saw a trend in which, as a result of veto provisions inserted in corporate documents to protect minority interests, there would be more deadlocks or stalemates. Stalemate, which he defined as the "consistent non-coopera-

* Professor of Law at Loyola University; former Dean of Loyola University Law School; former Deputy Attorney General for the State of Illinois; J.D., Loyola University Law School, 1963.

1 *Humphrys v. Winous Co.*, 165 Ohio St. 45, 50, 133 N.E.2d 780, 783 (1956).

2 Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952).

3 *Id.* at 780-81. For example, although New York struck down a shareholder agreement requiring unanimity for director action, in *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 60 N.E.2d 829 (1945), the decision was overruled by the legislature three years later when § 9 was added to the New York Stock Corporation Law. See *In re Burkin*, 1 N.Y.2d 570, 136 N.E.2d 862, 165 N.Y.S.2d 898 (1956).

4 As used in this Article, a "freeze-out" is used to denote the situation in which a minority shareholder retains his or her interest but is deprived either of employment or of dividends such that he or she is unable to realize any return on the investment in the close corporation. On the other hand, "squeeze-out" is used to denote the situation in which the interest of the minority shareholder is involuntarily acquired by the corporation, for example, in a "cash-out" merger. Also, as used in this Article, the phrase "minority shareholder" includes not only a less than 50% shareholder but also a 50% shareholder who is excluded from participation in management.

tion, with or without moral justification,"⁵ of one or more individuals, could have the effect of seriously harming the enterprise and the interest of the majority. Thus, since dissolution could work to the advantage of all concerned, Professor Israel's advocated judicial liberality in dissolving corporations at the instance of minority shareholders.

While dead-lock occasionally rears its head⁶ and while minority shareholders sometimes use their veto power to the detriment of the majority and the corporate enterprise,⁷ the ensuing years have demonstrated that it is still the minority shareholders who are most likely to be disadvantaged in the corporate enterprise. Often, if not generally, predispute planning is lacking⁸ and the view of dissolution as a "drastic" remedy generally works to the disadvantage of minority shareholders.⁹ From a relational standpoint, people enter closely-held businesses in the same manner as they enter marriage: optimistically and ill-prepared. Minority shareholders often fail to obtain counsel and protect themselves through veto provisions or otherwise; accordingly, litigation subsequent to Professor Israel's article has been predicated not so much upon dead-lock but rather upon statutory provisions that enable a shareholder to seek dissolution if the actions of those in control of the corporation are "oppressive."¹⁰

Because corporate dissolution has been judicially viewed as a drastic remedy, courts have struggled with the concept of oppression and the conduct that is necessary to establish oppression. Jurisdictions have varied in the breadth they were willing to attach to this concept¹¹ and have sought to flesh out its meaning in a variety of restatements of the term.¹² At least through the 1970s, predicting what manner of conduct would give rise to a finding of oppression had been uncertain at best.

In the 1970s, the analogy of a close corporation to a partnership led to the development of a body of law that recognized that controlling

5 Israel, *supra* note 2, at 781.

6 See *Ward v. Colcord*, 110 Ill. App. 2d 68, 249 N.E.2d 137 (1969); *Jackson v. Nicolai-Neppach Co.*, 219 Or. 560, 348 P.2d 9 (1959); *infra* note 118 and accompanying text. See generally Comment, *Deadlock and Dissolution in the Closed Corporation: Has the Sacred Cow Been Butchered?*, 58 NEB. L. REV. 791, 814-24 (1979).

7 *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

8 See *infra* note 275 and accompanying text.

9 See *infra* notes 228-33 and accompanying text.

10 See *infra* text following note 195.

11 Compare *Capitol Toyota, Inc. v. Gervin*, 381 So. 2d 1038, 1039 (Miss. 1980) (no oppression was found "where the complaining party's reasonable expectations have been thwarted, but not grossly so") with *Gidwitz v. Lanzit Corrugated Box Co.*, 20 Ill. 2d 208, 220, 170 N.E.2d 131, 138 (1960) (oppression was found in a situation where the president "acted in an arbitrary and high-handed manner"). See also *infra* notes 198-241 and accompanying text.

12 See, e.g., *Notzke v. Art Gallery, Inc.*, 84 Ill. App. 3d 294, 299, 405 N.E.2d 839, 843 (1980) ("overbearing and heavy-handed"); *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 72, 473 N.E.2d 1173, 1179, 474 N.Y.S.2d 799, 805 (1984) ("[C]onduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise"); *Mardikos v. Arger*, 116 Misc. 2d 1028, 1031, 457 N.Y.S.2d 371, 374 (Sup. Ct. 1982) ("conduct which fair-minded people would find objectionable"); *Scottish Co-Operative Ltd. v. Meyer*, 3 All E.R. 66, 71, 86 (1958) ("burdensome, harsh, and wrongful" and "a lack of probity and fair dealing"); *Elder v. Elder & Watson, Ltd.*, 1952 Sess. Cas. 49, 55 (1951) ("a visible departure from the standards of fair dealing").

shareholders have a fiduciary duty to treat minority shareholders fairly.¹³ While this doctrine afforded minority shareholders some leverage against "freeze-out" ploys¹⁴ by the majority, it did not necessarily¹⁵ provide the minority shareholder with a way to recover his investment and exit the corporation. As long as the minority shareholder was left within the corporation, when the majority terminated the minority shareholder's employment or refused to declare dividends or engaged in other conduct disadvantageous to the minority, it was often uncertain whether courts would apply the business judgment rule¹⁶ or the majority's fiduciary duty rule to the questioned transaction.

Through the late 1970s and into the 1980s, a substantial number of states enacted statutes providing for alternative remedies to dissolution. These statutes generally included a judicially supervised buy-out of the minority by the corporation or the controlling shareholders.¹⁷ In judicial decisions in those states which have enacted such statutory alternatives, or in those jurisdictions where the courts themselves have recognized their own inherent equity power to fashion alternatives, there is a trend to liberalize the concept of oppression and to make relief more readily available to minority shareholders.

That such a trend should exist is not surprising. In the past, courts have hesitated to order dissolution because they have viewed it as a drastic remedy. However, once the legislature or the courts recognize an alternative which, since it keeps the enterprise in existence, is less drastic than dissolution, it would follow that the conduct giving rise to relief under this less drastic form need itself be less drastic. In other words, if dissolution is a drastic remedy, then the conduct necessary to constitute oppression and justify dissolution must be "drastic" or severely oppressive; on the other hand, if alternative remedies are less drastic, then the conduct necessary to give rise to the less drastic remedy need itself be less drastic or less oppressive.

Alternative remedies generally fall into one of three categories: (1) direct judicial action, generally by way of injunction, e.g., mandating the declaration of dividends;¹⁸ (2) appointment of a provisional director or

13 See *infra* notes 62-108.

14 See *supra* note 4. See also *infra* note 77 and accompanying text.

15 See *infra* notes 102-06 and accompanying text (some states have adopted an "equal opportunity" doctrine which gives the minority the right to be bought out if, but only if, the majority causes some of its shares to be repurchased).

16 See *infra* notes 25-39 and accompanying text.

17 See *infra* notes 243-58 and accompanying text.

18 See, e.g., *Patton v. Nicholas*, 154 Tex. 385, 398, 279 S.W.2d 848, 857 (1955), in which the Texas Supreme Court, in considering the lower courts' appointment of a receiver to liquidate a profitable corporation, substituted a new decree that "will include a mandatory injunction requiring the corporation and the petitioner as its dominant officer and stockholder to declare and pay at the earliest practical date a reasonable dividend on the stock of the corporation." The court went on to state:

This means that the amount of such dividend shall be substantial and shall take into consideration, as a strong factor in favor of greater size or amount, the amount of accumulated surplus of the corporation, the fact that the respondents have been wrongfully deprived of their dividends since the beginning, the more or less liquid or 'current asset' character of the large inventory of presumably salable merchandise, as well as such other matters as have logical bearing.

custodian;¹⁹ or (3) a judicially ordered buy-out of the minority at a fair price.²⁰ The first two alternatives carry with them the potential drawback that, if the problem is triggered by animosity among the shareholders, there may be an endless parade back to court to seek additional relief, should the animosity not be resolved.²¹ Therefore, in many instances, the only permanent resolution to the problem would be to eliminate the complaining minority interest by a repurchase of shares.

However, for a judicially mandated repurchase to be an effective remedy for minority shareholders, the price must be "fair," and fairness certainly is an illusive concept. As litigation has demonstrated, the majority and the minority have dramatically different views as to what constitutes a fair price.²² Often the alleged oppressive conduct itself impacts on price: if the majority is taking excessive salaries to the exclusion of the minority, the earnings of the corporation will be thereby reduced and any valuation technique predicated upon earnings, such as capitalized earnings or discounted cash flow, will be "unfair" unless earnings and cash flow are adjusted to reflect the situation that would exist absent the oppressive conduct.²³

One of the major obstacles that minority shareholders have had to confront in dealing with a judicial determination of fair value has been the issue as to whether a discount should be employed in the valuation process.²⁴ The thrust of this Article is to suggest not only that the existence of alternative remedies has "liberalized" the concept of what consti-

Id. See also § 825 (2)(c) of the Michigan Corporation Code, MICH. COMP. LAWS ANN. § 450.1825(2)(c) (West 1973 & Supp. 1988) which gives a circuit court the power to grant relief other than dissolution when the acts of those in control are oppressive.

19 See *In re Jamison Steel Corp.*, 158 Cal. App. 2d 27, 322 P.2d 246 (1958); *Giuricich v. Emtrol Corp.*, 449 A.2d 232 (Del. Super. Ct. 1982); *ARC Mfg. Co. v. Konrad*, 321 Pa. Super. 72, 467 A.2d 1133 (1983). See also statutes in Alabama (ALA. CODE § 10-2A-309 (1987)), Georgia (GA. CODE ANN. § 22-703 (1977 & Supp. 1988)), Hawaii (HAW. REV. STAT. § 415-96 (1985 & Supp. 1988)), Mississippi (MISS. CODE ANN. § 79-4-14.32 (Supp. 1988)), Tennessee (TENN. CODE ANN. § 48-24-303 (1988)), and Virginia (VA. CODE ANN. § 13.1-748 (1985)).

20 See *infra* notes 243-70.

21 See *In re Fulton-Washington Corp.*, 3 Misc. 2d 277, 279, 151 N.Y.S.2d 417, 419 (1956). The court reasoned that:

Whatever may have been the expectations of Burkin and Katz for corporate management based upon harmonious unanimity of action, they were short-lived. . . . A bare enumeration of the times one side or the other has resorted to our courts since 1953 would indicate the litigiousness which has been the chief characteristic of these ventures, but it would not place in true perspective the intransigent hostility of the warring principals which has produced the *paralysis from which these corporations suffer*. The court is painfully aware of the fact that the litigation of the principals thus far has consumed the time and efforts of not less than six Justices sitting in Special Term, has involved one appeal to the Appellate Division of the Second Department, four to the Appellate Division of the First Department, and one appeal to the Court of Appeals.

Id. (emphasis added).

22 *Coggins v. New England Patriots Football Club, Inc.*, 397 Mass. 525, 492 N.E.2d 1112 (1986) (controlling shareholder sought to cash out public at \$15 per share; court awarded rescissory damages in the range of \$80 per share); *Donahue v. Rodd Electrotyping Co. of New England*, 367 Mass. 578, 583, 584 n.10, 328 N.E.2d 505, 510, 511 n.10 (1975) (the Rodds offered to have the Donahue's stock bought out by the corporation at between \$40 and \$200 per share but bought out the elder Rodd out at \$800 per share); *Taines v. Gene Barry One Hour Photo Process, Inc.*, 123 Misc. 2d 529, 474 N.Y.S.2d 362 (1983) (plaintiff's expert valued company at \$20.7 million while defendant's expert testified the value was \$71,000; court considered the testimony of the two experts "absurd").

23 See *infra* text following note 334.

24 See *infra* notes 349-88 and accompanying text.

tutes oppressive conduct, but also that the existence of buy-out relief, coupled with the recognition that those in control owe fiduciary duties to the minority, has dramatically changed the bargaining position of the minority shareholder. In this changed environment, the process of discounting minority shares—a major impediment to the minority shareholder receiving a fair price—is no longer justified.

II. The Basic Problem—Locked-In and Frozen-Out—And Judicial Recognition of the Fiduciary Duty/Partnership Analogy

A. *The Business Judgment Rule*

Deeply imbedded in corporate law is the business judgment rule which is a “judicial creation that presumes propriety, under certain circumstances, in a board’s decision.”²⁵ Early cases reposed almost unfettered discretion in the board of directors. The court, in an early New York case, stated:

[The acts of the directors] in good faith and the exercise of an honest judgment, are valid, and conclude the corporation and the stockholders. Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.²⁶

Similarly, in a frequently cited 1892 decision, the Illinois Supreme Court observed:

It is, however, fundamental in the law of corporations that the majority of its stockholders shall control the policy of the corporation, and regulate and govern the lawful exercise of its franchise and business. Every one purchasing or subscribing for stock in a corporation impliedly agrees that he will be bound by the acts and proceedings done or sanctioned by a majority of the shareholders, or by the agents of the corporation [directors] duly chosen by such majority, within the scope of the powers conferred by the charter. And courts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and that the business would be more successful if other methods were pursued.²⁷

Judicial deference to decisions of the board of directors involving operational matters, when untainted by self-interest, is essential if business is to be conducted efficiently and profitably. The business of business is almost by definition the taking of risks—how much to buy? when?

²⁵ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981). See *Smith v. Van Gorkum*, 488 A.2d 858, 873 (Del. 1985) (directors must act “in an informed and deliberate manner”). There must be a rational basis for the decision and the decision must not be tainted by self-interest. *PRINCIPLES OF CORP. GOVERNANCE* § 4.1(c) (Tent. Draft No. 4, 1985).

²⁶ *Pollitz v. Wabash R.R. Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 723-24 (1912).

²⁷ *Wheeler v. Pullman Iron & Steel Co.*, 143 Ill. 197, 207-08, 32 N.E. 420, 423 (1892) (citations omitted).

to whom to sell? at what price? and much more. Directors are not guarantors of the success of a corporation.²⁸ Nor should they need constantly to look back over their shoulders, fearing their actions, taken in the pressure of the moment, will be judged with the luxury of hindsight.

Directors are guardians of the corporate purse. Thus, decisions as to whom to hire, whom to fire, how much to pay, whether or not to declare a dividend, and whether to repurchase shares are within the province of board discretion.

Yet, this is the stuff out of which the dilemma of the minority shareholder is fashioned.²⁹ The minority shareholder by definition has funds invested in the corporation. Often the shareholder also has invested time and energy and has forsaken other opportunities to participate in the corporate enterprise.³⁰ It is fundamental that a person makes such an investment in order to generate a return. In the sphere of publicly held corporations, directors today are under a duty to maximize shareholder value.³¹

But how can value be realized, let alone maximized, for the minority shareholder in a closely-held corporation. By judicial definition, a closely-held corporation is one in which there is not a ready market for its shares.³² In the past, dividends generally were not declared in close corporations.³³ The practice—or nonpractice, depending upon your perspective—was at least in part tax driven: earnings were either taken out in the form of compensation, which was tax deductible whereas dividends were not,³⁴ or were retained to build value within the corporation so that, when it was later sold, the earnings were in effect taxed at the

28 The riskiness of decision making was recognized by the court in *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982). The court referenced an example by Professor Klein illustrating that riskier ventures may be more profitable. W. KLEIN, *BUSINESS ORGANIZATION AND FINANCE* 147-49 (1980).

29 In *Exadaktilos v. Cinnaminson Realty Co.*, 167 N.J. Super. 141, 154, 400 A.2d 554, 561 (1979), the court stated:

Traditional principles of corporate law, such as the business judgment rule, have failed to curb this abuse [freeze-outs of the minority by those in control]. Consequently, actions of close corporations [rather, actions by those in control] that conform with these [traditional] principles cannot be immune from scrutiny.

For a thorough analysis of the application of the business judgment rule in the closely held corporation, see Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456 (1985).

30 See *In re Mordka v. Mordka Enters., Inc.*, 143 Ariz. 298, 693 P.2d 953 (1984) (plaintiff moved his family from New Zealand and was fired by his brothers four months later); *Harris v. Mardan Business Sys., Inc.*, 421 N.W.2d 350 (Minn. Ct. App. 1988) (plaintiff left longstanding employment with 3M to join new venture); *In re Topper*, 107 Misc. 2d 25, 433 N.Y.S.2d 359 (1980) (petitioner severed a 25-year employment relationship and moved family from Florida to New York).

31 Cf. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (in takeover situation in which it was clear corporation would be sold, directors' role was to act as "auctioneers charged with getting the best price for the shareholders").

32 *Galler v. Galler*, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1964); *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975); *Estate of Schroer v. Stamco Supply, Inc.*, 19 Ohio App. 3d 34, 36, 482 N.E.2d 975, 978 (1984).

33 F. O'NEAL, *CLOSE CORPORATIONS* § 1.07 (3d ed. 1986).

34 I.R.C. § 162(a)(1) (1989). See, e.g., *Mann-Paller Found. v. Econometric Research, Inc.*, 644 F. Supp. 92, 96 (D.D.C. 1986), where the court, in analyzing the plaintiff's action for dividends in *Wilderman v. Wilderman*, 315 A.2d 610 (Del. Ch. 1974), stated that "[t]he controversy [in *Wilderman*] centered around the amount of compensation defendant had caused to be paid to himself. The compensation originated in a policy designed to avoid corporate taxation by paying out net corporate profits in the form of executive compensation to avoid double taxation."

lower capital gains rate.³⁵ As a result, minority shareholders were often left with employment by the corporation as the only means to realize a return on their investment.

If the employment of a shareholder were terminated, a classic case of being "frozen-out," yet "locked-in," would exist.³⁶ The shareholder would be frozen-out of any participation in the earnings of the corporation since no dividends would be paid and no compensation would be earned.³⁷ The shareholder would be locked-in since his capital investment would be held by the corporation with the shareholder having neither a right to withdraw³⁸ nor a ready market for sale of his shares.³⁹

What the minority shareholder wants—a job, dividends, repurchase of his shares, or possibly liquidation of the corporation—can be rejected by those in control and ostensibly justified by resort to the business judgment rule. This dilemma requires the development of an effective remedy for minority shareholders, which must provide recourse in situations in which the minority shareholders are treated unfairly by those in control, while at the same time not undercutting the application of the business judgment rule in appropriate situations.

B. *The Business Judgment Rule v. Duty of Loyalty*

The common law traditionally has recognized that there are situations in which judicial deference to director decision-making will not be recognized. This is reflected in the duty of care/duty of loyalty dichotomy. One of the time-honored duties of an agent,⁴⁰ which has been carried over to directors,⁴¹ is the duty to exercise due care in conducting the affairs of the principal. This creates a quandary: How can courts defer to the judgment of the board of directors and yet oversee the directors' duty of care in exercising the responsibilities of their office.⁴² Courts⁴³ and commentators⁴⁴ have resolved this dilemma by viewing the duty of care as a "process" duty rather than a qualitative duty. If directors follow proper "process," there need be only a rational basis for their deci-

35 I.R.C. § 1201(a) (1986) (amended 1987); I.R.C. §§ 1221-23 (1986).

36 As the court, in *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 849, 353 N.E.2d 657, 662 (1976) stated:

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.

37 *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 367 Mass. 578, 588-89, 328 N.E.2d 505, 513 (1975).

38 Cf. UNIF. PARTNERSHIP ACT § 31(2), 6 U.L.A. 376 (1969) (in a partnership, a partner has an absolute right to "get out," even if "getting out" violates the partnership agreement).

39 [W]hen . . . 'freeze-outs' are attempted by the majority stockholders, the minority stockholders, cut off from all corporation-related revenues . . . cannot easily reclaim [their] capital . . . [a] market is not available [and they] . . . can never 'authorize' . . . dissolution by [their] own vote. . . . Thus, . . . the minority. . . may be trapped.

Donahue, 367 Mass. at 590-92, 328 N.E.2d at 514-15.

40 RESTATEMENT (SECOND) OF AGENCY §§ 377-98 (1957).

41 H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 234 (3d ed. 1983).

42 *Murdock, Careless Directors: A New Public Policy for the State of Illinois*, 77 ILL. B.J. 42, 43 (1988).

43 See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

44 See, e.g., A.L.L., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 43-51 (Tent. Draft No. 4, 1985).

sions.⁴⁵ Rationality, not reasonableness, becomes the norm. As a result, the number of cases in which directors of nonfinancial institutions were held liable for simple negligence, uncomplicated by fraud or self-dealing, was almost infinitesimal. In the decades preceding the 1970s, there apparently were only four such cases.⁴⁶ Clearly, the presumption in favor of the director in duty of care cases is extremely difficult to surmount.⁴⁷

On the other hand, cases involving the duty of loyalty are legion.⁴⁸ Where a conflict of interest or usurpation of a corporate opportunity is alleged, courts have little reticence about inquiring into the underlying facts and, if the allegations are substantiated, setting aside the transaction or affording other relief.⁴⁹ In the duty of loyalty area, the courts are not dealing with untainted decision-making by directors where the sole issue is what is best for the corporation; rather, in this area, director judgment is clouded by considerations as to what is best for the director.

The easiest duty of loyalty case is the direct self-dealing situation in which the director engages in a transaction with the corporation. When the subject matter is property, such as where the director buys stock⁵⁰ from, or sells⁵¹ or rents⁵² real estate to, the corporation, holding the director accountable presents little problem.⁵³ Compensation issues, in which the corporation requires the services of the director and the only

45 *Id.* § 4.01 (c)(3).

46 Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-1100 (1968). Subsequently, there are at least three cases recognizing director liability: *Joy v. North*, 692 F.2d 880 (2d Cir. 1982); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981). However, the *Van Gorkom* decision raised a cry of protest from the corporate bar. See, e.g., Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW. 1 (1985). Accordingly, Delaware adopted a new statute exculpating directors from breaches of the duty of care. See 65 Del. Laws 289 (1985) (codified at DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988)). See also Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987).

47 For example, in *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 183, 237 N.E.2d 776, 781 (1968), the plaintiff alleged that 19 of the 20 major league teams played night baseball, that the Chicago Cubs lost money during the past four-year period, and that the Chicago White Sox outdrew the Cubs during the week, when the Sox played night games, while their attendance was comparable on weekends. Even though the Cubs were a maverick and were losing money, the court stated that directors need not "follow the lead of the other corporations in the field" and that their conduct did not manifest "a clear . . . dereliction of duty." *Id.*

48 A LEXIS search, States library, Omni file, of "conflict of interest w/25 director or officer w/25 corporat!" found 245 cases.

49 Currently, even in the takeover situation, courts have recognized the potential for director self-interest in adopting defensive measures. See, e.g., *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987). This has led to the adoption in Delaware of an "intermediate" standard of review. See Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Proportionality Review*, 44 BUS. LAW. 247 (1989).

50 See, e.g., *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968); *Ross Transp., Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946).

51 See, e.g., *New York Trust Co. v. American Realty Co.*, 244 N.Y. 209, 155 N.E. 102 (1926).

52 See, e.g., *Romanik v. Lurie Home Supply Center, Inc.*, 105 Ill. App. 3d 1118, 435 N.E.2d 712 (1982).

53 Even though determining liability may be straightforward, establishing value is always fraught with difficulty.

issue is amount,⁵⁴ and control issues, in which the corporation takes action to ward off a third party,⁵⁵ are more difficult.

Duty of loyalty cases involve fiduciary duties to the corporation, however. The minority shareholder is only indirectly affected.⁵⁶ The suit is derivative and recovery is generally by the corporation.⁵⁷ Nevertheless, the duty of loyalty doctrine can be an effective weapon for minority shareholders. It has been utilized to prevent the majority from entrenching itself in control by purchasing stock at an inadequate price.⁵⁸ It has also been somewhat effective in preventing those in control from depleting corporate assets and earnings through excessive compensation.⁵⁹ It is also an essential tool in readjusting a balance sheet and income statement for valuation purposes.⁶⁰

But since the duty runs directly to the corporation, it does not afford relief for wrongful conduct aimed directly at the minority shareholder. While courts have recognized a duty by directors and those in control to treat all shareholders equally, the failure to declare a dividend not only is ostensibly protected by the business judgment rule but also impacts all shareholders equally, thus arguably implicating no self-dealing.⁶¹ However, if effective remedies are to be available to minority shareholders, development of the law beyond the duty of loyalty must take place.

C. Shareholder Fiduciary Duty—The Partnership Analogy

1. Development of the Concept of Shareholder Fiduciary Duty

Courts have, over the years, recognized some sort of fiduciary duty of majority or controlling shareholders toward minority shareholders.⁶² Often shareholder and director action were intertwined.⁶³ *Jones v. H.F. Ahmanson & Co.*,⁶⁴ in 1969, appears to be the first "pure" shareholder fiduciary duty case. It is a "pure" shareholder fiduciary case because all actions of the defendant shareholders were taken by them in their capac-

54 See, e.g., *Miller v. Magline, Inc.*, 76 Mich. App. 284, 256 N.W.2d 761, 767 (1977) ("test to be applied was whether . . . compensation was reasonable, and . . . 'reasonableness in this connection must be an area or a broad spectrum of compensation'").

55 See, e.g., *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964).

56 *Hetherington & Dooley, Illiquidity and Exploration: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 12-13 n.30 (1977) ("The notion that the fiduciary obligations of management run only to the corporation provides the minority in close corporations virtually no protection against oppression and exploitation by the control group."). See 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 848 (rev. perm. ed. 1975). Cf. *Donahue v. Rodd Electrotype Co. of New England*, 367 Mass. 578, 589 n.14, 328 N.E.2d 505, 513 n.14 (1975).

57 But see *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); *Lynch v. Patterson*, 701 P.2d 1126 (Wyo. 1985).

58 *Katzowitz v. Sidler*, 24 N.Y.2d 512, 249 N.E.2d 359, 301 N.Y.S.2d 470 (1969). But see *Hyman v. Velsicol Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1951). See also *supra* note 50.

59 *Bessette v. Bessette*, 385 Mass. 806, 808, 434 N.E.2d 206, 208 (1982); *Donahue v. Draper*, 22 Mass. App. Ct. 30, 35, 491 N.E.2d 260, 263-64 (1986).

60 See *infra* notes 335-48 and accompanying text.

61 Cf. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 721-22 (Del. 1971) (In the context of declaring a dividend, the court held that, since "Sinclair received nothing . . . to the exclusion of [the] minority . . . these dividends were not self-dealing." A similar argument could be made with respect to nondeclaration of dividends.).

62 See H. Henn & J. Alexander, *supra* note 41, at 653.

63 *Id.* at 651; *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947).

64 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

ity as shareholders of the operating company, not as directors. The controlling shareholders in the operating company transferred their shares to a holding company and took the holding company public. From their perspective, all they did was transfer their shares, an action to which they were entitled and which was wholly consistent with a fundamental characteristic of the corporate form—the free transferability of shares.⁶⁵ Nevertheless, the court held that the majority had used their control power in the operating company to create indirectly⁶⁶ a market for their shares in the operating company to the exclusion of the minority shareholders.

While disadvantageous actions toward the minority in a close corporation usually involve director action or an amalgam of director and shareholder action, the finding of a fiduciary duty on the part of controlling shareholders in *Ahmanson* set the tone for judicial developments beginning in the mid-1970s. The most significant case is *Donahue v. Rodd Electrottype Co. of New England, Inc.*,⁶⁷ where the Massachusetts Supreme Judicial Court, after analyzing the plight of the minority shareholder in depth, 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.”⁶⁸ The court, quoting Justice Cardozo, described this duty as follows: “Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”⁶⁹ The court saw the standard applicable to controlling shareholders to be “more exacting than the traditional good faith and inherent fairness standard” that generally applies to corporate directors.⁷⁰

In *Donahue*, the court was confronted with a close corporation that initially had two shareholders holding two hundred shares and fifty shares, respectively. The controlling shareholder transferred some shares to his children and the corporation then redeemed forty-five of his shares with the result that each child would have fifty-one shares and the minority shareholder, fifty. The minority shareholder sought to have her shares repurchased by the corporation as well.

The court adopted an “equal opportunity”⁷¹ rule and required either that the corporation repurchase the minority’s shares at the same price as that paid to the father or that the father repay to the corporation the consideration he had received for his shares. In adopting this rule, the court found two evils in the transaction by the majority which disadvantaged the minority. First, citing *Ahmanson*, the court found that those

65 Treas. Reg. § 301.7701-2(a)(1)(vi), -2(e) (1987).

66 The majority had transferred their shares in the operating company to a holding company and took the holding company public. The minority retained their shares in the operating company for which there was no public market.

67 367 Mass. 578, 328 N.E.2d 505 (1975). *Shepard’s* indicates this case has been cited over 80 times.

68 *Id.* at 593, 328 N.E.2d at 515 (footnotes omitted).

69 *Id.* at 594, 328 N.E.2d at 516 (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928)).

70 *Id.* at 595, 328 N.E.2d at 516.

71 *Id.* at 598-600, 328 N.E.2d at 518-19.

in control had made a market for the father's shares but not the minority's.⁷² They transformed the father's previously illiquid investment into a liquid one, to the exclusion of the minority shareholder. Second, the transaction provided personal access to corporate assets on a discriminatory basis. In effect, the transaction was a preferential distribution of the assets of the corporation.⁷³

The following year, the Massachusetts court followed, but refined, its decision in *Donahue*. This time the court was confronted with what is probably a more typical problem in the close corporation—termination of the employment of a minority shareholder. In *Wilkes v. Springside Nursing Home, Inc.*,⁷⁴ the plaintiff had been one of the four investors who had organized a close corporation in 1951 to operate the Springside Nursing Home. Each investor was a director and was assigned particular responsibilities for which, beginning in 1952, each received the same compensation as the others. In 1959, one of the original four sold his shares to a new investor who, in 1965, purchased the corporate property adjacent to the nursing home. Wilkes successfully argued for a higher price than the new investor had wanted to pay and this triggered a deterioration of their relationship. The strained relationship spread to the other investors as well and, in 1967, Wilkes indicated his desire to sell. Instead, at a directors' meeting, his salary was terminated and, at the annual shareholders meeting, he was not elected a director⁷⁵ or an officer.

The court stated that it was immaterial whether Wilkes' claim was viewed as arising under partnership law or corporate law involving close corporations.⁷⁶ Under either approach, those in control would have breached their fiduciary duty to him by frustrating his purposes in entering the venture and by denying him an equal return on his investment.

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.' 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.' . . .

⁷² *Id.* at 598-99, 328 N.E.2d at 518.

⁷³ *Id.* at 599, 328 N.E.2d at 519. The court stated that the purchase of the father's shares had the following effect:

In exchange for his shares, he receives a percentage of the contributed capital and accumulated profits of the enterprise. The funds he so receives are available for his personal use. The other stockholders benefit from no such access to corporate property and cannot withdraw their shares of the corporate profits and capital in this manner unless the controlling group acquiesces.

Id.

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

⁷⁵ There apparently was no cumulative voting, for otherwise Wilkes would have been able to insure his election as a director. However, the majority of the board could have ousted him as an officer and, from a return-on-investment standpoint, compensation as an officer is much more significant than compensation as a director.

⁷⁶ 370 Mass. at 848, 353 N.E.2d at 661.

[B]arring him from corporate office . . . [also] severely restricts his participation in the management of the enterprise⁷⁷

However, the *Wilkes* court did recognize that "[t]he 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."⁷⁸ Where the minority alleges a breach of fiduciary duty, the majority is entitled to demonstrate a legitimate business purpose for their actions.⁷⁹ But even if the majority can advance an ostensible business purpose, the minority must have the opportunity to show that "the same legitimate [business] objective could have been achieved through an alternative course of action less harmful to the minority's interest."⁸⁰

In *Wilkes*, there was no evidence demonstrating a legitimate business purpose for terminating Wilkes. Accordingly, the court found that the majority had breached its fiduciary duties to Wilkes and that Wilkes was entitled to money damages for "the salary he would have received had he remained an officer and director of Springside."⁸¹

This pair of Massachusetts cases is the leading exposition of the controlling shareholder fiduciary duty. Both cases have been cited in several other jurisdictions,⁸² though not necessarily followed,⁸³ and have been characterized as "pioneer[ing] in developing an effective cause of action for minority shareholders who have been denied their fair share of benefits in close corporations."⁸⁴

2. Limitations on the Fiduciary Duty Approach

From the standpoint of providing an effective remedy generally for minority shareholders, subsequent cases have suggested three possible problem areas with the *Donahue/Wilkes* approach. The first limitation is that the corporation in question must be a close corporation; the second, that the relationship between the shareholders must be that of partners; and the third, that justification of the transaction under the business purpose doctrine must be excluded.

Two Minnesota decisions illustrate the first two problem areas. In *Sundberg v. Lampert Lumber Co.*,⁸⁵ an action was brought by minority share-

⁷⁷ *Id.* at 849-50, 353 N.E.2d at 662 (citations omitted). Thus, termination would "frustrate" his purposes and "deny him an equal return." *Id.* at 850, 353 N.E.2d at 663.

⁷⁸ *Id.* at 850-51, 353 N.E.2d at 663.

⁷⁹ *Id.* at 851, 353 N.E.2d at 663 (regarding the "business purpose" doctrine, see the cases and law review articles cited by the court). See also *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), where the doctrine was adopted by Delaware in squeeze-out mergers, and *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), where it was abandoned. The doctrine, however, appears alive and well in New York and Massachusetts. See *Leader v. Hycor, Inc.*, 395 Mass. 215, 479 N.E.2d 173 (1985); *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 473 N.E.2d 19, 483 N.Y.S.2d 667 (1984).

⁸⁰ 370 Mass. at 851-52, 353 N.E.2d at 663.

⁸¹ *Id.* at 854, 353 N.E.2d at 665.

⁸² As of this writing, *Shepherd's* indicates that *Donahue* has been cited 89 times in 25 jurisdictions and *Wilkes* has been cited 38 times in 11 jurisdictions.

⁸³ See, e.g., *Toner v. Baltimore Envelope Co.*, 304 Md. 256, 498 A.2d 642 (1985) (declined to hold selective purchase as per se breach of duty).

⁸⁴ *Sugarman v. Sugarman*, 797 F.2d 3, 7 (1st Cir. 1986).

⁸⁵ 390 N.W.2d 352 (Minn. Ct. App. 1986).

holders to require the corporation to repurchase their shares, representing about ten percent of the outstanding shares. The Lampert family owned about seventy percent of the shares and another twenty percent was held by ninety other shareholders. During the previous thirty years, there had been eighty-five redemptions of shares, but in only two cases did the redemptions exceed 1000 shares. Because the president's sister had been using company funds to pay her bills, he decided to repurchase her shares to stop her from "leaning on the company."⁸⁶ Her 7,222 shares were purchased in 1980 for about \$1.2 million. Shares were repurchased from other family members in 1981 for \$386,063 and \$432,562. The plaintiffs were not aware of these repurchases until the annual shareholders meeting in March 1981, and in May they asked the corporation to repurchase their shares for approximately \$2 million. In September, the board suspended all redemptions to avoid a "run on the bank."⁸⁷ Plaintiffs' request was the first to be denied by the corporation.

The trial court ordered redemption but the court of appeals reversed on three bases: (1) the Minnesota alternative remedy statute⁸⁸ authorized a judicially ordered buy-out only for closely held corporations, defined as those with not more than thirty-five shareholders;⁸⁹ (ii) the *Donahue* "equal opportunity" duty for controlling shareholders was also limited to closely held corporations; and, (iii) there was no breach of the duty of care in repurchasing the shares of family members, apparently because the plaintiffs had not argued that the family repurchases harmed the corporation in any way.

The *Lampert Lumber* court clearly engaged in an unduly restrictive reading of *Donahue*. While it is true that *Donahue* analogized a close corporation to a partnership in the process of imposing a fiduciary obligation on those in control to treat the minority fairly, *Donahue* also recognized that one of the characteristics of a closely held corporation is the lack of a market for its shares. It is this lack of a market that enables those in control to "freeze-out" the minority.⁹⁰

Donahue should not be read as condoning freeze-outs in nonclosely held corporations. *Lampert Lumber* involved what has been referred to as a "quasi-public" corporation.⁹¹ It might better be referred to as a "quasi-close" corporation. Though there were 122 shareholders, there was no market for minority shares for the same reason that there is no market for minority shares in a close corporation: no power, no market. Even in Delaware, where squeeze-outs can be accomplished without a business purpose, the majority nevertheless must demonstrate the "inherent fairness" of the bargain which encompasses "fair dealing" and "fair price."⁹² The preferential distribution of assets in *Lampert Lumber*

86 *Id.* at 354.

87 *Id.* at 355.

88 MINN. STAT. § 302A.751 (1984).

89 *Id.* § 302A.011.

90 *Donahue v. Rodd Electrotypes Co. of New England*, 367 Mass. 578, 590-92, 328 N.E.2d 505, 514-15 (1975).

91 Knauss, *Corporate Governance — A Moving Target*, 79 MICH. L. REV. 478, 481 (1981).

92 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983).

could have been invalidated in Delaware under *Sinclair Oil Corp. v. Levien*.⁹³

Minnesota threw another wrench into the development of effective remedies for minority shareholders in *Harris v. Mardian Business Systems, Inc.*,⁹⁴ in which the court held that the plaintiff, who had been induced by the defendant to leave a secure position with Minnesota Mining & Manufacturing, was an employee, not a partner. According to the court, shareholders in a close corporation, like partners in a partnership, owe fiduciary duties to one another. However, "since partners do not owe a fiduciary duty to employees, neither should shareholders."⁹⁵ Although the plaintiff held five percent of the shares and had an option to acquire five percent more, the court noted that the defendant had organized the corporation himself and that the plaintiff had acquired his shares as part of a compensation package. Thus, the plaintiff was an employee, not a partner, and his relationship with the defendant was not controlled by fiduciary principles.

It is paradoxical that, under the partnership analogy, holders of a fifty-percent interest have been protected by the fiduciary duties imposed upon those in control.⁹⁶ Even holders of seventy-five percent of the shares have had a cause of action against a twenty-five percent shareholder who improperly exercised a veto power.⁹⁷ Yet a ten-percent holder goes unprotected under the initial holding in *Harris*. This holding should be contrasted with the New York decisions finding "oppressive" conduct which justified a judicially ordered buy-out when a person was induced to leave employment elsewhere to join the defendant and was later fired.⁹⁸ The New York statute does require, however, a threshold of twenty percent to bring suit.

The Minnesota court's decision may be justified on an alternative basis. Citing *Wilkes*, the *Harris* court pointed out that the defendant demonstrated a legitimate business purpose for terminating Harris—sales and morale in the United States operations which Harris supervised were low, and Harris failed to follow proper business procedures.⁹⁹ Moreover, Harris was offered alternative employment as a regional sales manager at the same salary and "ha[d] not suggested any less drastic alternative."¹⁰⁰

Viewed from this perspective, *Harris* adds a helpful gloss to *Wilkes*. In *Wilkes*, the court suggested that, if the majority had a legitimate business purpose for their actions, it was open to the minority to suggest a less drastic alternative. In *Harris*, the court accepted the majority's claim that Harris was not competent to run the United States operations. Had

93 280 A.2d 717 (Del. 1971).

94 421 N.W.2d 350 (Minn. Ct. App. 1988).

95 *Id.* at 353.

96 *Zimmerman v. Bogoff*, 402 Mass. 650, 524 N.E.2d 849 (1988); *68th Street Apartments, Inc. v. Lauricella*, 142 N.J. Super. 546, 362 A.2d 78 (N.J. Super. Ct. Law Div. 1976), *aff'd*, 150 N.J. Super. 47, 374 A.2d 1222 (N.J. Super. Ct. App. Div. 1977).

97 *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

98 *See infra* notes 274-78 and accompanying text.

99 421 N.W.2d at 353.

100 *Id.*

the majority shareholder simply fired Harris, he could have claimed he was competent to handle a less demanding position and should have been retained in some capacity. But here, the majority shareholder pre-empted this argument by offering a lesser position which Harris declined to accept.

Caution must be employed when the majority seeks to justify its conduct by resorting to the "legitimate business purpose" doctrine. While several courts have approved *Donahue's* equal opportunity doctrine,¹⁰¹ both *Lampert Lumber* and *Toner v. Baltimore Envelope Co.*¹⁰² have rejected the doctrine, at least in part because of a business purpose justification. *Lampert Lumber* has already been criticized for permitting the majority to make preferential use of corporate assets;¹⁰³ *Toner* is of the same genre.

In *Toner*, two shareholders, Charles and Elma, each owned fifty percent of the voting shares. Elma and her daughters also owned about fifty percent of the nonvoting shares. Toner was Charles' sister and owned about twenty percent of the nonvoting shares. Elma wanted to accept an offer to sell the company's assets and then liquidate. However, Charles, the president, wanted to continue the business in operation. Both Charles and Toner wanted to acquire Elma's holdings but neither had the requisite funds. Charles joined forces with another director and caused the corporation to borrow \$300,000 to acquire Elma's nonvoting shares; the other director then purchased her voting shares for \$100,000.

The court recognized that majority shareholders have fiduciary obligations in certain matters;¹⁰⁴ it declined, however, to find that a selective purchase of shares by the majority is a per se breach of fiduciary duty.¹⁰⁵ The court's rejection of a per se rule is acceptable: it postulated that one minority shareholder could join a competitor and then use his shareholder status to inspect the corporate books and records. In such a situation, the court opined that, should the corporation decide to purchase the disloyal shareholder's shares, another minority shareholder ought not to be able to use this situation to force the corporation to buy her shares as well.¹⁰⁶

But the court then leapt from this example to justify withholding relief from Toner on the basis that Charles and the other director believed it was in the best interests of the other shareholders to prevent dissolution and maintain the business in operation. What the court failed to recognize was that Charles and the other director could have purchased the "business" out of a dissolution proceeding. In such a circumstance, Toner would have been, in effect, "bought out" and the two directors could have leveraged the corporate assets to assist in financing

101 *Tillis v. United Parts, Inc.*, 395 So. 2d 618 (Fla. Dist. Ct. App. 1981); *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Estate of Schroer v. Stamco Supply, Inc.*, 19 Ohio App. 3d 34, 482 N.E.2d 975 (1984).

102 304 Md. 256, 498 A.2d 642 (1985).

103 See *supra* notes 91-93 and accompanying text.

104 304 Md. at 267-68, 498 A.2d at 647-48.

105 *Id.* at 273, 498 A.2d at 650.

106 *Id.* at 276, 498 A.2d at 652.

the purchase price. This practice is analyzed in the next section of this Article.¹⁰⁷

Clearly, in those jurisdictions that recognize the partnership analogy and hold controlling shareholders to stringent fiduciary duty standards, the minority shareholder is in a much stronger position than she was before the development of this body of law. However, except in rare circumstances,¹⁰⁸ the minority shareholder remains "within" the corporation. While she may be able to challenge excessive compensation or self-dealing under the duty of loyalty, and may challenge termination of employment or heavy handedness under the shareholder fiduciary duty concept, her presence in the corporation is clouded by the prospect of continued litigation and the spectre of continued animosity. Objectively, it may be better that the parties live apart. Therefore, the question becomes: may the minority shareholder retrieve the value of her investment in the corporation? Basically, two possibilities exist: dissolution of the corporation or repurchase of the minority's shares by the corporation or by the controlling shareholders.

III. Dissolution as a Resolution

At the turn of the century, corporation statutes did not provide for dissolution of a corporation at the instance of a minority shareholder.¹⁰⁹ Judicial decisions generally declined to imply the power to dissolve. However, in 1933, Illinois enacted its Business Corporation Act which became the model for other states and for the Model Business Corporation Act.¹¹⁰ Section 86 of the Illinois Act,¹¹¹ and comparable provisions in other jurisdictions, gave the courts power to dissolve corporations upon the petition of a shareholder if certain jurisdictional elements, particularly "oppressive" conduct by controlling shareholders, were present. Unfortunately, courts hesitated to decree this relief which they viewed as a "drastic remedy." Accordingly, the availability of this form of relief for minority shareholders will turn upon what conduct is oppressive and whether courts will view this relief as drastic.

A. *Is Dissolution a Drastic Remedy?*

The cases in which courts refer to dissolution or liquidation as a drastic remedy,¹¹² if not legion, are certainly numerous. In characterizing dissolution as a drastic remedy, courts either (i) reflect a concession

¹⁰⁷ See *infra* notes 128-35 and accompanying text.

¹⁰⁸ A rare exception would occur when those in control cause the corporation to repurchase their own shares and the jurisdiction recognizes the *Donahue* equal opportunity doctrine, which requires the purchase of the minority shareholder's shares as well. See *supra* note 101.

¹⁰⁹ See, e.g., *Reid Drug Co. v. Salyer*, 268 Ky. 522, 105 S.W.2d 625 (1937); *Fix v. Fix Material Co.*, 538 S.W.2d 351, 357 (Mo. Ct. App. 1976); *Bowman v. Gum, Inc.*, 321 Pa. 516, 184 A. 258 (1936).

¹¹⁰ See *infra* notes 199-202 and accompanying text.

¹¹¹ ILL. REV. STAT. ch. 32, para. 157.86 (1983). The Illinois Business Corporation Act of 1983 repealed the 1933 Act. For the present grounds for judicial dissolution of a corporation, see ILL. REV. STAT. ch. 32, para. 12.50 (1987).

¹¹² A LEXIS search in the States library, Omni file, for "dissol! or liquidat! w/15 drastic or severe w/50 corporation" produced 66 cases. This search also produced 30 cases respectively in the Genfed library, Courts file.

theory of corporate law by offering obeisance to the legislature: when an artificial entity comes into existence through the will of the legislature, courts ought not lightly to preside over the death of such an entity;¹¹³ or (ii) fail to recognize the distinction between dissolution and liquidation, that is, they reflexively assume that death of the entity also signals the death of the enterprise.¹¹⁴

The validity of the first possibility warrants little discussion since it has almost no merit. The history of legislative activity for the past twenty years or so has clearly evidenced a permissive or enabling approach by the legislatures of the various states as opposed to a prescriptive approach. Delaware, generally considered a "management" state, has been accused of leading a legislative "race for the bottom."¹¹⁵ Even Illinois, generally viewed as a "shareholder" state, amended its Constitution in 1970, *inter alia*, to eliminate the constitutional mandate for cumulative voting that had been in effect since the adoption of its 1870 Constitution.¹¹⁶ Moreover, Illinois, in adopting its new Business Corporation Act of 1983, arguably a "balanced" statute, was aware that "more and more small and medium-sized Illinois corporations are being chartered outside our state."¹¹⁷ Legislatures are not seeking to control corporations as much as to curry their favor. Thus, corporate statutes are not some legislative hoop through which one must jump in order to be endowed by the legislature with the privilege of doing business in the corporate form; rather they are an attempt to provide a format in which business can prosper, pay taxes, and employ voters.

1. Is Going Concern Value Lost in Dissolution?

The real reason that courts view dissolution as a drastic remedy is the concern that death of the entity leads to death of the enterprise. In other words, the fear is that dissolution inexorably leads to liquidation which inexorably leads to destruction of the going concern and to the sale of "dead" assets. Illustrative of this concern is the statement of the Oregon Supreme Court in *Jackson v. Nicolai-Neppach Co.*, affirming the trial court's dismissal of a petition for dissolution, notwithstanding a longstanding deadlock: "The plant employs about 65 men and there is a public interest in preserving it as a going concern."¹¹⁸

The court opined that the two parties would either settle their differences or would not. If they composed their differences amicably—fine; if not, the court speculated:

113 See, e.g., *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash. 2d 944, 948, 632 P.2d 512, 514 (1981) ("At common law, many courts refused to intervene in shareholder disputes since the State licensed the corporation, and as such the State and not the courts had the authority to dissolve the corporation.").

114 For evidence that this is not the case, see *infra* notes 136-48 and accompanying text.

115 Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 665-66 (1974).

116 See ILL. CONST. art. XI, § 3 (1870); ILL. CONST. art. XIII, § 6 (1970), Transition Sched. § 8.

117 Letter from Jim Edgar, Secretary of State of Illinois, to the Citizens of Illinois, reprinted in *The Business Corporation Act of 1983* (Secretary of State pamphlet 1984).

118 219 Or. 560, 586, 348 P.2d 9, 22 (1959).

[W]e think that denial of relief at the present time may well lead to a fairer buy-sell agreement than the remedy of enforced liquidation, a remedy which might destroy the going concern value of the plant and give both parties an unduly small return for the value of their investment.¹¹⁹

The court unfortunately offered no insight for its opinion that failure to resolve differences amicably would lead to a fair buy-sell agreement. History in the form of litigation in other jurisdictions indicates that such optimism is not warranted.¹²⁰ Absent goodwill on the part of the majority, it is unrealistic to expect that the party not in control will receive a fair price, short of actual or potential judicial intervention. The notion of fair price is predicated upon the model of arm's length bargaining between a willing buyer and a willing seller. But if the person in control has no impetus to buy, and if the minority has no alternative market and thus no leverage, we can expect that the price agreed upon will be heavily weighted to the advantage of those in control.¹²¹

Nevertheless, the Oregon court clearly believed that dissolution would be disadvantageous to both parties because it would "destroy the going concern value of the plant" and give each shareholder an unduly small return on investment. The question, of course, is "who is going to buy?" And the implicit answer of the Oregon court is "no one," at least no one at a fair price.¹²²

But generally there will be at least one potential buyer, namely, the person or persons who were in control prior to the dissolution. A significant issue will be the price that is paid. It rarely will be too high; it often will be alleged to be too low. But the fairness or lack of fairness of price impacts only the shareholders *inter se*. The real issue from a policy or public interest standpoint is what is bought. If the assets are dismembered in the sense that the enterprise is fragmented, the going concern value lost, employees terminated, and products or services lost, then there is a public concern with the termination of corporate existence.¹²³ Often with a third party bidder and invariably with a shareholder bidder, however, what will be purchased from the liquidating corporation are the assets of the enterprise as a going concern. In such a case, the only real change, besides the elimination of the minority shareholders, will be the

119 *Id.* at 587, 348 P.2d at 22.

120 See *infra* notes 153-74 and accompanying text.

121 *Donahue v. Rodd Electrotypes Co. of New England*, 367 Mass. 578, 592, 328 N.E.2d 505, 515 (1975) ("Majority 'freeze-out' schemes . . . are designed to compel the minority to relinquish stock at inadequate prices.").

122 For a different view of what occurs when a business is liquidated and the assets sold, see *Graham v. McAdoo*, 135 Ky. 677, 684, 123 S.W. 260, 263 (1909), where the court stated:

[T]he chancellor will doubtless order the sale on such terms as to time as will enable either party to purchase it if they desire, and this will insure such an active competition between the factions, and perhaps others, for the property, as will insure that there will be no sacrifice of it at the sale.

123 This concern is reflected today in the somewhat analogous situation of tender offers in which state legislatures are enacting antitakeover techniques to protect local corporations, and the jobs they represent, from hostile bidders who sell off assets or terminate employees after the acquisition in order to be able to service the debt that they incurred. See Waldman, *New RJR Chief Faces a Daunting Challenge at Debt-Heavy Firm*, Wall St. J., Mar. 14, 1989, at 1, col. 6; Bartlett, *New Type of Owner Emerges in Wave of Company Buyouts*, N.Y. Times, Nov. 8, 1988, at A1, col. 3.

name on the door. No employees will be terminated, nor any goods or services lost.

This situation is illustrated in the context of a voluntary dissolution in *Lebold v. Inland Steel Co.*,¹²⁴ where Inland Steel, in its capacity as owner of eighty percent of the shares of a captive steamship company, caused the steamship company to be dissolved, bid on the three boats owned by the steamship company at \$1,120,000 (the acknowledged fair value of the boats), distributed to the minority shareholders their pro rata portion of the proceeds, and continued the transportation business of the steamship company without interruption. The *Inland Steel* court found that the so-called dissolution was merely a device whereby the steel company appropriated the business of the steamship company to the detriment of the minority shareholders of the steamship company. The *Inland Steel* court recognized that there "was value over and above physical assets"¹²⁵ of the steamship company, namely, its "going concern" value, and instructed the district court to compute damages based on the difference between the proceeds received by plaintiffs from the sale of assets and the value of the steamship company as a going concern.¹²⁶

Inland Steel demonstrates that dissolution is not necessarily synonymous with either destruction of the enterprise or with loss of going concern value. To maintain the enterprise in existence or to recoup going concern value, however, it is necessary that there be either a third party bidder who values the business as a whole or a shareholder bidder who has the wherewithal to continue the business and fund the purchase price.¹²⁷

2. Financing the Buy-out of the Business as a Going Concern

At the risk of oversimplification, businesses can be divided into two categories: those that are labor-intensive, such as service businesses, and those that are capital-intensive, such as retail, wholesale, and manufacturing operations.¹²⁸ In a service operation, such as a real-estate brokerage firm or an advertising firm, the real assets are the customers who generally follow the individual principals as opposed to having loyalty to the juristic entity.¹²⁹ In such a case, the most important "hard" asset may be the lease on the premises where the business is conducted. Such an asset often can be acquired merely by undertaking the future contractual obligation of the dissolved corporation on the lease. Thus, if the

124 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942).

125 *Id.* at 374.

126 *Id.* at 375.

127 The enterprise can be continued even if pricing is predicated upon a distress sale situation; however, in this situation, as foreseen by the court in *Nicolai-Neppach*, the shareholders, in reality only the nonpurchasing shareholders, would receive an unduly small return for their investment. To realize going-concern value, either a competitive bidding, nondistress environment is necessary or, with respect to a shareholder bidder, some legal constraint must be in place to insure that a fair price is paid.

128 The dichotomy between these two types of businesses, and the implications for minority shareholders, is discussed *infra* notes 153-74 and accompanying text.

129 See, e.g., *Duane Jones Co. v. Burke*, 306 N.Y. 172, 117 N.E.2d 237 (1954); Brill, *In the War for Dick Lord's Ad Agency, Tough Wasn't Smart*, Am. Law., May 1988, at 30.

service business was viable prior to dissolution, it will most likely continue, in one form or another, after dissolution.

With respect to capital-intensive businesses, the key to continuation is financing. As the leveraged buy-outs of the last few years have demonstrated, if a business is successful, its acquisition can be financed, even if the sums are enormous.¹³⁰ The management of public companies, holding only a small percentage of the shares, has often managed to fund the buy-out of the public shareholders, in part from the ability of the company's assets to provide security for financing the buy-out.¹³¹

In a closely-held corporation, if a shareholder, rather than a third party, is the purchaser, all that needs to be financed, in effect, is the interest of the outgoing shareholder. If, for example, the plaintiff is a twenty-percent shareholder and the value of the business is one-hundred units, all that need be financed is twenty units. On the other hand, if the falling out is between two fifty-percent shareholders, then fifty units must be financed. Failure to understand these simple economics may account for the hesitancy of courts and legislatures to entertain dissolution at the suit of a "small" minority shareholder.¹³² Because liquidation is viewed as a drastic remedy, courts apparently conclude that a shareholder with a modest stake should not be able to set in motion such an untoward event. On the other hand, if dissolution is simply viewed as financing the buy-out of the minority interest, the smaller the interest, the simpler the financing.

Key factors in determining whether a shareholder can acquire the business after dissolution are: (i) the shareholder's personal financial situation; (ii) the percentage interest of the outgoing shareholder; (iii) the extent to which the assets of the business are already leveraged; and, (iv) the method of valuation. Obviously, if the shareholder has access personally to funds adequate for the acquisition, there is no problem. In many instances, however, the bulk of the personal assets of a shareholder in a closely-held corporation is tied up in the corporation.¹³³ Thus, in most cases, the other three factors will be controlling.

As indicated previously, the impact of the first of these factors, the percentage holding of the minority, varies directly with the size of the holding. If the percentage held by the minority is small, the difficulty in financing that part of the business represented by the minority interests will also be small. Yet, a 1977 study¹³⁴ indicates that the relationship between the size of the minority interest and the likelihood of the courts granting relief when involuntary dissolution is sought is an inverse relationship: the smaller the interest, the less likely the grant of relief. From

130 See Wallace, *Complex Ties in Battle for Nabisco*, N.Y. Times, Nov. 8, 1988, at D7, col. 1; Sterngold, *Suitors Quarrel Over RJR Nabisco*, N.Y. Times, Nov. 8, 1988, at D1, col. 2; Kilborn *Takeovers: A Friendly Climate*, N.Y. Times, Nov. 6, 1988, at 1, col. 2.

131 See *supra* note 130.

132 Hetherington & Dooley, *supra* note 56, at 31 ("It thus appears that the judicial reluctance to order dissolution is most clearly manifested in suits by small minorities."). In addition, some statutes condition suits for dissolution upon the petitioner holding a threshold percentage of shares. See, e.g., N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986) (20%).

133 2 F. O'NEAL, *CLOSE CORPORATIONS* § 9.02 (3d ed. 1988).

134 Hetherington & Dooley, *supra* note 56.

the standpoint of the conventional wisdom that dissolution is a drastic remedy, this result is rational: if the economic stake is small, it does not warrant extraordinary relief. But in reality, the result is irrational: that which can most easily be accomplished is least often undertaken. As a result of the courts' failure to understand the true impact of dissolution, we have the paradoxical situation in which the shareholder with the least leverage—who is thus most in need of judicial intervention—is the least likely to obtain relief.

The second factor, the degree to which the assets are already leveraged, is relevant because of the impact it has upon the ability of the buying shareholder to generate funds from the assets of the business to fund the pay-out to the minority shareholder. For example, if the adjusted book value of the business is one-hundred units, working capital is a wash, and the fixed assets of two-hundred units are encumbered by security interests of one-hundred units—and if the nature of the business and character of the assets would warrant moving the financing level from fifty to sixty-five percent—the additional thirty units of cash generated by the refinancing would be sufficient to buy-out a thirty-percent shareholder, assuming the value of the shareholder's interest was predicated upon adjusted book value.¹³⁵ On the other hand, if the assets were already leveraged with 110 units of debt, refinancing could only generate 20 units of cash. Further, if the assets were already leveraged at the 130 level, no additional funds could be generated unless the lenders could be induced to take a less secure position by providing greater than sixty-five percent financing.

Finally, the last factor, the method of valuation, is relevant because of the impact it has on the size of the payout to minority interests, which in turn affects the ease of financing. The previous example was predicated upon an adjusted book value method of valuation. If the assets, however, are sold to a control shareholder at less than the appraised value, this would facilitate such shareholder's ability to fund the payout for the minority interest. Nonetheless, the ease of financing for the majority should not be a relevant factor in valuing the minority's interest.

With reference to the foregoing example, if the assets were valued at 177 units instead of 200, and if they were still encumbered with 110 units of debt, the interest of the minority would be $30\% \times (177-110)$, or 20 units. In other words, with a lower valuation upon liquidation, the control shareholder would be able to fund the payout of the minority shareholder even with the business being more highly leveraged prior to the dissolution. On the other hand, should the assets be valued higher than the adjusted book value, for example, to reflect capitalized earnings as a going concern, the burden of funding the payout by the majority for the minority interest would be exacerbated, rather than facilitated.

What the foregoing examples illustrate is that the judicial expectation that dissolution and death are synonymous is not sound, even from a

¹³⁵ "Adjusted book value" means the book value of a company but with "adjustments" to reflect the current value of investment-type assets, land and buildings, and equipment. See S. PRATT, VALUING A BUSINESS—THE ANALYSIS AND APPRAISAL OF CLOSELY-HELD COMPANIES 70-71 (1981).

theoretical standpoint. We would expect that service businesses, or capital-intensive businesses that are not overly leveraged, should continue in existence even after the juristic entity in which they were held has been dissolved. The question then becomes whether reality accords with such an expectation.

3. Myth v. Reality: Dissolved Businesses Do Continue

Professors Hetherington and Dooley, in their 1977 study, obtained data on over fifty cases in which involuntary dissolution was sought.¹³⁶ In twenty-five cases, plaintiffs were unsuccessful;¹³⁷ in twenty-seven cases, either the complaint was sustained on appeal or some form of relief was awarded.¹³⁸ Where the plaintiffs were successful, in only six of twenty-seven cases was the business liquidated.¹³⁹ In twenty cases, the business was sold, either to the other shareholders (seventeen cases)¹⁴⁰ or to a third party (three cases).¹⁴¹ Even where the court declined to grant dissolution, the business was liquidated in three instances.¹⁴² In fourteen cases, the plaintiffs were bought out¹⁴³ and in two cases the business was sold to a third party.¹⁴⁴ The conclusion to be drawn from this data is that death of the enterprise when a business is liquidated is the exception rather than the rule. On the other hand, even where relief in the form of dissolution is not granted, the business may not survive.

What is also instructive is the background in the nine cases of fifty-two¹⁴⁵ in which the business was liquidated. Of the six cases where the business was liquidated following the grant of affirmative relief to the plaintiff, three involved marginal or failing businesses. It is not unlikely that these businesses would have been liquidated anyway. Witness the fact that liquidation occurred in three cases in which the plaintiff was denied relief, two of which involved marginal or failing businesses.¹⁴⁶ It is questionable, therefore, whether the formal act of judicial dissolution has any significant impact upon whether the business ultimately will be liquidated. If the business is viable, it will be continued, either by the other shareholders or a third party; if the business is not viable, it will be terminated, irrespective of judicial action or inaction.

This conclusion is reinforced by recasting the Hetherington and Dooley data regarding the nine firms that they treated as having been liquidated. In three cases, the businesses were continued after liquidation and, in another, the business was at least partially continued. One

136 Hetherington & Dooley, *supra* note 56, at 30, 64-75 (tables).

137 *Id.* at 30, 64-69 (table I). Note that Professors Hetherington and Dooley included two cases for which information regarding the final disposition was unavailable in their total number of cases in which the plaintiff was unsuccessful. Therefore, for the purposes of this discussion, these two cases have been omitted.

138 *Id.* at 30, 70-75 (table II).

139 *Id.*

140 *Id.*

141 *Id.*

142 *Id.* at 31, 64-69 (table I).

143 *Id.*

144 *Id.*

145 *Id.* at 33.

146 *Id.* at 33, 64-69 (table I, cases 6, 9).

case involved a profitable apartment building that was sold to a third party; another, a network of family corporations that was apportioned among the shareholders; and a third, successful service businesses that were operated separately after dissolution.¹⁴⁷ The case in which there was a partial continuation was one in which the defendant was involved in a competing firm which acquired some of the dissolved corporation's business.¹⁴⁸ When the data is recast in this light, it is evident that only the failing or marginal businesses failed to survive. One could conclude that not only does judicial dissolution have no *significant* impact upon whether a business will survive or die, it has none at all.

B. *Is Dissolution an Effective Remedy?*

Still, while dissolution is not a drastic remedy, neither is it necessarily an effective remedy. Its lack of effectiveness from the standpoint of a minority shareholder stems from two related factors. The first factor is that dissolution impacts minority shareholders disparately, depending upon the nature of the business. Some of the adverse repercussions of this factor could be mitigated were it not for the second factor: the dissolution concept, so long as it is viewed as corporate death, is inconsistent with a valuation theory that would provide minority shareholders with a fair price.

1. Circumstances in Which It Is Better to Be "Locked-In" Than "Bought Out"

According to conventional wisdom, the primary vulnerability of a minority shareholder is the spectre of being "locked-in," that is, having a perpetual investment in an entity without any expectation of ever receiving a return on that investment. That this spectre is both real and devastating cannot be gainsaid. There are circumstances, however, in which the minority does not want to "go out," *at least at the price which is in prospect*. If what the minority would receive upon dissolution is the "dead asset" value, and if the "going concern" value is markedly higher, the minority might prefer to run the risk of being temporarily "locked in" in order to realize greater gains in the future.¹⁴⁹ For example, if the business is one that might be attractive to a third party buyer, and if conditions are such that the majority might be interested in a subsequent sale, the minority might prefer to "wait it out" rather than be forced to convert its interest currently to cash.¹⁵⁰ This example assumes that, in the short run, were the business to be dissolved, it would be purchased by the majority interests. It also assumes that the price paid by the majority would reflect "adjusted book value,"¹⁵¹ or something less, rather than "going concern" value.¹⁵²

147 *Id.* at 32-33, 70-75 (table II, cases 16, 1 & 10).

148 *Id.* at 33, 70-75 (table II, case 13).

149 See *infra* notes 153-74 and accompanying text.

150 *Cf. Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987); *Michaels v. Michaels*, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

151 See *supra* note 135.

152 See *infra* text following note 317.

At the risk of over simplification, the foregoing can be illustrated by drawing a distinction between a profitable service or labor-intensive business, on the one hand, and an unprofitable capital-intensive business on the other. Two leading New York cases from the 1950-1960 period dramatize this dichotomy.

In *In re Radom & Neidorff, Inc.*,¹⁵³ the New York Court of Appeals affirmed dismissal of a petition on the ground of deadlock. Radom, the petitioner, owned fifty percent of the shares, and Neidorff, his sister and the respondent, owned the other fifty percent following the death of her husband. The brother and the husband had worked well together; however, the brother and sister, to state it euphemistically, were estranged. When the petition was filed, it listed the assets and liabilities of the corporation as follows:¹⁵⁴

	<u>Assets</u>		<u>Liabilities</u>
Machinery & supplies	\$ 9,500	Payable (to Radom)	\$17,000
Cash	<u>82,000</u>		
Total	<u>91,500</u>		

Thus, the liquidating value of the corporation appeared to be \$74,500. The sister, based upon these figures, would have received \$37,250.

When the husband was alive, however, both he and the brother drew salaries of \$25,000. From the cash position of the corporation listed above, it would appear that the corporation had been profitable. If the services of the husband did not need to be replaced, not an unlikely assumption,¹⁵⁵ the corporation would be all the more profitable. Shortly after the husband's death, Radom offered his sister \$75,000 for her interest and, upon her rejection of the offer, "threatened to have the corporation dissolved and to buy it in at a low price or, if she should be the purchaser, that he would start a competing business."¹⁵⁶ Three years later, it was undisputed that corporate profits for those years had totalled \$242,000, an average of \$71,000 per year according to the court, and that the corporation had cash on deposit of \$300,000. It is not clear whether the foregoing figures had made allowance for the brother's salary of \$25,000 per year. Thus, three years later—even if the court were then to liquidate the corporation—the sister's interest had risen to the \$150,000 range,¹⁵⁷ as contrasted with the \$75,000 the brother had offered and the \$37,000 she might have received had dissolution been granted promptly and the brother been able to "buy it in at a low price" or at the book value figure suggested by the brother's petition. The value of this business as a going concern, based upon a capitalized earnings approach, theoretically could be substantially higher. If a relatively

¹⁵³ 307 N.Y. 1, 119 N.E.2d 563 (1954).

¹⁵⁴ *Id.* at 5, 119 N.E.2d at 564.

¹⁵⁵ There was no indication in the case that a replacement was hired.

¹⁵⁶ 307 N.Y. at 6, 119 N.E.2d at 564.

¹⁵⁷ Profits in the interim were \$242,000 and the corporation had \$300,000 on deposit in banks. *Id.*

modest price earnings ratio of five¹⁵⁸ were applied to the average earnings of \$71,000 for the past three years, the value thus determined would be \$355,000, or \$177,500 for the sister's half interest. Similarly, a multiplier of eight would produce a value of \$284,000 for the sister's investment.

What the foregoing analysis demonstrates is the tremendous variation in value that can exist, depending upon timing and method. Thus:

<u>Valuation Approach</u>	<u>Timing</u>	<u>Value</u>
Liquidation at book	Upon filing	\$ 37,250
Brother's offer	Upon H's death	75,000
Liquidation at book	Three years later	150,000
Capitalized earnings 5	Hypothesized	177,500
Capitalized earnings 8	Hypothesized	284,000

Such variations are not uncommon.¹⁵⁹ What is clear is that liquidation immediately following the filing of the brother's petition would have been extremely disadvantageous for the sister. This conclusion—that liquidation is disadvantageous to the minority—would generally follow whenever the ratio of profitability to capital is high and the sale of the assets in dissolution does not take into account going concern value. It is all the more true when profitability is increasing.

On the other hand, when the converse is true—that is, when the ratio of profitability to capital is low—dissolution will generally be advantageous to the minority, assuming that the minority is not employed in the enterprise. This is illustrated by the later New York case of *Kruger v. Gerth*¹⁶⁰ in which the New York Court of Appeals again upheld dismissal of a petition for dissolution. In *Kruger*, the petition was brought by the widow of Kruger, a forty-six percent shareholder. Arthur Gerth, the primary respondent, owned fifty-three percent of the shares of the corporation. Both Kruger, before his death in 1961, and Gerth had been employed by the corporation. Kruger, who had been ill since 1951 and was not active in the business, received a salary of \$6,000; Gerth, for the past four years, had received compensation averaging slightly over \$15,000 per year, consisting of \$9,000 salary and \$6,000 bonus. The net worth (or book value) of the corporation was over \$100,000; however, its earnings were less than \$2,000 before income taxes. Thus, the return on investment was about two percent annually. The petitioner sought dissolution on the ground that the award of bonuses to Gerth so reduced the profits of the corporation that there were insufficient earnings to provide a fair return on the plaintiff's investment in the corporation.¹⁶¹ The Court of Appeals summarily affirmed the Appellate Division on the basis that the grounds for the petition were meager.

¹⁵⁸ The cases discussed in this Article utilize multipliers ranging from 4.48 to 15.2. See *infra* notes 329-30 and accompanying text.

¹⁵⁹ *Id.*

¹⁶⁰ 16 N.Y.2d 802, 210 N.E.2d 355, 263 N.Y.S.2d 1 (1965) (mem.), *aff'g* 22 A.D.2d 916, 255 N.Y.S.2d 498 (1964).

¹⁶¹ *Id.* at 803, 210 N.E.2d at 355, 263 N.Y.S.2d at 1.

Chief Judge Desmond, who had written for the majority in *In re Radom & Neidorff* in rejecting dissolution, this time dissented and argued for dissolution on the basis that "the corporation is being kept alive solely to pay [Gerth's] salary plus bonus."¹⁶² He suggested that even though the bonuses were not extravagant, the effect of the bonus was to render plaintiff's stock "both unprofitable and unsalable"¹⁶³ and thus constituted a breach of the fiduciary duty owed by majority shareholders to the minority. Judge Fuld, who dissented in both cases, relied upon Professor Israel's argument in *The Sacred Cow of Corporate Existence*¹⁶⁴ that a close corporation should be treated like a partnership and that courts should be able to decree a remedy which would produce a fair result.¹⁶⁵

Kruger v. Gerth is a classic example of a "locked-in" minority shareholder. In effect, Kruger and Gerth invested in a business to provide each with jobs. So long as each was employed, the situation was acceptable. The return on capital took the form of payment of salaries. But when Kruger died, the widow received no return, either by way of salary or dividends. Thus, her capital was now being used to maintain employment for Gerth.

The majority was unswayed by the argument that such a situation justified dissolution. This was in line with how one would expect most courts to react—at least prior to the development of the "reasonable expectations" test.¹⁶⁶ In theory, one chooses the corporate form because it provides continuity of existence: death does not terminate the corporate form as it would a partnership.¹⁶⁷ According to this line of reasoning, if Kruger wanted his investment in the enterprise to be made available to his widow upon his death, he should have chosen the partnership form.

Under traditional analysis,¹⁶⁸ the widow has little legal leverage available to her. Even in terms of 1960 dollars, compensation of \$15,000 is not so exorbitant as to give rise to challenge as oppressive or as a waste of corporate assets, possible bases for judicial dissolution.¹⁶⁹ Nor does the widow have the corporate leverage to create deadlock, another basis for dissolution.¹⁷⁰ While the widow could challenge the salary as unfair within the scope of a conflict of interest statute,¹⁷¹ recovery of any excess compensation does not necessarily mean that such excess recovered by the corporation would thereafter be distributed to her as a dividend.¹⁷²

Thus, in the *Kruger* situation, where the ratio of profitability to capital is low, dissolution would be an effective remedy. Since the likelihood

162 *Id.* at 804, 210 N.E.2d at 356, 263 N.Y.S.2d at 2.

163 *Id.*

164 *See supra* note 2.

165 16 N.Y.2d at 806, 210 N.E.2d at 357, 263 N.Y.S.2d at 4.

166 *See infra* text following note 271.

167 *See* UNIF. PARTNERSHIP ACT § 31(4), 6 U.L.A. 376 (1969).

168 The traditional analysis views dissolution as a drastic remedy. *See supra* text following note 112.

169 *See* MODEL BUSINESS CORP. ACT § 14.30(2)(ii), (iv) (1984).

170 *See id.* § 14.30(2)(i), (iii). (In *Kruger*, the widow held only 46% of the shares.).

171 *Id.* § 8.31.

172 *See infra* notes 334-36 and accompanying text.

of increased profitability is low,¹⁷³ there is no advantage to "staying in," absorbing the lack of current return in expectation of a greater pay-off later. Yet, in this situation where liquidation could make economic sense—at least from the perspective of the minority shareholder—it has been often, if not generally, unavailable.¹⁷⁴

2. Does "Corporate Death" Lead to a "Dead Asset" Approach to Valuation

What is clear from a comparison of *Radom* and *Kruger* is that there is no general rule that dissolution is an effective remedy. While it would have been helpful to the widow in *Kruger*, it would have been disastrous for the sister in *Radom*. The reason why dissolution would have been disastrous to the sister in *Radom* is that the court contemplated, apparently, that she would receive the dead asset value of the business assets. The inventory to which the court made reference listed as assets machinery and supplies worth \$9,500 and cash of \$82,000. There is no indication of anything representing a going concern value. The value of the equipment was probably the depreciated book value, not the market value.

Let me transpose the *Radom* facts to a business with which we are all familiar—a real estate brokerage firm, or an insurance brokerage firm, or a law practice. In such a case, if the office is leased, the hard assets (the \$9,500 in *Radom*) would consist of desks, file cabinets, and, in the past, typewriters, but today, computers and copy machines. But, in a sense, the real value is in the file cabinets—not in the \$250 of metal but in the paper inside: the client files, listings, and other business development data.

Generally, the going concern value of these businesses is substantially greater than the tangible asset value. Often a simple formula, such as two times gross sales or cash flow, is used to value such businesses. While business valuation experts criticize such formulas and prefer to work with earnings based formulae,¹⁷⁵ earnings in closely held businesses are so distorted by owner compensation that actual buyers often look to more objective data such as gross billings. However, either a gross sales or net income approach will generally produce a valuation above tangible assets.

The problem, then, is how to realize value upon a sale in a dissolution proceeding. In a voluntary dissolution, the officers and directors are charged with selling the assets of the company.¹⁷⁶ Were they to buy in at a low price, as the brother in *Radom* threatened to do,¹⁷⁷ there would be a conflict of interest,¹⁷⁸ and the sister, in a derivative proceeding, argua-

173 According to Chief Judge Desmond, dissenting in *Kruger*, "there is (as testified by the majority stockholder) no prospect of the corporation ever making enough profit to pay any dividend . . ." 16 N.Y.2d at 804, 210 N.E.2d at 356, 263 N.Y.S.2d at 2.

174 In addition to *Kruger*, see *Fix v. Fix Material Co.*, 538 S.W.2d 351 (Mo. Ct. App. 1976).

175 G. MCCARTHY & R. HEALY, VALUING A COMPANY—PRACTICES AND PROCEDURES 377 (1971).

176 MODEL BUSINESS CORP. ACT §§ 14.05(a)(2), (b)(3) (1984).

177 See *supra* text accompanying note 156.

178 MODEL BUSINESS CORP. ACT § 8.31 (1984).

bly could require the brother to pay a fair price. This is what the Seventh Circuit mandated in *Lebold v. Inland Steel Co.*¹⁷⁹ In a similar case, the Louisiana Supreme Court stated that "the burden is on the liquidator as a fiduciary not only to prove the good faith of the transactions involved but also to show their inherent fairness from the viewpoint of both the majority and minority shareholders."¹⁸⁰

In an involuntary dissolution case, however, there is a likelihood that the court will appoint a receiver to sell the assets.¹⁸¹ From the minority shareholder's standpoint, there is no assurance that the receiver will be either diligent or sophisticated. From the receiver's perspective in a *Radom* situation, the simplest procedure is to sell to the brother—at whatever price the brother offers. This is undoubtedly what the brother in *Radom* had in mind.

This uncritical approach to realizing value is possible so long as courts view the dissolution process as a drastic remedy resulting in "judicially-imposed [corporate] death."¹⁸² It need not, and ought not, be so viewed. Eighty years ago, a court upheld what was, in effect, a dissolution of a corporation based upon oppression and stated:

[T]he chancellor will doubtless order the sale on such terms as to time as will enable either party to purchase it if they desire, and this will insure such an active competition between the factions, and perhaps others, for the property, as will insure that there will be no sacrifice of it at the sale.¹⁸³

A similar theme was echoed forty years ago when the Missouri Supreme Court, in ordering dissolution of a corporation, stated that "[s]ince it has a successful going business, which should be preserved and continued, it should be sold as such if possible. Furthermore, if the parties can agree upon a sale of the interest of one to the other . . . they should be permitted to do so."¹⁸⁴ Contemporary courts should be no less astute in recognizing that dissolution is not the end of the world and insuring that procedures are in place to preserve to the minority the fair value of the corporate assets.

IV. Oppression as a Basis for Dissolution

As discussed above, there are two interrelated impediments to dissolution as an effective remedy for minority shareholders. The first is its availability. So long as courts look at a dissolution as the death of the corporation and conclude that it is a drastic remedy, the likelihood of dissolution being decreed by a court is curtailed. Witness the Hethering-

179 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942).

180 *Levy v. Billeaud*, 443 So. 2d 539, 541 (La. 1983).

181 MODEL BUSINESS CORP. ACT §§ 14.31(c), 14.32 (1984).

182 *In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 7, 119 N.E.2d 563, 565 (1954).

183 *Graham v. McAdoo*, 135 Ky. 677, 684, 123 S.W. 260, 263 (1909) (one shareholder had arrogated control to his family in a fashion analogous to the leading Illinois oppression case, *Gidwitz v. Lanzit Corrugated Box Co.*, 20 Ill. 2d 208, 170 N.E.2d 131 (1960)).

184 *Handlan v. Handlan*, 360 Mo. 1150, 1167, 232 S.W.2d 944, 951 (1950) (liquidation sale deferred for six months to allow the deadlocked brothers the opportunity to develop their own solution).

ton & Dooley study: dissolution was granted in only half the cases.¹⁸⁵ Also, so long as dissolution is viewed as corporate death, the minority shareholder may fear that what he or she will receive is the "dead asset" value of the corporation, not the going concern value of the business.¹⁸⁶ The sister, in *Radom & Neidorff*, might well not have resisted dissolution if she had known she would receive her half of the going concern value of the business that her husband, as well as her brother, had developed.

While alternatives to dissolution must be developed to complete the picture of effective minority relief, dissolution today is still the prevalent relief afforded minority shareholders by legislatures.¹⁸⁷ For the widow in *Kruger v. Gerth*, something is better than nothing. As long as the corporation exists, she has neither her investment nor any return. With little going concern value, dissolution, even if it meant dead asset value, was the best for which she could hope.

Accordingly, it is worthwhile to examine the traditional four bases for involuntary judicial dissolution to evaluate them for their potential to afford relief. Section 90 of the original Model Business Corporation Act provided as follows:

The . . . courts shall have full power to liquidate the assets and business of a corporation:

(a) In an action by a shareholder when it is established:

(1) That the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is being suffered or is threatened by reason thereof; or

(2) That the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent; or

(3) That the shareholders are deadlocked in voting power, and have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election of their successors; or

(4) That the corporate assets are being misapplied or wasted.¹⁸⁸

185 See *supra* note 56.

186 Recall that the brother in *In re Radom & Neidorff* had threatened to have the corporation dissolved and to buy it in at a low price. See *supra* text accompanying note 156.

187 Only about 20 states have statutes providing for alternative remedies to dissolution. See *infra* notes 243-70 and accompanying text.

188 In October, 1946, the Committee on the Law of Corporations of the American Bar Association (ABA) submitted its final draft of a Model Business Corporation Act to the ABA's Section on Corporation, Banking and Mercantile Law. See *A Model Business Corporation Act*, 1 BUS. LAW. 6 (No. 2, 1946). This Model Act was revised and resubmitted to the Section on Corporation, Banking and Business Law in November, 1950. In the introduction to the 1950 Model Act, specific attention was called to the provisions of the Act on receiverships and liquidations. It was observed that, in the case of a management deadlock, for example, "at the instance of a shareholder, a receiver may be appointed to preserve the corporate assets and, if the deadlock is not broken, eventually liquidate the business, whereupon the court may then dissolve the corporation." *Id.* at 7. Further, it was observed that, "the jurisdiction and authority of the state courts might be in doubt if there is no express statutory provision." *Id.* See Garrett, *History, Purpose and Summary of the Model Business Corporation Act*, 6 BUS. LAW. 1, 6-7 (No. 1, 1950). As promulgated in 1950, § 90(a) of the Model Act contained only three subsections. While §§ 90(a)(1), (2) & (4), as set forth in the text preceding note 188, appeared, verbatim, as §§ 90(a)(1), (2) & (3) in the 1950 Model Act, there was no provision regarding shareholder deadlock and the resultant failure to elect directors. See MODEL BUSINESS CORP. ACT, § 90, reprinted in 6 BUS. LAW. 75 (1950). The Model Act was again revised in 1953. See MODEL

One deadlock-type basis—shareholders failing to elect a successor for two annual meeting dates—is not calculated to stir the blood of a sitting judge.¹⁸⁹ It invites the query “So what? Who is hurt?” For that reason, Illinois dropped this provision in its new Business Corporation Act.¹⁹⁰

The other deadlock provision—directors deadlocked and the corporation suffering irreparable injury—has been the source of relief but it is not nearly the effective remedy that Professor Israels foresaw.¹⁹¹ This provision has two hurdles. One is the fact that the jurisdictional language is permissive, not mandatory. The introductory language of the section provides that courts “shall have full power” to liquidate, not that courts “shall liquidate,” if the enumerated bases are present.¹⁹² The second problem is that deadlock is not sufficient; there must be irreparable injury to the corporation. But injury to the shareholder does not necessarily mean injury to the corporation.¹⁹³ In fact, the converse may be true. A minority shareholder may be terminated and a replacement hired at a lower salary, or possibly not replaced at all. Often a shareholder will become disabled or die, and thereafter the spouse or other family member will not succeed to the employed position. This was the case in *Radom* and in *Kruger v. Gerth*. Exclusion from employment and absence of dividend declarations do not injure the corporation. For this reason, the

BUSINESS CORP. ACT xi (1957) (Preface to the 1953 Revision). The 1953 revisions added § 90(a)(3), bringing § 90 to the form seen in the text preceeding note 188.

In 1969, the Committee on Corporate Laws of the ABA again revised the Model Act. In the course of this revision, the text of § 90 remained unchanged but the section was renumbered as § 97. See Official Forms for Use Under the Model Business Corporation Act—1969 Addendum and Conversion Table 105; MODEL BUSINESS CORP. ACT § 97 (1969). The text of § 97 remained the same over the years, until the Committee on Corporate Laws undertook and completed a major revision and restructuring of the Model Act. These efforts culminated in the current Model Business Corporation Act (1984). The 1984 Model Act completely redrafted the provisions on judicial dissolution, which are now contained at §§ 14.30-14.33.

189 For example, in *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash. 2d 944, 632 P.2d 512 (1981), the court held that merely meeting the jurisdictional test of having failed to elect successor directors at two successive annual meetings does not warrant dissolution of a solvent corporation; rather it is necessary to determine whether dissolution is in the best interests of the shareholders. See also *Jackson v. Nicolai-Neppach Co.*, 219 Or. 560, 348 P.2d 9 (1959). However, where egregious facts are coupled with deadlock, courts are more likely to grant dissolution. See, e.g., *In re Collins-Doan Co.*, 3 N.J. 382, 70 A.2d 159 (1949); *In re Evening Journal Ass'n*, 15 N.J. Super. 58, 83 A.2d 38 (1951); *Strong v. Fromm Laboratories, Inc.*, 273 Wis. 159, 77 N.W.2d 389 (1956).

190 See ILL. ANN. STAT. ch. 32, para. 12.50(b) (Smith-Hurd 1985).

191 Israels, *supra* note 2, at 789-91.

192 The court stated in *Nicolai-Neppach*, 219 Or. at 566, 348 P.2d at 16:

The shareholder deadlock provisions of the Illinois Business Corporation Act, of the Model Business Corporation Act, and of the Oregon Business Corporation Law are clearly couched in language of permission. It is incredible that the many able lawyers who worked from time to time on these three identical acts would have used such phraseology to express a mandate. The statute contemplates that the court of equity shall take jurisdiction once a requisite showing of fact is made and contemplates further that having taken jurisdiction it will bring its discretion to bear in granting or refusing to grant equitable relief. The very fact that the legislature has made the remedy of liquidation a matter of discretion for the courts is a mandate to us to use discretion, and we would not be carrying out the legislative will by simply decreeing liquidation as a matter of course once the jurisdictional facts and nothing more are proven.

193 Some courts have, however, essentially ignored the requirement of irreparable injury to the corporation and focused upon injury to shareholders. See, e.g., *Gillingham v. Swan Falls Land & Cattle Co.*, 106 Idaho 859, 683 P.2d 895 (Idaho Ct. App. 1984).

Model Act was modified in 1984 to provide an alternative basis to irreparable injury to the corporation: "the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally."¹⁹⁴ This language should expand the utility of the deadlock provision.

The provision that empirically seems to be the most fruitful avenue for minority shareholders to pursue, however, is one using a finding of oppression as the basis for liquidation.¹⁹⁵ While the provision also speaks of illegal and fraudulent acts, the courts have consistently observed that, not only is oppression a concept separate and distinct from fraud and illegality, but also that it embraces conduct that would not be encompassed within those terms.¹⁹⁶ While the fourth jurisdictional basis, waste or misapplication of corporate assets, probably *would* stir the blood of a sitting judge, its specificity narrows the situations that it can reach—terminating a minority shareholder is unlikely to involve waste—and judicial decisions appear to incorporate conduct within its reach into the concept of oppression.¹⁹⁷ Accordingly, the next two sections of this Article will explore the development of the concept of oppression and its evolution to embrace the "reasonable expectations of minority shareholders."

A. *The Development of the Concept of Oppression*

1. Illinois

Until the 1980s, the most significant developments in the concept of oppression occurred in Illinois. Thereafter, New York adopted the reasonable expectations test which will be discussed in the next section.¹⁹⁸

The Illinois Business Corporation Act of 1933¹⁹⁹ (the "1933 Act") is often viewed as the first modern corporation code and was the basis for the Model Business Corporation Act.²⁰⁰ Section 86(a)(3) of the 1933 Act was the basis for section 90(a)(2), later section 97(a)(2), and finally section 14.30(2)(ii) of the various versions of the Model Act,²⁰¹ and introduced the concept of oppression as a basis for liquidation.²⁰²

194 MODEL BUSINESS CORP. ACT § 14.30(2)(i) (1984).

195 See *Gidwitz v. Lanzit Corrugated Box Co.*, 20 Ill. 2d 208, 170 N.E.2d 131 (1960); *Central Standard Life Ins. Co. v. Davis*, 10 Ill. 2d 566, 141 N.E.2d 45 (1957).

196 See *supra* note 195.

197 *Id.*

198 See *infra* text accompanying notes 271-88.

199 1933 Ill. Laws 308-87. Illinois is generally credited with introducing "oppression" as a basis for liquidation in its 1933 Act. See *Exadaktilos v. Cinnaminson Realty Co.*, 167 N.J. Super. 141, 150-51, 400 A.2d 554, 559 (1979). However, in 1931, California enacted a provision that would permit dissolution if directors were guilty of "persistent unfairness" to minority shareholders. 1931 Cal. Stat. 1829. Later California decisions have, in effect, equated persistent unfairness to oppression. This provision did not persist; it was deleted from the statute. 1933 Cal. Stat. 1414. Professor Ballantine, who has had a strong influence on California law, is a major opponent to involuntary dissolution. See 2 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 360 (4th ed. 1974).

200 See Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412, 424 (1952); MODEL BUSINESS CORP. ACT 84 (1953 revision).

201 See *supra* note 188.

202 *Central Standard Life Ins. Co. v. Davis*, 10 Ill. 2d 566, 572, 141 N.E.2d 45, 49 (1957).

In interpreting the scope of "oppression" under section 86 of the 1933 Act, no clear pattern developed until the 1960s. Two early cases either held²⁰³ or appeared willing to accept²⁰⁴ that a sale of corporate assets at a grossly inadequate price was oppressive conduct. Two later cases gave only summary consideration to whether conduct was oppressive.²⁰⁵ However, in 1957, the Illinois Supreme Court considered the concept of oppression and took a very broad view. In *Central Standard Life Insurance Co. v. Davis*, the court stated: "[W]e reject defendants' argument that the word [oppression] is substantially synonymous with 'illegal and fraudulent.' Misapplication of assets or mismanagement of funds are not, as we read the statute, indispensable ingredients of 'oppressive' conduct."²⁰⁶ Nevertheless, the court declined to liquidate a hotel corporation, as sought by a shareholder holding over half the preferred shares, even though no dividends had been paid for a quarter of a century. This meant that the defendant, who owned substantially all the common shares and also the operating company which leased the hotel, had been arrogating all the financial benefits to himself. Counterbalancing this possible conflict of interest was the fact that the plaintiff had bought its shares at a discount; the court questioned whether the plaintiff was oppressed and stated that "[e]quity will not award the drastic relief here sought in order to aid a plaintiff in what might be a profitable speculation."²⁰⁷ In addition, the lease was expiring in two years and there were indications that a favorable lease restoring profitability might be available at that point.

The rhetoric providing a broad gloss in defining oppression bore fruit three years later when the court confronted another alleged case of oppression. *Gidwitz v. Lanzit Corrugated Box Co.*²⁰⁸ involved a corporation in which the shares were evenly split between two dissident family factions. The president of the corporation had, for almost ten years, operated it as though it were a sole proprietorship. The following factors combined to indicate oppression within the meaning of the statute: officers were hired and salary increases were given without director approval; loans were made to corporations in which the president had an interest without director approval; a subsidiary was organized without director approval; the matter of payment of dividends had not been presented to the board of directors; and the other family was excluded from all incidents of control and corporate participation. The court pointed out that it was "not necessary that fraud, illegality or even loss be shown to exhibit oppression"²⁰⁹ and concluded that the cumulative effects of the aforementioned acts, and their indicated continuing nature,

203 *Long v. Wilson Stove & Mfg. Co.*, 277 Ill. App. 57 (1934).

204 *Sulinski v. Humboldt & Wabansia Bldg. Corp.*, 315 Ill. App. 392, 43 N.E.2d 181 (1942).

205 *Marnik v. Northwestern Packing Co.*, 335 Ill. App. 568, 82 N.E.2d 195 (1948) (abstract only); *Lush'us Brand Distributions, Inc. v. Fort Dearborn Lithograph Co.*, 330 Ill. App. 216, 70 N.E.2d 737 (1946).

206 10 Ill. 2d at 573-74, 141 N.E.2d at 50 (relying upon the interpretation of § 210 of the British Companies Act in *Elder v. Elder & Watson*, 1952 Sess. Cas. 49, 55).

207 *Id.* at 576, 141 N.E.2d at 51.

208 20 Ill. 2d 208, 170 N.E.2d 131 (1960).

209 *Id.* at 220, 170 N.E.2d at 138.

established oppression entitling the plaintiffs to liquidation. Although corporate dissolution was deemed to be a drastic remedy, "when oppression is positively shown, the oppressed are entitled to the protection of the law."²¹⁰

After a slight detour in which an appellate court cautioned that "[t]he ends of justice would not be served by too broad an application of the statute, for that would merely eliminate one evil by substituting a greater one—oppression of the majority by the minority,"²¹¹ there followed a series of appellate court decisions decreeing dissolution based upon a broad reading of what constitutes oppressive conduct. Conduct which excludes a minority shareholder from participation in the enterprise or which can be characterized as heavy-handed or overbearing has sufficed to warrant dissolution. For example, in *Compton v. Paul K. Harding Realty Co.*, where the defendant was charged with managing the corporation to the exclusion of the plaintiff and with withdrawing an excessive salary, the court stated that "an arbitrary, overbearing and heavy-handed course of conduct . . . justified] the finding of oppression. . . ."²¹² In examining the record, the court stated: "Specific instances of such evidence include testimony regarding the failure of defendant Harding to call meetings of the board of directors or to consult with plaintiff Compton regarding management of corporate affairs, his imperious attitude when questioned about his salary and his dilatory reaction to the plaintiffs' requests."²¹³

Misuse of corporate funds or assets has also led to a conclusion of oppression. Thus, where the defendant has taken excessive salaries²¹⁴ or misused corporate assets,²¹⁵ the courts have found oppressive conduct justifying dissolution. And, in a case in which an accounting was sought, the court indicated that the failure "to pay dividends to minority stockholders, due to large salaries drawn by officer-majority stockholders" could constitute oppressive conduct.²¹⁶

2. Other Jurisdictions

Following, at least in part, the lead of Illinois, several other jurisdictions have adopted an expansive definition of oppression. In *White v. Perkins*, the Supreme Court of Virginia noted that "[o]ppression as a [statutory] ground for corporate dissolution . . . first occurred in Illinois in 1933 . . . [and] [b]y 1965 at least eleven other states, including Virginia

210 *Id.* at 221, 170 N.E.2d at 138.

211 *Polikoff v. Dole & Clark Bldg. Corp.*, 37 Ill. App. 2d 29, 36, 184 N.E.2d 792, 795 (1962) (involving an unprofitable real estate complex; the court shrugged off plaintiff's allegations by citing *Wheeler*, discussed *supra* note 27 and accompanying text).

212 6 Ill. App. 3d 488, 499, 285 N.E.2d 574, 581 (1972). *See also* *Notzke v. Art Gallery, Inc.*, 84 Ill. App. 3d 294, 405 N.E.2d 839 (1980). *Cf. Liddell v. Smith*, 65 Ill. App. 2d 352, 213 N.E.2d 604 (1965) (court did not specify what facts led to conclusion of oppression; simply recited the facts at length).

213 6 Ill. App. 3d at 499, 285 N.E.2d at 581.

214 *Cf. id.* at 496, 285 N.E.2d at 579.

215 *Ross v. 311 North Central Ave. Bldg. Corp.*, 130 Ill. App. 2d 336, 264 N.E.2d 406 (1970). *Cf. 65 Ill. App. 2d at 357-58, 213 N.E.2d at 606.*

216 *Gray v. Hall*, 10 Ill. App. 3d 1030, 1034, 295 N.E.2d 506, 509 (1973) (the court also indicated that withholding dividends to freeze-out a minority shareholder could be oppressive).

had adopted similar statutes.”²¹⁷ In *Perkins*, White, the majority shareholder in a bulk oil distributorship, refused to lease a service station to the corporation as the parties had agreed or to declare dividends. Perkins, the minority shareholder, who was the only full-time employee of the profitable business, was thus paying taxes on income he did not actually receive. White also began using corporate funds for the benefit of his service station. When Perkins objected and filed suit, White terminated him. Citing *Central Standard Life Insurance* and *Gidwitz*, the court stated:

The word ‘oppressive,’ as used in the statute does not carry an essential inference of imminent disaster; it can contemplate a continuing course of conduct. The word does not necessarily savor of fraud, and the absence of ‘mismanagement, or misapplication of assets,’ does not prevent a finding that the conduct of the dominant directors or officers has been oppressive. It is not synonymous with ‘illegal’ and ‘fraudulent.’²¹⁸

As did the Illinois court in *Central Standard Life Insurance*, the Virginia court agreed with the English case of *Elder v. Elder & Watson, Ltd.*, defining oppression as “a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.”²¹⁹ Quoting from another Commonwealth case, the court stated that oppression also means “a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members.”²²⁰

Relying upon the foregoing principles and authorities, the court upheld the trial court’s determination that White’s conduct was oppressive. However, it overturned the chancellor’s order directing a dividend and granting severance pay to Perkins on the basis that the “alternatives provided . . . [in the statute—dissolution or custodian] are exclusive rather than inclusive.”²²¹

The following year, the Oregon Supreme Court, in *Baker v. Commercial Body Builders, Inc.*, relied on similar authority and adopted the same rhetoric in defining oppression but added the gloss that oppression and breach of fiduciary duty are closely related concepts:

Thus, an abuse of corporate position for private gain at the expense of the stockholders is ‘oppressive’ conduct. Or the plundering of a ‘close’ corporation by the siphoning off of profits by excessive salaries or bonus payments and the operation of the business for the sole benefit of the majority of the stockholders, to the detriment of the minority stockholders, would constitute such ‘oppressive’ conduct as to authorize a dissolution of the corporation under the terms of ORS 57.595.²²²

217 213 Va. 129, 134, 189 S.E.2d 315, 319 (1972) (citations omitted).

218 *Id.* (citing *Central Standard Life Ins. Co. v. Davis*, 10 Ill. 2d 566, 141 N.E.2d 45 (1956); *Gidwitz v. Lanzit Corrugated Box Co.*, 20 Ill. 2d 208, 170 N.E.2d 131 (1960)).

219 213 Va. at 134, 189 S.E.2d at 320 (quoting *Elder v. Elder & Watson, Ltd.*, 1952 Sess. Cas. 49, 55).

220 *Id.* (quoting *Scottish Co-op Wholesale Soc’y v. Meyer*, 3 All E.R. 66, 86 (1958)).

221 *Id.* at 135, 189 S.E.2d at 320.

222 264 Or. 614, 629, 507 P.2d 387, 394 (1973) (footnotes omitted).

On the other hand, the court cautioned that the oppressive conduct must be "extremely serious"²²³ or that the oppressors must be "incorrigible"²²⁴ before dissolution is warranted. "[V]ague apprehensions"²²⁵ of future mischief will not suffice. While the plaintiff's employment had been terminated, business had been bad, he had worked only part time for the corporation, he had not been productive, and he had been offered about fifty percent more for his shares than he had paid three years earlier. While some of the defendant's acts could be deemed oppressive, the *Baker* court did not view them as serious enough to warrant dissolution.

However, the *Baker* decision is most notable for its gratuitous listing of ten alternative actions a court may take rather than dissolve a corporation where the conduct of those in control is oppressive.²²⁶ As will be discussed in the next section, the development of alternatives to dissolution has freed courts to broaden the scope of what constitutes oppressive conduct, particularly by adopting a reasonable expectations test.²²⁷ The *Baker* decision may have foreshadowed the premise that less drastic remedies may be justified by less oppressive conduct than that required to dissolve a corporation.

While the abstract formulations of what constitutes oppressive conduct appeared favorable to minority shareholders, such shareholders had difficulty in the 1970s obtaining relief in jurisdictions other than Illinois. In *Fix v. Fix Material Co., Inc.*,²²⁸ a Missouri court said all the right things, citing *Perkins*, *Baker*, and the Illinois decisions and adding that "the law imposes equitable limitations on the rights of dominant shareholders to act in their own self-interest,"²²⁹ but then declined to grant relief.

In *Fix*, the plaintiff was a forty-one percent shareholder and the widow of one of two brothers who had controlled the company. In the ten years following her husband's death, no dividends were paid, the other brother and his son received both salaries and occasional bonuses while assets were being sold to generate cash, and the book value of the company had dropped about ten percent. The court, while recognizing the "position of frustration and corporate impotence [in] which minority shareholders sometimes find themselves,"²³⁰ denied relief but stated that the combination of facts "comes narrowly close to a level of oppressive or illegal conduct within the meaning of the statute."²³¹

The court did, however, send a message to those in control by stating that "[i]f the conditions continue in the direction described, a future

223 *Id.* at 630, 507 P.2d at 394.

224 *Id.*

225 *Id.*

226 *Id.* at 631-33, 507 P.2d at 395-96. See *infra* notes 259-70 and accompanying text. Since the court did not find such oppression as might justify dissolution, there was no need to find an alternative to dissolution.

227 See *infra* text following note 271.

228 538 S.W.2d 351 (Mo. Ct. App. 1976).

229 *Id.* at 358.

230 *Id.* at 361.

231 *Id.*

action by those aggrieved might well produce a different result.”²³² The court did not suggest where the “aggrieved” party would obtain the funds to bring another action, an important omission in light of the court’s recognition that the “plaintiff received no return or benefit from her investment in any form.”²³³ The decision here should be contrasted with that of the New York court ten years later where, on what would appear to be less egregious facts, the widow was awarded relief.²³⁴ The *Fix* court, which recognized the ten alternatives to dissolution suggested by *Baker*,²³⁵ could have retained jurisdiction to liquidate the corporation “[i]f the conditions [did] continue in the direction described.”²³⁶

Finally, in 1979, a New Jersey court, in *Exadaktilos v. Cinnaminson Realty Co.*, after reviewing the foregoing authority, concluded that, “[w]hile the terminology employed by both the statute and case law certainly provides the court with the latitude necessary to deal with all the circumstances peculiar to any case brought to its attention, it fails to suggest any perspective from which to judge what is oppressive or unfair.”²³⁷ The *Exadaktilos* court critically reviewed the differences between publicly held corporations and close corporations and concluded that “[t]he special circumstances, arrangements and personal relationships that frequently underly the formation of close corporations generate certain expectations among the shareholders concerning their respective roles in corporate affairs, including management and earnings.”²³⁸

The task, then, for the court is to determine what understandings initially characterized the relationship. As is often the case, the understandings of the parties were not incorporated in any written agreement. The court was therefore required to review the evidence chronicling the history of their relationship. The plaintiff held twenty percent of the shares and was the son-in-law of a forty-percent holder. Two other shareholders each held twenty percent and the father-in-law brought the plaintiff into the business over their objection. The son-in-law failed to get along with the other employees, quit on more than one occasion, and generally performed unsatisfactorily. In concluding that his termination was not oppressive, the court stated: “The promise of employment was honored, the opportunity being lost to plaintiff through no fault of defendants. The parties’ expectation that plaintiff would at some time participate in management was likewise thwarted by plaintiff’s failure to satisfy the condition precedent to participation, i.e., that he learn the business.”²³⁹ The court evidenced some concern for his lack of return on investment but left that issue for another day. Once again, this deci-

232 *Id.*

233 *Id.* at 356.

234 *In re Mintz*, 113 A.D.2d 803, 493 N.Y.S.2d 488 (N.Y. App. Div. 1985).

235 One of the alternatives suggested by *Baker* was to retain jurisdiction. See *infra* note 262.

236 538 S.W.2d at 361. In *Handlan v. Handlan*, 360 Mo. 1150, 232 S.W.2d 944 (1950), the court (i) ordered liquidation of one corporation in six months unless the two brothers reached agreement to break the deadlock and (ii) continued another corporation in receivership until the oppressive conduct was terminated.

237 167 N.J. Super. 141, 152, 400 A.2d 554, 560 (1979).

238 *Id.* at 154, 400 A.2d at 561.

239 *Id.* at 156, 400 A.2d at 562.

sion should be contrasted with the development of the law of oppression in New York.²⁴⁰

While the plaintiff did not prevail in *Exadaktilos*, four years later a terminated employee did prevail—even though his termination accorded with good business judgment. While there may have been a basis to terminate him, he performed his duties “creditably and conscientiously” and thus, his “lack of effectiveness was not due to misconduct.”²⁴¹ While this fact may rationalize the different result, the other significant factor was that the court in *Hughes* was considering oppression in light of an alternative remedy, a judicial buy-out, and not dissolution. The significance of alternative remedies will be addressed in the next section.

V. Alternative Remedies and the Evolution of Oppression Into Reasonable Expectations

While the New Jersey court in *Exadaktilos* introduced the notion of expectations as a standard by which to measure whether the challenged conduct was oppressive, the reasonable expectations test reached full bloom in New York after the legislature, in 1979, provided for a buy-out of the minority shareholder as an alternative to dissolution when the minority alleged oppressive conduct by those in control.²⁴² Many of the jurisdictions which have given a broad gloss to the definition of oppression in the 1980s also recognize alternative remedies, particularly judicially supervised buy-outs, to dissolving a corporation when oppression is found. Thus, the expansion of the concept of oppression is inextricably linked to the recognition and adoption of alternative remedies to dissolution.

A. *The Development of Alternative Remedies*

The concept of alternative remedies to dissolution is not new. In 1941, California broadened its grounds for involuntary dissolution by adding a provision that would permit liquidation when it was “reasonably necessary for the protection of the rights or interests of any substantial number of the shareholders, or of the complaining shareholders.”²⁴³ Professor Ballantine had been vocal in his opposition to dissolution at the behest of minority shareholders. This “make[s] it too easy for an obstreperous minority to interfere with the legitimate control and management of the majority by creating a cash nuisance value.”²⁴⁴ To “assure fairness to minority shareholders and at the same time to lessen the danger of minority abuse,”²⁴⁵ the legislature also enacted, in 1941, a provision providing for a buy-out of the complaining shareholder by the

240 See *Gimpel v. Bolstein*, 125 Misc. 2d 45, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984) (family member who was fired for theft was nonetheless entitled to a return on his investment) (discussed *infra* note 279 and accompanying text).

241 *Hughes v. Sego Int'l, Ltd.*, 192 N.J. Super. 60, 65, 469 A.2d 74, 77 (1983).

242 N.Y. Bus. Corp. Law §§ 1104-a, 1118 (McKinney 1986 & Supp. 1988).

243 1941 Cal. Stat. 2057-58 (codified as amended at CAL. CORP. CODE § 1800(b)(5) (West 1977)).

244 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS 256 (1933 Supp.).

245 *Stumpf v. C.E. Stumpf Sons, Inc.*, 47 Cal. App. 3d 230, 234, 120 Cal. Rptr. 671, 674 (1975).

majority if the majority so elected.²⁴⁶ If the parties could not agree on price, the court would determine the fair cash value of the shares.

However, even though the courts were decrying dissolution as a drastic remedy, there was no rush by legislatures to provide alternative remedies, at least in the form of a buy-out option, until the 1970s.²⁴⁷ At least seven states enacted buy-out provisions in the 1970s²⁴⁸ and at least three additional states enacted such provisions in the 1980s.²⁴⁹ The statutory schemes range from simple to detailed and from a focus solely upon buy-outs to a multi-remedy approach.

The simplest, and most typical,²⁵⁰ pattern is that of Michigan which provides:

Sec. 825. (1) The circuit court of the county in which the registered office of the corporation is located may adjudge the dissolution of, and liquidate the assets and business of, a corporation, in an action filed by a shareholder when it is established that the acts of the directors or those in control of the corporation are illegal, fraudulent or willfully unfair and oppressive to the corporation or to such shareholder.

(2) In an action filed by a shareholder to dissolve the corporation on a ground enumerated in subsection (1), the circuit court upon establishment of such ground may make such order or grant such relief, other than dissolution, as it deems appropriate, including, without limitation, an order providing for any of the following:

(a) Cancellation or alteration of a provision contained in the articles of incorporation, or an amendment thereof, or in the by-laws of the corporation.

(b) Cancellation, alteration or injunction against a resolution or other act of the corporation.

(c) Direction or prohibition of an act of the corporation or of shareholders, directors, officers or other persons party to the action.

(d) Purchase at their fair value of shares of a shareholder, either by the corporation or by the officers, directors or other shareholders responsible for the wrongful acts.²⁵¹

246 1941 Cal. Stat. 2058-59 (codified as amended at CAL. CORP. CODE § 2000 (West 1977 & Supp. 1989)).

247 Rhode Island did adopt a buy-out provision in 1969. 1969 R.I. Pub. Laws ch. 141, § 1 (codified at R.I. GEN. LAWS § 7-1.1-90.1 (1985)).

248 See Maine, 1971 Me. Laws 756 ch. 439, § 1 (codified at ME. REV. STAT. ANN. tit. 13A, § 1123 (1981)); Maryland, 1975 Md. Laws 1679 ch. 311, § 2 (codified at MD. CORPS. & ASS'NS CODE ANN. § 4-603 (1985)); Michigan, 1972 Mich. Pub. Acts 847 no. 284, § 825 (codified at MICH. COMP. LAWS ANN. § 450.1825(2) (West 1973)); New Jersey, 1973 N.J. Laws 1036 ch. 366, § 67 (codified at N.J. STAT. ANN. § 14A:12-7 (West 1978)); New York, 1979 N.Y. Laws ch. 217, § 3 (codified at N.Y. BUS. CORP. LAW § 1118 (McKinney 1980)); North Carolina, 1973 N.C. Sess. Laws 557 ch. 469, § 41 (codified at N.C. GEN. STAT. § 55-125.1 (1979)); West Virginia, 1974 W. Va. Acts 290 ch. 13 (codified at W. VA. CODE § 31-1-134 (1988)).

249 See Illinois, 1983 Ill. Laws 7019-20 Art. 12, § 12.55 (codified at ILL. ANN. STAT. ch. 32, para. 12.55 (Smith-Hurd 1985)); Minnesota, 1981 Minn. Laws ch. 270, § 108 (codified at MINN. STAT. ANN. § 302A.751 (West 1985)); South Carolina, 1981 S.C. Acts 626 No. 146, § 2 (codified at S.C. CODE ANN. § 33-21-155 (Law. Co-op. 1987)).

250 See also Maine, North Carolina, and South Carolina, *supra* notes 248-49 (Maine also provides for a provisional director).

251 MICH. COMP. LAWS ANN. §§ 450.1825 (West 1973) (repealed 1989).

The standard is broad: that which the court "deems appropriate." In addition, in Michigan, the court may order the purchase on its own motion while in other jurisdictions, a petition or election is necessary, either by the corporation,²⁵² or the other shareholders,²⁵³ or the complaining shareholder.²⁵⁴ The statutes uniformly establish that the purchase price shall be "fair value," not "fair market value."²⁵⁵ New Jersey recognizes that there may need to be "adjustments deemed equitable" in establishing the price because of the oppressive conduct,²⁵⁶ while Minnesota would use the price established in a shareholder agreement,²⁵⁷ unless it is unreasonable—as is so often the case.²⁵⁸

Complementing these statutes are decisions in several jurisdictions in which the courts have recognized that the general equitable powers of a court suffice to order a remedy other than dissolution when the grounds for dissolution exist. *Baker v. Commercial Body Builders, Inc.*²⁵⁹ is frequently cited for this proposition. In *Baker*, the Oregon Supreme Court, after reviewing the approach of other jurisdictions in defining oppressive conduct, adopted a broad approach and analogized oppressive conduct to that which would be a breach of the fiduciary duty of the majority of "good faith and fair dealing"²⁶⁰ owed to the minority. The court, however, stated that "the remedy of a forced dissolution . . . may equally be 'oppressive' to the majority stockholders"²⁶¹ and set forth ten alternative remedies that might be appropriate.²⁶² While the *Baker* court

252 See California, Illinois, Maryland, Minnesota, New Jersey, and Rhode Island, *supra* notes 247-49.

253 See Connecticut, West Virginia, and jurisdictions noted *supra* note 252.

254 See Illinois and Minnesota, *supra* note 249.

255 The significance of this terminology is discussed *infra* notes 352-54 and accompanying text and notes 373-75 and accompanying text.

256 N.J. STAT. ANN. § 14A: 12-7(8)(a) (West Supp. 1989).

257 MINN. STAT. ANN. § 302A.751 (subd. 2) (West 1985 & Supp. 1989).

258 See, e.g., *In re Pace Photographers, Ltd.*, 71 N.Y.2d 737, 525 N.E.2d 713, 530 N.Y.S.2d 67 (1988) (Agreement provided for a stated value which had not been updated for four years and then applied a 50% discount to the stated value. Book value is often used in such agreements, and, if book value bears any relation to the value of the business, it is fortuitous.).

259 264 Or. 614, 507 P.2d 387 (1973).

260 *Id.* at 629, 507 P.2d at 394.

261 *Id.* at 630, 507 P.2d at 394.

262 *Id.* at 632-33, 507 P.2d at 395-96. The remedies listed are the following:

- (a) The entry of an order requiring dissolution of the corporation at a specified future date, to become effective only in the event that the stockholders fail to resolve their differences prior to that date;
- (b) The appointment of a receiver, not for the purposes of dissolution, but to continue the operation of the corporation for the benefit of all the stockholders, both majority and minority, until differences are resolved or 'oppressive' conduct ceases;
- (c) The appointment of a 'special fiscal agent' to report to the court relating to the continued operation of the corporation, as a protection to its minority stockholders, and the retention of jurisdiction of the case by the court for that purpose;
- (d) The retention of jurisdiction of the case by the court for the protection of the minority stockholders without appointment of a receiver or 'special fiscal agent';
- (e) The ordering of an accounting by the majority in control of the corporation for funds alleged to have been misappropriated;
- (f) The issuance of an injunction to prohibit continuing acts of 'oppressive' conduct and which may include the reduction of salaries or bonus payments found to be unjustified or excessive;
- (g) The ordering of affirmative relief by the required declaration of a dividend or a reduction and distribution of capital;

declined to grant the plaintiff any relief, four years later the Oregon court granted a buy-out.²⁶³

The focus of alternative relief typically has been upon buy-outs of minority shareholders.²⁶⁴ An Iowa court, in upholding a buy-out of the plaintiffs' shares, noted that the Iowa statute authorizing dissolution for oppressive conduct and waste of corporate assets was comparable to the Oregon statute pursuant to which alternative remedies could be granted according to the *Baker* court. The Iowa court accordingly concluded that the Iowa statute, though silent on remedies other than dissolution, "allows the district court to fashion other equitable relief."²⁶⁵

Since the Oregon statute is based upon the Illinois Act and the Model Act,²⁶⁶ which in turn are the bases for most of the oppression statutes,²⁶⁷ the logic of the Iowa court would mean that alternative relief, particularly buy-outs of minority shareholders, is available in most, if not all, jurisdictions. In this vein, the Supreme Court of West Virginia has stated that "most courts have concluded that because of the drastic consequences of dissolution, less drastic alternatives should be fashioned if possible."²⁶⁸ Similarly, the Supreme Court of North Dakota held that a "trial court abused its discretion in ordering the extreme remedy of dissolution"²⁶⁹ and instructed the trial court to require either the corporation or the majority shareholder to purchase plaintiff's shares "at a price determined by the court to be the fair value thereof."²⁷⁰ Accordingly, it cannot be gainsaid that minority shareholder buy-outs are firmly established throughout the states as alternative relief to dissolution when such shareholders have been subject to oppressive actions by those in control. The availability of alternative remedies, in turn, has had a substantial impact on the recognition of reasonable expectations as the basis for determining whether oppressive conduct exists.

(h) The ordering of affirmative relief by the entry of an order requiring the corporation or a majority of its stockholders to purchase the stock of the minority stockholders at a price to be determined according to a specified formula or at a price determined by the court to be a fair and reasonable price;

(i) The ordering of affirmative relief by the entry of an order permitting minority stockholders to purchase additional stock under conditions specified by the court;

(j) An award of damages to minority stockholders as compensation for any injury suffered by them as the result of 'oppressive' conduct by the majority in control of the corporation.

Id. (footnotes omitted.) See also *Fix v. Fix Material Co.*, 538 S.W.2d 351, 357 (Mo. Ct. App. 1976).

263 *Delaney v. Georgia-Pacific Corp.*, 278 Or. 305, 564 P.2d 277 (1977).

264 *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980) (after remand, finding of oppression and order of buy-out), *aff'd sub nom.* *Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985); *Maddox v. Norman*, 206 Mont. 1, 669 P.2d 230 (1983); *McCauley v. Tom McCauley & Son, Inc.*, 104 N.M. 523, 724 P.2d 232 (Ct. App. 1986); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987); *Delaney v. Georgia-Pacific Corp.*, 278 Or. 305, 564 P.2d 277 (1977); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. Ct. App. 1988).

265 *Sauer v. Moffitt*, 363 N.W.2d 269, 275 (Iowa Ct. App. 1984).

266 See *supra* notes 199-202 and accompanying text.

267 See, e.g., *Fix v. Fix Material Co.*, 538 S.W.2d 351, 356-57 (Mo. Ct. App. 1976).

268 *Masinter v. Webco Co.*, 164 W. Va. 241, 249, 262 S.E.2d 433, 439 (1980).

269 *Balvik v. Sylvester*, 411 N.W.2d 383, 389 (N.D. 1987).

270 *Id.*

B. *Reasonable Expectations—The New York Decisions*

While Illinois earlier led the way in specifying what conduct can be deemed oppressive,²⁷¹ since 1980 New York has played the dominant role by developing the reasonable expectations test to define oppressive conduct. A year after the New York legislature enacted the statutory scheme embodying oppression as a ground for dissolution but permitting the corporation or the other shareholders to avoid dissolution by electing to purchase the petitioner's shares, the first significant suit, *In Re Topper*,²⁷² was brought. Topper had worked for twenty-five years for a company in Florida when he left to become a one-third shareholder in two pharmacies in New York. In addition to uprooting himself and his family, he invested his life savings in the ventures and executed personal guarantees. He first received a salary of \$30,000 which was later raised to \$75,000. Then, within one year of the organization of the two corporations, his employment was terminated. The court, in finding oppression and interpreting defendants' affidavits as an election to buy out the plaintiff, stated:

Whether the controlling shareholders discharged petitioner for cause or in their good business judgment is irrelevant. The Court finds that the undisputed understanding of the parties was such at the time of the formation of the corporations that the respondents' actions have severely damaged petitioner's reasonable expectations and constitute a freeze-out of petitioner's interest; consequently, they are deemed to be 'oppressive' within the statutory framework.²⁷³

This approach stands in marked contrast, not only to the business judgment rule, but also to the shareholder fiduciary duty rule—at least in those situations in which a court would, in effect, permit a "business purpose" defense to a claim of breach of fiduciary duty. For example, even *Wilkes* recognized that conduct that appears to be a breach of duty can be justified by a business purpose.²⁷⁴ The difference in result may be rationalized by the difference in focus and the difference in remedy. In determining whether there has been a breach of fiduciary duty, the focus is upon wrongdoing by the person in control and the remedy is to invalidate the transaction, either by enjoining it or by awarding damages. In the reasonable expectations test, the focus is on the minority shareholder and the remedy is not to undo a corporate transaction but to permit or order another transaction—a buy-out of the minority shareholder. Thus, the crux is not identifying a traditional wrong but rather identifying the basis of the bargain—what were the explicit or implicit conditions pursuant to which the parties associated themselves together in the corporate form. The court recognized that these conditions or expectations are not likely to be in written form:

271 See *supra* notes 198-216 and accompanying text.

272 107 Misc. 2d 25, 443 N.Y.S.2d 359 (Sup. Ct. 1980).

273 *Id.* at 28, 433 N.Y.S.2d at 362.

274 *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 851, 353 N.E.2d 657, 663 (1976). See also *supra* notes 79-107 and accompanying text.

This Court, too, recognizes that in a close corporation the bargain of the participants is often not reflected in the corporation's charter, by-laws nor even in separate signed agreements. The parties' full understanding may not even be in writing but may have to be construed from their actions. Unlike their counterparts in large corporations, minority shareholders in small corporations often expect to participate in management and operations. 'Furthermore, there generally is an expectation on the part of some participants that their interest is to be recognized in the form of a salary derived from employment with the corporation.' These reasonable expectations constitute the bargain of the parties in light of which subsequent conduct must be appraised.²⁷⁵

This approach has become the touchstone for evaluating oppressive conduct in the 1980s.

The following year, the New York court again faced an egregious situation in which the minority shareholders, in a chain of retail film processing stores, had failed to protect themselves.²⁷⁶ The plaintiff alleged that a son from each family was to be an operating employee with the three fathers in supervisory capacities. The plaintiff further alleged that his son was the moving force behind the creation of the business and that both he and his son had relocated to New York to participate in the business. Within a year, the other principals removed the plaintiff and his son as officers and employees and offered the plaintiff \$10,000 for his shares. Parenthetically, in a later opinion, the court valued the plaintiff's interest at \$452,000.²⁷⁷ The court held that "the actions of the majority in eliminating the petitioner and his son from the active operation of the Corporation in which they had participated, and in which they had every reasonable expectation of being able to continue to participate, constitutes 'oppressive' conduct."²⁷⁸

The next significant New York case, *Gimpel v. Bolstein*,²⁷⁹ involved two unique twists: the plaintiff had been terminated for embezzlement and the plaintiff was a third-generation owner. The court, in reviewing the decisions on oppression, found two themes: the "reasonable expectations" test, and the "conduct which fair-minded people would find objectionable" test. With respect to termination as defeating reasonable expectations, the court stated:

Also, it must be recognized that 'reasonable expectations' do not run only one way. To the extent that Robert may have entertained 'reasonable expectations' of profit in 1975, the other shareholders also entertained 'reasonable expectations' of fidelity and honesty from him.

275 107 Misc. 2d at 33-34, 433 N.Y.S.2d at 365 (quoting *Exadaktilos v. Cinnaminson Realty Co.*, 167 N.J. Super. 141, 400 A.2d 554 (1979)) (citations omitted).

276 *In re Gene Barry One Hour Photo Process, Inc.*, 111 Misc. 2d 559, 444 N.Y.S.2d 540 (Sup. Ct. 1981). The court observed that "[t]he parties did not enter into any shareholders' or any other written agreement with respect to the operation of the Corporation and many organizational formalities, including adoption of by-laws, do not seem to have taken place prior to institution of this proceeding." *Id.* at 560, 444 N.Y.S.2d at 541.

277 *Taines v. Gene Barry One Hour Photo Process, Inc.*, 123 Misc. 2d 529, 474 N.Y.S.2d 362 (Sup. Ct. 1983), *aff'd*, 108 A.D.2d 630, 486 N.Y.S.2d 699 (App. Div.), *appeal dismissed*, 66 N.Y.2d 757, 488 N.E.2d 113, 497 N.Y.S.2d 367 (1985). See *infra* notes 307-09 and accompanying text.

278 111 Misc. 2d at 565, 444 N.Y.S.2d at 544.

279 125 Misc. 2d 45, 477 N.Y.S.2d 1014 (Sup. Ct. 1984).

All such expectations were shattered when Robert stole from the corporation. His own acts broke all bargains. Since then, the only expectations he could reasonably entertain were those of a discovered thief: ostracism and prosecution.²⁸⁰

The court went on to question whether the reasonable expectations approach is applicable when the existing shareholders are generations removed from the founders. Nevertheless, even though there was no problem with the termination and even if the reasonable expectations test was not appropriate, the court found that the plaintiff was still entitled to relief:

Even though Robert may not lay claim to the reasonable expectation of any specific benefits, it does not necessarily follow that the majority shareholders may treat him as shabbily as they please. . . . Although a minority shareholder may be in the position of a stranger to them, the majority must still act with 'probity and fair dealing,' and if their conduct becomes 'burdensome, harsh and wrongful,' they may be found to have been guilty of oppression and the corporation may be subject to dissolution.²⁸¹

Accordingly, the court concluded that "the majority must make an election: they must either alter the corporate financial structure so as to commence payment of dividends, or else make a reasonable offer to buy out Robert's interest."²⁸²

With this background, the New York Court of Appeals in *In re Kemp & Beatley, Inc.*,²⁸³ considered the petition of two former employees who had forty-two and thirty-five years of service but who now were receiving no compensation. The six other shareholders were apparently still employed by the company. In the past, *de facto* dividends based upon stock ownership had been paid in the form of extra compensation bonuses. After their employment was terminated, the extra compensation was still paid but not based upon stock ownership.

The court of appeals clarified that the concept of oppressive conduct, under the statute, is distinct from illegality or fraud and that the distinction has been resolved "by considering oppressive actions to refer to conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise."²⁸⁴ Accordingly, the court held that "utilizing a complaining

280 *Id.* at 52, 477 N.Y.S.2d at 1019-20 (citations omitted).

281 *Id.* at 53, 477 N.Y.S.2d at 1020.

282 *Id.* at 56, 477 N.Y.S.2d at 1022.

283 64 N.Y.2d 63, 473 N.E.2d 1173, 484 N.Y.S.2d 799 (1984).

284 *Id.* at 72, 473 N.E.2d at 1179, 484 N.Y.S.2d at 805. Before determining what reasonable expectations might be, the court stated:

It is widely understood that, in addition to supplying capital to a contemplated or ongoing enterprise and expecting a fair and equal return, parties comprising the ownership of a close corporation may expect to be actively involved in its management and operation.

His [the shareholder in the close corporation] participation in that particular corporation is often his principal or sole source of income. As a matter of fact, providing employment for himself may have been the principal reason why he participated in organizing the corporation. He may or may not anticipate an ultimate profit from the sale of his interest, but he normally draws very little from the corporation as dividends. In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his

shareholder's 'reasonable expectations' as a means of identifying and measuring conduct alleged to be oppressive is appropriate."²⁸⁵ The court cautioned that expectations must be reasonable and objective²⁸⁶ and concluded that such was the case in the matter before it:

Kemp & Beatley had a long-standing policy of awarding *de facto* dividends based on stock ownership in the form of 'extra compensation bonuses.' . . . [T]here was uncontroverted proof that this policy was changed either shortly before or shortly after petitioners' employment ended. Extra compensation was still awarded by the company. The only difference was that stock ownership was no longer a basis for the payments.²⁸⁷

What the New York decisions make clear is that those in control of a corporation may no longer use the business judgment rule to shield from judicial scrutiny actions that are detrimental to minority shareholders. The courts have recognized the reality that compensation paid to those in control has a two fold function: to recompense services and to provide a return on investment. To deny a minority shareholder employment when a job was part of his rationale in investing²⁸⁸ is oppressive, as is the failure to pay dividends to nonemployee shareholders when employed shareholders are receiving *de facto* dividends through salaries.

While a reasonable expectations test may appear as elusive to apply as oppression, it does provide a focus from which to evaluate a situation. That people often invest in a closely held corporation to provide a job is almost self-evident; if there is doubt, the proposition can be confirmed empirically by surveying representative businesses.

C. *The Development of the Reasonable Expectations Test in Other Jurisdictions*

The reasonable expectations test, as developed by the New York courts, has had a substantial impact upon the recognition of minority shareholder rights. *Kemp & Beatley*, of course, has been followed in subsequent New York decisions.²⁸⁹ But it also has strongly influenced the

capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.

Id. at 71, 473 N.E.2d at 1178, 484 N.Y.S.2d at 804 (quoting F. O'NEAL, CLOSE CORPORATIONS 21-22 (2d ed. 1971)).

285 *Id.* at 73, 473 N.E.2d at 1179, 484 N.Y.S.2d at 805.

286 The court stated:

Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression.

Rather, oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture.

Id.

287 *Id.* at 74, 473 N.E.2d at 1180, 484 N.Y.S.2d at 806.

288 The New York courts have recognized that a passive investor in a real estate corporation has no stake in employment. See *In re Farega Realty Corp.*, 132 A.D.2d 797, 517 N.Y.S.2d 610 (1987). See also *In re Brach*, 135 A.D.2d 711, 522 N.Y.S.2d 612 (1987).

289 See, e.g., *In re Rambusch*, 143 A.D.2d 605, 533 N.Y.S.2d 423 (1988) (error to dismiss petition of 30% shareholder who was dismissed after 36 years); *In re Burack*, 137 A.D.2d 523, 524 N.Y.S.2d 457 (1988) (termination of shareholder employed for 40 years was oppressive and justified buy-out); *In re Imperatore*, 128 A.D.2d 707, 512 N.Y.S.2d 904 (1987) (while minority shareholder's salary could have been reduced for poor performance, it was oppressive to fire him); *In re Mintz*, 113

highest courts of North Dakota and Alaska to adopt a reasonable expectations test to measure oppressive conduct. The North Dakota Supreme Court, after holding that a freeze-out of a thirty-percent shareholder by terminating his employment defeated his reasonable expectations and was therefore oppressive, reversed the order of dissolution and instructed the trial court to frame a buy-out remedy.²⁹⁰ The Alaska Supreme Court, in upholding the trial court's finding of oppressiveness and ordering of a buy-out, stated that what constitutes oppressive conduct can be difficult to discern; it noted that it favored the reasonable expectations test embodied in *Kemp & Beatley*.²⁹¹ Both cases coupled a reasonable expectations approach with a recognition of judicial power to fashion alternative remedies to dissolution.

Prior to *Kemp & Beatley*, but relying upon *Topper* and *Exadaktilos*, the Montana Supreme Court adopted a reasonable expectations approach in finding that a brother, who was a twenty-five to fifty-percent shareholder in three related family owned corporations, had been oppressed when the corporations were so operated as to deny any benefit to him.²⁹² Similarly, the Supreme Court of North Carolina, in interpreting a North Carolina statute which permitted dissolution when "reasonably necessary for the protection of the rights or interests of the complaining shareholder,"²⁹³ relied upon *Topper* and *Gidwitz*²⁹⁴ in adopting a reasonable expectations approach.²⁹⁵ *Meiselman v. Meiselman*, however, offered a new insight in applying the reasonable expectations test, one that it believed was dictated by the state's unique statute. The statutory focus was upon protecting the rights and interests of the shareholder rather than upon oppression. The trial court had dismissed the suit, finding no wrongdoing or breach of duty by the defendant. The supreme court reversed and instructed the trial court to determine what were plaintiff's "rights or interests"—his 'reasonable expectations.'"²⁹⁶ The court should then determine whether they needed protection and, if so, what form of relief, including statutory alternatives to dissolution, was appropriate.

Two other jurisdictions, New Mexico and Texas, have reviewed the case law defining oppression and have concluded that it is "an expansive term that is used to cover a multitude of situations dealing with improper conduct."²⁹⁷ While not explicitly adopting a reasonable expectations test, the courts of both states opined that the absence of a rigidly defined

A.D.2d 803, 493 N.Y.S.2d 488 (1985) (error to dismiss petition alleging family of retired shareholder received no dividends for 12 years while other shareholders received salaries); *In re Wiedy's Furniture Clearance Center Co.*, 108 A.D.2d 81, 487 N.Y.S.2d 901 (1985) (oppression where son, who left another position to join family business, was terminated 10 years later).

290 *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987).

291 *Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985). The parties were previously before the court in *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980); where they suggested that the plaintiff could force a buy-out of her shares if she could establish oppression or waste.

292 *Fox v. 7L Bar Ranch Co.*, 198 Mont. 20, 645 P.2d 929 (1982).

293 N.C. GEN. STAT. § 55-125(a)(4) (1982).

294 See *supra* note 208 and accompanying text.

295 *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983).

296 *Id.* at 306, 307 S.E.2d at 567.

297 *McCauley v. Tom McCauley & Son, Inc.*, 104 N.M. 523, 527, 724 P.2d 232, 236 (1986); *Davis v. Sheerin*, 754 S.W.2d 375, 381 (Tex. Ct. App. 1988).

standard for oppressive conduct enabled courts to determine, on a case-by-case basis, "whether the acts complained of serve to frustrate the *legitimate expectations* of minority shareholders."²⁹⁸ In connection with their findings of oppression, both courts also held that there is general equitable power to fashion remedies as alternatives to dissolution when oppression is found.

Several other cases also point to a broadening of protection for minority shareholders. A Maryland court recently clarified an earlier decision and held that self-dealing transactions could constitute oppression,²⁹⁹ and two other jurisdictions, Louisiana and Minnesota, interpreted their unique statutory provisions for dissolution in a broad manner. In *Gooding v. Millet*,³⁰⁰ a one-third shareholder charged that another shareholder operated the corporation, which had never declared dividends, as his alter ego and thus the corporation had been guilty of "gross and persistent ultra vires acts."³⁰¹ The situation was somewhat akin to the conduct found oppressive in *Gidwitz*; the Louisiana court found that such conduct warranted dissolution since the legislature intended that a broad application be given to the statute. Finally, in *Sheehan v. Mondati (In re Villa Maria, Inc.)*,³⁰² the Minnesota Supreme Court held that the action of a fifty percent shareholder in running the business as he pleased and failing to pay dividends, thus depriving the other shareholder of any return on investment, was an abuse of authority under the Minnesota dissolution statute.³⁰³

The foregoing perspective demonstrates that courts in this decade have almost uniformly³⁰⁴ taken a broad approach to defining oppressive conduct, and where alternatives to dissolution do not exist by statute, have upheld the general equitable power of the courts to fashion such alternatives. The pattern appears firmly established.

The most common form of alternative remedy is the buy-out of the minority shareholder. But such a remedy can only be meaningful if the price is fair and realistic. Since the parties will often differ markedly on what is a fair and realistic price, courts will need to confront valuation

298 104 N.M. at 527, 724 P.2d at 236 (emphasis added); 754 S.W.2d at 381 (emphasis added).

299 *Valerino v. Little*, 62 Md. App. 588, 490 A.2d 756 (1985) (clarifying *Lynch v. Buchanan*, 37 Md. App. 413, 377 A.2d 592 (1977)).

300 430 So. 2d 742 (La. Ct. App. 1983).

301 LA. REV. STAT. ANN. § 12:143-A(7) (West 1969).

302 312 N.W.2d 921 (Minn. 1981).

303 MINN. STAT. ANN. § 301.49 (West 1980) (repealed by 1981 Minn. Laws ch. 270, Ann. § 302A.751 (West. 1985 & Supp. 1989)).

304 Two courts have taken a very restrictive view of what constitutes oppression. In *Iwasaki v. Iwasaki Bros., Inc.*, 58 Or. App. 543, 649 P.2d 598 (1982), two brothers terminated the third and refused to pay dividends even though he was taxed on the undistributed income because of the corporation's subchapter S election. Income before salaries for the other two brothers had been averaging almost \$200,000 a year. The court found that the salary payments and the policy of not paying dividends were protected by the business judgment rule. In *Capitol Toyota, Inc. v. Gervin*, 381 So. 2d 1038 (Miss. 1980), the general manager, 25% shareholder of a dealership, was terminated by the new majority owners. The court found that his "reasonable expectations have been thwarted, but not grossly so." *Id.* at 1039. The court justified his termination on the basis that profits were higher under the new owners than under his management for the old owners. The court failed to understand that earnings were lower in the past because the old owners took large salaries and bonuses and charged the expenses of a yacht to the dealership. See *infra* note 335.

theory and issues in implementing buy-out relief. Accordingly, the balance of this Article will focus upon the valuation process.

VI. Valuation of Minority Interests in Judicial Buy-Outs

There is no question but that the development of a buy-out remedy for minority shareholders who are confronted with actions by those in control that are oppressive or that defeat the reasonable expectations of the minority is a very positive development. The efficacy of such a remedy, however, is inextricably intertwined with the valuation process. Invariably, the parties are far apart in their respective views of the value of the business.³⁰⁵ Often the "experts" are equally far apart.³⁰⁶ Prior to trial, in one well known case, the majority offered the minority shareholder \$10,000; at the hearing, defendants' expert opined the business was worth \$71,000 and plaintiff's expert opined \$20.7 million.³⁰⁷ The court characterized their testimony as absurd³⁰⁸ and determined the value of the corporation to be \$1,356,000.³⁰⁹ When experts can have such widely differing opinions, it is critical that the courts be vigilant to protect the interests of minority shareholders.

Valuation theory is essentially conservative. This is in large measure due to the fact that it has been tax driven. Most of the cases and articles in the field are generated by the taxing process.³¹⁰ If a conservative approach is not taken, the taxing process can become confiscatory. For example, if the tax rate is 50% and the corporation is erroneously valued at \$1 million, the tax would be \$500,000. However, if the corporation could only be sold for \$500,000, the taxing process would appropriate the full value of the property.

The assessment of a tax contemporaneously creates a need for liquidity in order that funds be available to pay the tax. In the case of a closely held corporation, if the shares are the primary asset and must be liquidated to pay the taxes, the overstatement of value, as compared to funds generated when the shares are sold, can result in a transfer of the entire value of the shares to the government. Accordingly, both public policy and equity dictate a conservative valuation process.

305 See *supra* note 22.

306 See, e.g., *Hickory Creek Nursery, Inc. v. Johnston*, 167 Ill. App. 3d 449, 521 N.E.2d 236 (1988) (where one expert valued plaintiff's interest at \$150,000 and the other expert valued it at zero).

307 *In re Gene Barry One Hour Photo Process, Inc.*, 111 Misc. 2d 559, 560, 444 N.Y.S.2d 540, 541 (N.Y. Sup. Ct. 1981).

308 *Taines v. Gene Barry One Hour Photo Process, Inc.*, 123 Misc. 2d 529, 532, 474 N.Y.S.2d 362, 365 (Sup. Ct. 1983).

309 *Id.* at 537, 474 N.Y.S.2d at 368 (the court treated each of three shareholders as having lent the corporation \$215,000; plaintiff's one-third of \$1,356,000 was \$452,000, including the \$215,000 "loan").

310 See generally Haynsworth, *Valuation of Business Interests*, 33 MERCER L. REV. 457 (1982). The author characterizes Revenue Ruling 59-60, 1959-1 C.B. 237, as the "most complete statement of the relevant factors to consider in valuing a closely held business." *Id.* at 466. His article is replete with citations to tax cases and tax-oriented secondary materials. His discussion of discounts relies almost exclusively on tax-oriented authority. *Id.* at 488-97. See also Smith, *Valuation and the Minority Discount*, 42 N.Y.U. INST. ON FED. TAX'N ch. 52 (1984); Comment, *Valuing Closely Held Stock: Control Premiums and Minority Discounts*, 31 EMORY L.J. 139 (1982).

On the other hand, what is at stake in the "oppression" cases is often a job—a very attractive job. For example, in one recent, superficially well-considered decision, a federal court ordered the "money" shareholder to buy out the "work" shareholder.³¹¹ At first glance, the decision appears sound: money has greater funds than work. And the value assigned to work's shares—\$844,174—was not insubstantial. What work lost, however, was a job paying \$250,000 per year. If he were to remain in that position for ten more years, the present worth of his employment, discounted at 8%, is \$1,677,525.³¹² If one year later, work was able to obtain another position at \$100,000, the present value of that position for nine more years would be \$624,690. What work has lost is \$1,052,835. While he received \$844,174, he needed to invade that principal for a year's living expenses while he found the new position.³¹³ The situation becomes all the more disadvantageous to the minority shareholder as the value of the shares decreases vis-a-vis the compensation he has been receiving.

While valuation is not an "exact science,"³¹⁴ as will be illustrated in the next section of this Article dealing with valuation generally,³¹⁵ that part of valuation theory which most critically needs to be reconsidered is the process of discounting minority interests. While such discounts make sense in the tax setting, they are wholly inappropriate in a state court proceeding in which a minority shareholder seeks to be bought out because of oppressive conduct by the majority.

The impact of such discounts can be devastating to a minority shareholder. For example, in *Cavalier Oil Corp. v. Harnett*, the appraiser for the defendants applied a minority discount of twenty-eight percent and a liquidity or nonmarketability discount of forty percent.³¹⁶ The net effect of the two discounts was to devalue the minority shares by fifty-seven percent.³¹⁷ The value of the shares determined by the court was \$302,000. Had the minority and liquidity discounts been applied, the plaintiff would have received only \$130,000. The court, however, found that neither a minority nor illiquidity discount was proper and awarded the plaintiff \$302,000.

Accordingly, the primary thrust of the balance of this Article will be to demonstrate that both minority and illiquidity discounts are inappro-

311 *Hendley v. Lee*, 676 F. Supp. 1317 (D.S.C. 1987).

312 The present-value factor for a ten-year annuity is 6.7101; the factor for a nine-year annuity is 6.2469. Multiplying the factor by the salary calculates the present value of the salary. See S. PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES app. A-2 (1981).

313 In my experience, terminated executives seldom walk into comparable paying jobs the next day. Were this not true, there would be no justification for the "golden parachutes" presently in vogue.

314 See, e.g., *Johnston v. Hickory Creek Nursery, Inc.*, 167 Ill. App. 3d 449, 454, 521 N.E.2d 236, 238 (1988), where the court stated: "It is well recognized that determination of the fair market value of a closely-held corporation is not an exact science as witnessed by the frequency with which appraisers differ in their opinions concerning the appropriate value to assign to a shareholder's interest in these corporations."

315 See *infra* text accompanying notes 318-34.

316 *Cavalier Oil Corp. v. Harnett*, Nos. 7959, 7960, 7967, 7968 (Del. Ch. Feb. 22, 1988) (LEXIS, states library, Del file), *aff'd*, 564 A.2d 1137 (Del. 1989).

317 Fair value minus 28% equals 72% fair value. Seventy-two percent fair value minus 40% equals 43% fair value.

priate in valuing minority shares when the trigger for valuation is oppressive or comparable conduct by those in control. Valuation in general, the adjustments to income and assets necessary to offset the effects of the oppressive conduct, and the effect of shareholder repurchase agreements will also be briefly considered.

A. Valuation—A General Perspective

It has already been noted that valuation is an inexact science.³¹⁸ While the Delaware block approach is the approach most commonly employed—either directly³¹⁹ or indirectly³²⁰—courts have recognized various other approaches, including multiples of gross revenue,³²¹ adjustments of an earlier price paid by those acquiring a majority interest,³²² and discounted cash flow. Delaware itself, in *Weinberger v. UOP, Inc.*, has rejected the Delaware block approach “to the extent it excludes other generally accepted techniques used in the financial community and the courts.”³²³ In so doing, the court accepted the discounted cash flow method of valuing UOP’s stock.

However, the Delaware block approach can be used to demonstrate just how inexact the valuation “science” is. In *Piemonte v. New Boston Garden Corp.*,³²⁴ the trial court, in arriving at a value of \$75.27 a share, employed a Delaware block approach as follows:

	Value		Weight		Result
Market Value:	\$ 26.50	×	10%	=	\$ 2.65
Earnings Value:	52.60	×	40%	=	21.04
Net Asset Value:	103.16	×	50%	=	51.58
Total Value Per Share:					\$75.27 ³²⁵

The most obvious softness in the valuation process is in the weighing. For example, if the weights for market value and net asset value were reversed, the value of the corporation would drop dramatically:

318 See *supra* note 314.

319 See *In re Delaware Racing Ass’n*, 42 Del. Ch. 406, 213 A.2d 203 (1965); *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 123 A.2d 121 (1956); *Piemonte v. New Boston Garden Corp.*, 377 Mass. 719, 387 N.E.2d 1145 (1979).

320 See, e.g., *Sarrouf v. New England Patriots Football Club*, 397 Mass. 542, 492 N.E.2d 1122 (1986) (court upheld a valuation predicated upon net asset value but stated that the same result could have been justified under a Delaware block approach in which earnings and market value are given little weight). Anytime a court considers multiple factors and assigns a weight to each, the court is, in effect, using a Delaware block approach.

321 See *supra* text preceding note 175.

322 See, e.g., *Stewart v. D.J. Stewart & Co.*, 37 Ill. App. 3d 848, 346 N.E.2d 475 (1976), where the court employed what might at first glance appear to be a variation of the Delaware block approach. However, the starting point for the court was the amount that had been paid by a company that had acquired 80% of D.J. Stewart & Co. 21 months earlier. In other words, the court took the price paid in the acquisition as presumptively reflecting fair value at that point in time and then adjusted that \$600 figure by various ratios reflecting the improvement in sales, operating profit, net income, and book value in the intervening 21 month period. The court thereby came up with a value of \$660 per share even though defendant’s appraiser, using a conventional Delaware block approach, testified that the value was \$195 per share.

323 457 A.2d 701, 712 (Del. 1983).

324 377 Mass. 719, 387 N.E.2d 1145 (1979).

325 *Id.* at 722 n.3, 387 N.E.2d at 1148 n.3.

	<u>Value</u>		<u>Weight</u>		<u>Result</u>
Market Value:	\$ 26.50	×	50%	=	\$13.25
Earnings Value:	52.60	×	40%	=	21.04
Net Asset Value:	103.16	×	10%	=	10.31
Total Value Per Share:					\$44.60

The drop from \$75.27 a share to \$44.60 is approximately 40%. This is not to suggest that appraisers capriciously juggle weights, but part of the discrepancy between the valuations by the experts of each party is traceable to the weighing process. For example, a caricature of the expert opinions in *Johnston v. Hickory Creek Nursery, Inc.*, would show one expert assigning a 100% weight to earnings in arriving at a value of the corporation of \$450,000 and the other assigning a 100% weight to assets in arriving at a value of zero.³²⁶ A 20/40/40 weighing in *Piemonte* will change the value from \$75 per share to \$68. And who can say with any degree of certainty that the appropriate weight for market value is 10% and not 5% or 20%?

In addition, each of the factors contains elements of softness. Normally, market value is fairly straightforward *if* there is a market. If there is no market, the appraisers seek to reconstruct a market.³²⁷ If the market is "thin," the question generally is how much weight to attach to market value.³²⁸

On the other hand, there is substantial softness in the earnings value approach or its "cousin," discounted cash flow. The earnings value is generally a product of earnings times the price/earnings ratio or "P/E" or "multiplier." The multipliers in the cases discussed in this Article range from 4.48³²⁹ to 15.2.³³⁰ Again, this is not to suggest that appraisers may arbitrarily choose a multiplier; their choice of a multiplier is based upon the multipliers of comparable companies.³³¹ There is considerable discretion available, however, in selecting "comparable" companies.³³² In addition, results will vary depending upon whether the most recent year's earnings are used or whether earnings over a number of years are averaged or weighted.³³³

Earnings, likewise, is a soft concept. Whether items are expensed or capitalized and what useful life is used for depreciation, as well as the

326 167 Ill. App. 3d 449, 521 N.E.2d 236 (1988).

327 See, e.g., 377 Mass. at 725, 387 N.E.2d at 1149; *Bell v. Kirby Lumber, Corp.*, 413 A.2d 137, 146 (Del. 1980).

328 See, e.g., 377 Mass. at 726, 387 N.E.2d at 1149 (only 4,372 shares were traded in 1972, less than one round lot per week). See also *In re Glosser Bros., Inc.*, 382 Pa. Super. 177, 555 A.2d 129 (1989) (court recognized that a thin trading market reduced the reliability of market value but did not necessarily warrant assigning it no weight).

329 *Hendley v. Lee*, 676 F. Supp. 1317, 1329 (D.S.C. 1987).

330 413 A.2d at 147.

331 See, e.g., 377 Mass. at 727, 387 N.E.2d at 1150.

332 Moreover, the multipliers from the comparable companies will vary over time. For example, in April 1987, the Standard & Poor's index of 500 companies was 19 times earnings, whereas in April 1989, it was 12 times earnings. See Sease, *The Market's Fine; the Street Isn't*, Wall St. J., Apr. 28, 1989, at 1, col. 3. Were companies overvalued in 1987 or undervalued in 1989 or is our economy one-third worse off today than two years ago. Similarly, whether a company was evaluated before or after the market break of October 19, 1987, could make a major difference.

333 See S. PRATT, *supra* note 312, at 56-60.

method of depreciation, all affect earnings. The most important potential adjustment in this area is the compensation and other withdrawals for the benefit of owner-employees. This subject will be addressed in the next section.

Even net asset value is not a "hard" concept. Book value, based as it is upon historical cost, necessarily bears no relation to the current value of assets. Generally, land and buildings have appreciated, notwithstanding the fact that the buildings have been depreciated for balance sheet and income statement purposes. This necessitates an appraisal of noncurrent items, which again submits the valuation to the vicissitudes of the appraisal process. In addition, more sophisticated issues can arise. In *Piemonte*, for example, it was necessary to value the Boston Bruins hockey franchise, as well as the value of the concessions.³³⁴ Clearly valuation is an inexact science.

B. *Adjustments Related to Oppressive Conduct*

The prototypic pattern for oppressive conduct is for those in control to fire the minority shareholder and to arrogate the earnings of the business to themselves in the form of compensation, leaving little or no income available to the minority in the form of dividends. In such a situation, the terminated shareholder has a two-fold goal: she wants out, but she wants out at a price which reflects the value of the business based upon earnings as they ought to have been, had the remaining shareholder(s) not taken excessive compensation. In effect, the same pattern of activity can give rise to two causes of action: a derivative action to recover the excess compensation or other waste of corporate assets, and a direct action alleging oppression and seeking dissolution or a buy-out.

Recovery in the derivative action would, generally, inure to the benefit of the corporation but would only indirectly benefit the minority shareholder by increasing the asset value of the corporation and by providing a basis to adjust earnings upward by decreasing salary expense.³³⁵ Some courts, however, have permitted direct recovery in a derivative action. In *Lynch v. Patterson*,³³⁶ where the minority shareholder alleged that those in control had withdrawn excessive salaries and fees from the corporation, the court determined that the improper payments were \$266,000 and awarded plaintiff \$79,800, stating: "Direct recovery assures that Patterson will reap some benefit from his lawsuit. We refuse to order payment into the corporate treasury in this case and risk necessitating a subsequent suit by Patterson to compel the directors to declare a dividend or apply the funds to legitimate corporate purposes." In a simi-

334 337 Mass. at 732, 387 N.E.2d at 1152.

335 There is a collateral value in bringing a derivative suit, namely, directing additional focus upon the wrongdoing of those in control. In *Capital Toyota, Inc. v. Gervin*, 381 So. 2d 1038, 1039 (Miss. 1980), the court found that the terminated shareholders' expectations were "thwarted, but not grossly so," in part because profits increased after the plaintiff was terminated. However, the former control shareholders had taken "large bonuses and salaries . . . for questionable services" and had charged expenditures for a yacht to the corporation. *Id.* A derivative suit would not only have increased the value of the corporation by recovering these payments but also would have explained why earnings were low while he was employed.

336 701 P.2d 1126, 1130-31 (Wyo. 1985). See also the cases cited therein.

lar vein, minority shareholders have characterized payments to majority shareholders as constructive dividends and thereby sought to recover a comparable dividend from the corporation. This theory has produced mixed results.³³⁷

The recoveries in a derivative suit can be substantial. In *Johnson v. Steel, Inc.*,³³⁸ a forty-three percent shareholder sought dissolution on the ground of misappropriation and waste of corporate assets in one count and, in a third count, sought derivative relief for \$650,000 compensation in excess of that authorized. The Supreme Court of Nevada reversed the trial court's dismissal of both counts. If the plaintiff were to be successful on both counts, she would receive approximately \$280,000 more than she otherwise would have received upon dissolution of the company.

*Donahue v. Draper*³³⁹ involved a different twist. There the controlling shareholder caused the corporation to be dissolved and arrogated the business of the dissolved corporation to a corporation he solely owned. The other shareholder received \$321,000 as his share of the net tangible assets upon dissolution but also filed suit to recover the unequal emoluments. The jury found excess salaries of \$71,000, excess pension payments of \$239,707, and goodwill of \$536,750. The plaintiff was entitled to half of each sum. In these circumstances, where there is no disinterested approval of the compensation or other payment, the burden is on the defendant to prove the reasonableness of the payments.³⁴⁰

The problem with the derivative-suit approach is both the spectre of deference to the business judgment of the directors, even though the questioned transactions invariably involve conflicts of interest, and the spectre of reference to tax analogs in determining what is reasonable compensation or what is a reasonable accumulation of earnings justifying nonpayment of dividends. For example, a familiar refrain when the minority charges that compensation to those in control is unreasonable is that "the IRS has approved the salary."³⁴¹ In point of fact, when the Internal Revenue Service audits a business, whether compensation will be challenged as unreasonable is as much a function of the individual

337 In *Alaska Plastics v. Coppock*, 621 P.2d 270, 277 (Alaska 1980), the court stated that "[s]uch transactions should be examined to determine whether they are in fact a distribution of dividends, and if so the excluded shareholder must participate equally in the payments received by other shareholders." See also *Erdman v. Yolles*, 62 Mich. App. 594, 233 N.W.2d 667 (1975); *Cerami v. Dignazio*, 283 Pa. Super. 424, 443, 424 A.2d 881, 891 (1980) ("[P]ayments [to defendants] had no reasonable relationship to the meager services performed by them and were in fact simply a distribution of profits. Accordingly, plaintiffs as shareholders were entitled to their proportionate share of such corporate earnings."). But see *Mann-Paller Found. v. Econometric Research, Inc.*, 644 F. Supp. 92 (D.D.C. 1986).

338 100 Nev. 181, 678 P.2d 676 (1984).

339 22 Mass. App. 30, 491 N.E.2d 260 (1986).

340 *Newton v. Hornblower*, 224 Kan. 506, 582 P.2d 1136 (1978).

341 See, e.g., *Romanik v. Lurie Home Supply Center, Inc.*, 105 Ill. App. 3d 1118, 1127, 435 N.E.2d 712, 718 (1982) ("[T]he actual cost to the corporation was only half of the \$54,600 salary because of the determination by the Internal Revenue Service that the compensation was reasonable for the allowance of a business deduction."); *Miller v. Magline, Inc.*, 76 Mich. App. 284, 301, 256 N.W.2d 761, 768 (1977) ("[A]lthough not conclusive on the question of reasonableness, it is significant that the Internal Revenue Service concluded, after three successive reviews from 1964 to 1968, that the levels of executive compensation for the years in question were within the range of proper business expenses.").

proclivities of the agent, and the trade-off among other challenged items, as a reflection upon the reasonableness of compensation. Reasonableness is a range, not a specific figure. If both the majority and minority are being compensated within that range, then, from a tax standpoint, the Internal Revenue Service ought not be able to challenge the compensation. If the majority, however, is operating at the high end of the range so as to preclude payments to the minority, relief ought to be available.³⁴²

Courts are becoming increasingly aware of what has been obvious to outside observers for a long time—that the shareholder in a close corporation “looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.”³⁴³ In view of this, when valuing a company to determine the fair value of an oppressed shareholder’s shares, “to truly reflect the companies’ earning power, the net income is adjusted by eliminating from the corporate expenses a portion of the officer-shareholders’ salaries that is considered excess compensation.”³⁴⁴ Thus, even if a derivative suit challenging excess compensation or other improper payments to those in control is not coupled with a count for dissolution or buy-out, adjustments to income must be made. Also, if asset value is part of the valuation process, then adjustments to the balance sheet must also be made to reflect the reinvestment of the improper withdrawals.³⁴⁵

This approach is an established procedure in valuation theory. For example, one authority states:

In closely-held companies, it is common to find that compensation and perquisites to owners and managers may be based on the personal desires of owners and on the company’s ability to pay rather than on the value of services performed for the company. How much the earning power base should be adjusted to reflect discrepancies between compensation paid and value of service performed depends on the purpose of the valuation.

Owners of successful closely-held businesses tend to take out what normally would be considered profits in the form of compensation and discretionary expenses. This may be an effort to avoid the double taxation that arises from paying a corporate income tax and then paying a personal income tax on what is left from that paid in the form of dividends. It is not uncommon to find an owner/manager of a successful company drawing \$150,000 annual compensation, even though his

342 Cf. *Gimpel v. Bolstein*, 125 Misc. 2d 45, 56-57, 477 N.Y.S.2d 1014, 1022 (1984), where the court, in giving the corporation the option to purchase the plaintiff’s shares or commence a dividend policy, stated that, if the latter course were chosen, “[t]o the extent that the salaries paid to majority shareholders have been fixed so as to include amounts in lieu of dividends, the salaries must be adjusted downward.”

343 *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 71, 473 N.E.2d 1173, 1178, 484 N.Y.S.2d 799, 804 (1984) (quoting F. O’NEAL, *CLOSE CORPORATIONS* 21-22 (2d ed. 1971)).

344 *Raskin v. Walter Karl, Inc.*, 129 A.D.2d 642, 643, 514 N.Y.S.2d 120, 121 (1987).

345 See, e.g., *Salvador v. Connor*, 87 Mich. App. 664, 671, 276 N.W.2d 458, 461 (1979), where the court granted dissolution and awarded the plaintiff \$167,897 in damages which included “accrued wages, attorney’s fees of \$2,500, the plaintiff’s one-third share of the defendant corporation, whose assets were increased by the court’s judgment finding the individual defendants liable to the corporation for some \$64,000 in improperly diverted profits, and \$50,000 in exemplary damages.”

services to the company could be replaced for \$60,000 per year. The extreme cases go much, much further.

If the owner/manager described in the previous paragraph wants to sell his business and retire, the difference between his compensation and what it will cost to replace him will become available as a part of pretax profits, and the earning power base should be adjusted accordingly in establishing the selling price of the business.³⁴⁶

These salary adjustments can have a dramatic impact upon fair value. In *Hendley v. Lee*,³⁴⁷ the pretax income for the prior fiscal year was \$203,971. To this was added a two percent growth factor so as to increase the income to \$208,050. If the multiplier accepted by the court, 4.48, had been applied to this income, the value would have been \$932,064. Both parties agreed that the salary of \$93,813 taken by inactive shareholder was "nonfunctional." Accordingly, his expert added his salary back into income and valued the business at \$1,334,072. The active shareholder's expert treated \$150,000 of the active shareholder's \$250,000 salary as nonfunctional and, though this expert utilized a lower multiple than did the expert for the passive shareholder, he appraised the business at \$1,950,000 because of the increased adjusted earnings. The court determined that only \$75,000 of the \$250,000 salary should be deemed nonfunctional and arrived at a value of \$1,688,348. These varying results are summarized below:³⁴⁸

<u>Pre-Tax Income</u>	<u>Adjusted Income</u>	<u>Multiplier</u>	<u>Value</u>
No Adjustment	208,050	4.48	932,064
Add back \$93,813 salary of inactive SH	301,863	4.48	1,334,072
Add back \$75,000 for active SH	376,863	4.48	1,668,348
Add back \$150,000 for active SH	451,860	4.0	1,950,000

Thus, adjusting income for "excess" or "nonfunctional" income can result in doubling the value of the corporation. The effect in a particular case will be a function of the relation between income before allowance for salaries, the salaries taken by shareholder-employees, and the salaries at which shareholder-employees could be replaced by other persons. Often shareholder-employees could not only be replaced at a lower compensation but also with less manpower. For example, in a three-owner corporation, it might be possible for two persons to do the work of the three shareholders.

C. *Minority and Illiquidity Discounts Are Inconsistent with "Fair Value"*

Valuation theory traditionally has incorporated a discount process when valuing interests held by minority shareholders. Such discounts are predicated either upon the proposition that a minority interest is worth less than a controlling interest (the "minority interest" discount)

³⁴⁶ See S. PRATT, *supra* note 312, at 172-73.

³⁴⁷ 676 F. Supp. 1317 (D.S.C. 1987).

³⁴⁸ Because of other minor adjustments, the value is not exactly equal to the product of the adjusted income and the multiplier.

or the proposition that shares in a closely held corporation are not readily marketable (the "liquidity" discount). The development of such discounts has been in large part tax driven. Legislative and judicial developments in the 1970s and 1980s, however, have reflected increased concern that minority shareholders be treated fairly. The cumulative effect of these discounts can reduce the value of the minority shares by fifty percent or more. Critical analysis of these discounts demonstrates that they are inappropriate in determining the fair value of shares when the valuation is triggered by oppressive conduct of those in control.

1. Valuation from a Tax Perspective

The process of utilizing discounts in valuation opinions is part of what has been traditionally a conservative approach to valuation. As previously indicated,³⁴⁹ in valuations triggered by governmental imposition of a tax based upon the value of property, a conservative approach is essential lest the taxing process become confiscatory. The simple example used in the introduction to this section assumed that, if the shares of a corporation constituted the entirety of the estate and were overvalued by a factor of two, the imposition of a tax at a rate of fifty-percent would result in confiscation of the estate. The use of a fifty percent rate in the illustration is realistic because, historically, estate tax rates have ranged up to seventy-seven percent³⁵⁰ and the impact of such rates must of necessity impact valuation theory.

In the real world, shares may not necessarily be sold when a tax is levied, but rather other assets may be used to provide the liquidity to pay the tax. However, the net effect is the same. Because the shares cannot readily be sold, the government appropriates the liquid assets of an estate, potentially leaving a surviving spouse with no liquid assets and thus with markedly reduced means of support. For example, with liquid assets valued at \$1 million and shares valued erroneously at \$1 million but saleable only at \$500,000, the \$1 million share value will lead to a \$2 million estate value and a tax of \$1 million. Thus, the government will receive the liquid assets and the surviving spouse will be left with shares that can only be liquidated for \$500,000. This is the same net effect as if the government had confiscated the stock and levied a \$500,000 tax on the \$1 million of liquid assets. On the other hand, had the corporation been valued at \$500,000, the estate value would have been \$1.5 million, the tax \$750,000, and the surviving spouse would have retained the shares plus \$250,000 of liquid assets. Accordingly, in tax driven valuations, discounting is essential to insure fairness to the holder of the shares.³⁵¹

The use of discounts—both minority and liquidity—is part of a "willing seller, willing buyer" methodology which in turn defines "market

349 See *supra* text accompanying note 310.

350 S. SURREY, P. MCDANIEL & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION—CASES & MATERIALS* 7 (1987).

351 It has the opposite effect in buy-out cases. See *infra* text preceding note 355.

value.”³⁵² Section 2031-1(b) of the estate tax regulations provides that property is to be valued at its “fair market value.”³⁵³ The reason for the focus upon fair market value and the “willing buyer, willing seller” test in tax valuations is again that imposition of the tax mandates a cash out-flow—with the concomitant requirement that at least some of the assets be converted into liquid form. By way of contrast, the alternative remedy statutes and judicially created buy-out remedies all speak of the “fair value” of the shares, not the market value. As an English court remarked in rejecting a discount for minority shares, if market value was that to which the minority shareholder was entitled, there would be no need to be in court; one could simply sell into the supposed market.³⁵⁴

Another perspective from which to view this situation is for the valuation process to resolve doubts as to value against the person who forces the sale. In the tax situation, it is the levying of a tax that mandates the sale, not the free choice of the holder to realize the value of the shares at a time the holder deems most propitious. In the situation in which the minority shareholder seeks a judicial buy-out because of oppressive conduct, it is the conduct of those in control that forces the sale. As in the tax situation, the disposition is not one freely chosen by the seller.

In contradistinction to the tax situation, in which the government wins and the minority shareholder loses from a *high* valuation, in a state court appraisal proceeding the controlling shareholder wins and the minority shareholder loses from a *low* valuation. Stated differently, in the tax situation, the valuation determines the flow of funds *from* the shareholder—the higher the valuation the greater the out-of-pocket *loss*. In the corporate situation, the valuation process determines the flow of funds *to* the shareholder—the higher the valuation the greater the *gain*. Thus, caution must be exercised in importing theory developed in tax cases into litigation seeking to protect the minority shareholder from the oppressive conduct of those who will ultimately be the buyer of his or her shares. State appraisal statutes are “designed to protect the minority from the very considerations which result in a discounted value in the tax cases. By statute, the minority is guaranteed the ‘real’ value of its stock.”³⁵⁵

2. Valuation from a State Law Perspective

Ten jurisdictions appear to have considered the validity of discounts in valuing shares of minority holders. All but one decision is within the last ten years.³⁵⁶ In addition, three federal courts have considered the issue.³⁵⁷ Appellate courts in Illinois have split on whether discounts are

352 *Atlantic States Constr., Inc., v. Beavers*, 169 Ga. App. 584, 314 S.E.2d 245, 249 (1984).

353 Treas. Reg. § 20.2031-1(b) (1989). The regulation provides in part that “fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.”

354 *In re Bird Precision Ltd.*, 2 W.L.R. 158, 169 (1986).

355 See *Woodward v. Quigley*, 257 Iowa 1077, 1088, 133 N.W.2d 38, 44 (1965).

356 See *id.*

357 *Hendley v. Lee*, 676 F. Supp. 1317 (D.S.C. 1987) (rejecting a discount when the valuation is for a buy-out as an alternative to dissolution); *Hernando Bank v. Huff*, 609 F. Supp. 1124 (D. Miss.

appropriate.³⁵⁸ Thus, excluding Illinois, nine jurisdictions have taken a position on either minority discounts or liquidity discounts.

Of the eight jurisdictions considering minority discounts, six have outright rejected such discounts,³⁵⁹ one has rejected it when the valuation approach is to capitalize earnings,³⁶⁰ and the one jurisdiction permitting the trial court to "consider" a minority discount has cautioned that "other factors, such as market value, may wholly or partially account for any relevant minority discount."³⁶¹ Thus, statistically, minority discounts are almost uniformly viewed with disfavor by state courts. As indicated above, the two jurisdictions that accepted minority discounts did so on a limited basis. On the other hand, the federal courts accepting a minority discount have glossed over the issue, one stating that minority shareholders have no power³⁶² and the other that it was "unconvinced that a minority share of stock should be valued as though it were a controlling share of the corporation."³⁶³

With respect to liquidity discounts, three courts have accepted them³⁶⁴ and one jurisdiction has explicitly rejected them.³⁶⁵ The jurisdictions that accept liquidity discounts do so on a premise they believe to be self-evident: minority shares are not freely marketable. The issue of liquidity discounts is not so simple and deserves more than the superficial treatment given to the issue by the courts in question. As the following analysis demonstrates, neither the rationale for minority nor liquidity discounts can withstand critical scrutiny.

1985), *aff'd*, 796 F.2d 803 (5th Cir. 1986) (applying minority discount in appraisal proceeding after merger); *Perlman v. Permonite Mfg. Co.*, 568 F. Supp. 222 (N.D. Ind. 1983), *aff'd*, 734 F.2d 1283 (7th Cir. 1984) (applying both a minority and a liquidity discount in appraisal proceeding after merger).

358 *Independence Tube Corp. v. Levine*, 179 Ill. App. 3d 911, 535 N.E.2d 927 (1989) (accepting both minority and liquidity discounts in appraisal proceeding after recapitalization); *Johnston v. Hickory Creek Nursery, Inc.*, 167 Ill. App. 3d 449, 521 N.E.2d 236 (1988) (rejecting discount where minority shares are acquired by remaining shareholders).

359 *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 154 Cal. Rptr. 170 (1979); *Cavalier Oil Corp. v. Harnett*, Nos. 7959, 7960, 7967, 7968 (Del. Ch. Feb. 22, 1988) (LEXIS, states library, Del file), *aff'd*, 564 A.2d 1137 (Del. 1989); *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980); *Eyler v. Eyler*, 492 N.E.2d 1071 (Ind. 1986), *vacating*, 485 N.E.2d 657 (Ind. Ct. App. 1985); *Woodward v. Quigley*, 257 Iowa 1077, 133 N.W.2d 38 (1965); *Dreiseszun v. FLM Indus., Inc.*, 577 S.W.2d 902, 910 (Mo. Ct. App. 1979) (value of plaintiff's shares must be computed "pro rata"); *Blake v. Blake Agency, Inc.*, 107 A.D.2d 139, 486 N.Y.S.2d 341 (1985).

360 *Moore v. New Ammest, Inc.*, 6 Kan. App. 2d 461, 474, 630 P.2d 167, 177 (1981). A capitalized earnings approach utilizes multipliers derived from quoted market prices.

361 *Atlantic States Constr., Inc. v. Beavers*, 169 Ga. App. 584, 589, 314 S.E.2d 245, 251 (1984).

362 *Perlman v. Permonite Mfg. Co.*, 568 F. Supp. 222, 226 (N.D. Ind. 1983), *aff'd*, 734 F.2d 128 (7th Cir. 1984).

363 *Hernando Bank v. Huff*, 609 F. Supp. 1124, 1126 (D. Miss. 1985), *aff'd*, 796 F.2d 803 (5th Cir. 1986).

364 *Id.*; *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553, 556 (Ky. 1982); *Raskin v. Walter Karl, Inc.*, 129 A.D.2d 642, 514 N.Y.S.2d 120 (1987); *In re Joy Wholesale Sundries, Inc.*, 125 A.D.2d 310, 508 N.Y.S.2d 594 (1986). *Blake v. Blake Agency, Inc.*, 107 A.D.2d 139, 149, 486 N.Y.S.2d 341, 349 (App. Div. 1985); *Fleischer v. Gift Pax, Inc.*, 123 Misc. 2d 830, 834-35, 475 N.Y.S.2d 324, 328 (Sup. Ct. 1984), *aff'd*, 107 A.D.2d 97, 486 N.Y.S.2d 272 (1985).

365 *Cavalier Oil Corp. v. Harnett*, Nos. 7959, 7960, 7967, 7968 (Del. Ch. Feb. 22, 1988) (LEXIS, states library, Del file), *aff'd*, 564 A.2d 1137 (Del. 1989).

3. The Theoretical and Empirical Bases to Reject Both Minority and Liquidity Discounts.

There are several bases to reject discounts in determining the fair value of minority shares in buy-out situations. First, it should be noted that most cases that have considered the minority discount issue have done so in the context of appraisal proceedings triggered generally by a merger. None of the three cases that considered discounts in the context of a buy-out of a shareholder by the corporation or another shareholder imposed a minority discount.³⁶⁶ Only New York accepted a discount for liquidity. While a distinction could be drawn between "fair value" in an appraisal proceeding for a shareholder dissenting to a merger and "fair value" in a buy-out proceeding predicated upon oppressive conduct, such is not necessary. Many of the bases for rejecting discounts are applicable in either proceeding, particularly where appraisal rights are triggered by a cash-out merger designed to "squeeze-out" a minority shareholder.

What courts recognizing discounts in mergers and related type transactions fail to appreciate is that a cash-out merger is a form of private eminent domain. Before the enactment of liberalized statutes, a unanimous vote of the shareholders was necessary for a merger or a sale of substantially all the assets of a corporation. When the legislature reduced the vote for mergers to two-thirds or majority, it also gave dissenters appraisal rights. The Iowa Supreme Court, in rejecting the use of discounts in valuing minority shares in an appraisal proceeding, stated:

The increase in the number of corporations and stock-holders made such a rule [unanimity] impracticable. The statute was enacted to permit a majority to vote to renew the corporate life and at the same time allow a dissenting minority to get out of the corporation with the 'real value' of its stock. It prevented the minority from being squeezed out for a lesser price.³⁶⁷

While the arguments against minority interests, on the one hand, and liquidity discounts, on the other, somewhat overlap, at the risk of being arbitrary the arguments can be allocated as follows.

Arguing, in fact mandating, rejection of the minority discount are the empirical data attending the premiums paid in takeover activity (thus demonstrating that the stock market values minority interests), the pro-rata nature of the valuation process in these circumstances (particularly where the buy-out is an alternative to liquidation), and the statutory language itself. Arguing against the liquidity discount are: (1) the explosion of available remedies in the past decade or so for minority shareholders which either provide a market for the minority's shares or give the minority shareholder the leverage to negotiate a better deal; (2) the fact that either the corporation or those in control are buying (and thus will not hold a minority position); and, (3) the inherent right of a

³⁶⁶ *Hendley v. Lee*, 676 F. Supp. 1317 (D.S.C. 1987); *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 154 Cal. Rptr. 170 (1979); *Blake v. Blake Agency, Inc.*, 107 A.D.2d 139, 486 N.Y.S.2d 341 (1985).

³⁶⁷ *Woodward v. Quigley*, 257 Iowa 1077, 1086, 133 N.W.2d 38, 43 (1965).

minority shareholder to await a propitious time to sell rather than being forced out by the oppressive conduct. These are discussed below.

a. *The "Market" Reflects Minority Value*

Takeover activity, particularly during the past five years, has clearly demonstrated that the values reflected in the reported markets are those representing the value of a minority interest. Conversely, the prices paid in takeovers reflect a premium for the acquisition of a control position. Were this not the case, acquirers would be derelict in the obligation they owe to their own shareholders by overpaying for the acquired assets. This position is now recognized both in valuation theory and by the courts.

As previously discussed, state courts generally reject minority discounts.³⁶⁸ Even a decision that has upheld the imposition of a minority discount has recognized that such a discount is not appropriate if the valuation technique has used market value to arrive at a valuation. In *Moore v. New Ammest, Inc.*, the appraiser acknowledged that "quoted market prices . . . already reflect the minority interest."³⁶⁹ Thus, valuation techniques that use market prices, either directly or indirectly by reference to P/E ratios or capitalization rates, should not employ a discount in the valuation process or else the minority interest will be doubly discounted. The court in *Moore* did uphold a minority discount with respect to asset values, a questionable decision in light of other matters discussed below.

b. *The "Pro Rata" Nature of the Triggering Event*

In the context of this Article, the events that trigger the need for a valuation are either an "organic" change that squeezes out a minority shareholder, such as a cash-out merger, thereby giving rise to dissenters' rights, or a suit for liquidation, generally predicated upon the oppressive conduct of those in control, followed by a request for alternative relief in the form of a judicially supervised buy-out. Both of these types of triggering events contemplate pro rata or nondiscriminatory distributions or payments of value. In a merger, for example, all holders of the same class of shares receive equal treatment, on a per-share basis, irrespective of whether one holder has fifty-one percent of the shares and another holder has one percent of the shares. Holders of larger aggregations of shares do not receive a higher price per share than do holders of a lesser number of shares.

Similarly, with respect to distributions pursuant to dissolution statutes, the essence of shares of the same class is that each share is entitled to a pro rata portion of that class's claim on the corporation's assets. In *Brown v. Allied Corrugated Box Co.*, the court observed:

Had plaintiffs been permitted to prove their case and had the corporation then been dissolved, it is clear that upon distribution of the disso-

³⁶⁸ See *supra* notes 359-61 and accompanying text.

³⁶⁹ 6 Kan. App. 2d 461, 474, 630 P.2d 167, 177 (1981).

lution proceeds each of the shareholders would have been entitled to the exact same amount per share, with no consideration being given to whether the share had been controlling or noncontrolling.³⁷⁰

The court noted that "since the jurisdiction of the court in an involuntary dissolution action includes determination of how the assets will be distributed, the minority shareholder is substantially protected from inequitable distribution at the hands of the majority."³⁷¹ Since the basic schemes are pro rata in nature, discounting a minority interest would upset the even-handedness inherent in the basic statutory schemes.³⁷²

c. *The Statutory Language—"Fair Price"*

Statutes establishing dissenters' rights and alternative remedies such as judicial buy-outs uniformly refer to "fair" price as opposed to "fair market" price. The rationale underlying this language is the recognition that the events that trigger the valuation process may either disrupt or preclude the market for the shares, if in fact such a market ever existed—as in the case of a closely held corporation. As previously discussed,³⁷³ the difference in language—fair value as opposed to fair market value—is in part what makes precedent from tax cases inapplicable. Courts generally have noted that these statutory provisions have been enacted for the benefit of minority shareholders³⁷⁴ and that minority shareholders ought not to be punished in the valuation process.³⁷⁵

d. *Minority Shareholders Are No Longer Locked in Without a Market*

The thrust of most of this Article has been to demonstrate that minority shareholders are no longer helpless in the face of majority misconduct. The specter of being "locked-in" but frozen out is being relegated to history. The development of the concept of fiduciary duties running from those in control to minority shareholders, the restatement of oppression in terms of the reasonable expectations of minority sharehold-

370 91 Cal. App. 3d 447, 486, 154 Cal. Rptr. 170, 176 (1979). See also *Dreiseszun v. FLM Indus.*, 577 S.W.2d 902, 910 (Mo. Ct. App. 1979).

371 91 Cal. App. 3d at 486 n.7, 154 Cal. Rptr. at 176 n.7 (quoting Comment, *Dissolution Under the California Corporation Code: A Remedy for Minority Shareholders*, 22 UCLA L. REV. 595, 609 (1975)).

372 See *In re Bird Precision Bellows Ltd.*, 1984 Ch. 419, 430, *aff'd*, 2 W.L.R. 158 (1986).

373 See *supra* notes 352-54 and accompanying text.

374 *Woodward v. Quigley*, 257 Iowa 1077, 1086, 133 N.W.2d 38, 43, *modified on reh'g*, 257 Iowa 1077, 136 N.W.2d 280 (1965) (quoting *Voeller v. Neilston Warehouse Co.*, 311 U.S. 531, 535 (1941)) (substituting majority rule for unanimity "opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares were widely adopted."); *Dreiseszun*, 577 S.W.2d at 906 ("[T]he court below . . . would place a different 'fair value' . . . depending upon whether the shares were held by a majority or minority stockholder. . . . The statute does not . . . intend that a minority stockholder be in any way penalized for resorting to the remedy afforded thereunder."); *Blake v. Blake Agency, Inc.*, 107 A.D.2d 139, 149, 486 N.Y.S.2d 341, 349 (1985) ("Business Corporation Law § 1104-a was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest pursuant to Business Corporation Law § 1118.").

375 *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 486, 154 Cal. Rptr. 170, 176 (1979) (If minority shares could be discounted, "the very misconduct which provoked the minority shareholders to seek involuntary dissolution could, in this manner, be further used to oppress them. This, the statutory scheme before us cannot be read as condoning.").

ers, and the development of a buy-out remedy converge into a vastly changed posture for minority shareholders. In New York, the court, in *Rosen v. Pace Photographers, Ltd.*, summarized the development as follows:

Prior to 1979, minority shareholders in close corporations who suffered abuse at the hands of the majority lacked the options available to business partners and shareholders in public corporations to extricate the value of their investments. To preserve and protect the interest of minority shareholders in such situations, the Legislature in 1979 provided a mechanism—a petition for dissolution—by which holders of at least 20% of the outstanding shares of a corporation whose stock is not traded on a securities market could salvage the value of their investments.³⁷⁶

It is paradoxical that New York, which has been in the forefront in protecting minority rights—legislatively through the buy-out remedy and judicially through the reasonable expectations test—is one of the three states that recognizes a liquidity discount. In the decision that introduced the minority discount into the buy-out process, *Fleischer v. Gift Pax, Inc.*,³⁷⁷ the referee had declined to apply a liquidity discount because the defendants, by electing to purchase the shares of the plaintiff, had become willing and available buyers. The court, however, took a very narrow view of the policy behind the statute and focused upon the fact that the valuation date was the day prior to filing the petition and was to be “exclusive of any element of value arising from such filing.”³⁷⁸ According to the court, this legislative language forbade the valuator to consider that there now was a market for the shares. The court distinguished the California decisions, which have rejected discounts, on the basis of the differing statutory language. Since other states either do not have the same language as New York or have judicially created buy-out remedies, the *Gift Pax* result should be limited to New York.³⁷⁹ It is illogical to ignore the existence of a market in applying a discount predicated upon the lack of a market. This incongruity may be why two later decisions³⁸⁰ limited the liquidity discount to ten percent whereas *Gift Pax* imposed a twenty-five percent discount.

The New York Court of Appeals has not yet considered this issue but its decision in *Pace Photographers*,³⁸¹ in which it held that the price provisions in a shareholders' agreement covering voluntary sales did not dictate the “fair value” of the minority shares, calls into question the *Gift Pax* rationale. In *Pace Photographers*, the shareholder agreement was in effect the day prior to filing the petition and no election to buy had been made; in *Gift Pax*, the minority had no assurance of a buy-out the day prior to filing. But if the court of appeals can look to post-filing activity

376 71 N.Y.2d 737, 744, 525 N.E.2d 713, 716, 530 N.Y.S.2d 67, 70 (1988).

377 123 Misc. 2d 830, 475 N.Y.S.2d 324 (Sup. Ct. 1984), *aff'd*, 107 A.D.2d 97, 486 N.Y.S.2d 272 (1985).

378 *Id.* at 834, 475 N.Y.S.2d at 328.

379 The decisions in Georgia and Kentucky which approved liquidity discounts arose in appraisal proceedings triggered by mergers.

380 *Raskin v. Walter Karl, Inc.*, 129 A.D.2d 642, 514 N.Y.S.2d 120 (1987); *In re Joy Wholesale Sundries, Inc.*, 125 A.D.2d 310, 508 N.Y.S.2d 594 (1986).

381 71 N.Y.2d 737, 525 N.E.2d 713, 530 N.Y.S.2d 67 (1988).

to negate the dictates of a shareholders' agreement, then the New York courts ought to look to post-filing activity, namely the now existent market, and decline to impose a liquidity discount.

In point of fact, it is not even necessary to look to post-filing activity to reject the *Gift Pax* rationale. While the actual election to buy, or a court order mandating a buy-out, cannot occur until after suit is filed, the legislation—or in some states, judicial decisions—creating this new market is already existent. Once a buy-out remedy as an alternative to dissolution is in place, the position of the minority shareholder with regard to liquidity has changed dramatically. The *Gift Pax* court simply failed to recognize this reality.

Clearly legislatures and courts have provided liquidity where heretofore it either did not exist or existed on a more limited basis. If courts are to consider all relevant factors, as courts that apply liquidity discounts have opined, one very relevant factor is the existence of legislatively and judicially created exits from the corporation. It would be incongruous to discount the shares of a minority shareholder for lack of liquidity when the valuation is being done in connection with a proceeding that creates liquidity.

e. *Significance of the Purchaser*

In both dissenters' rights proceedings and those involving a judicial buy-out, the purchaser of the minority shares is either the corporation or those in control. Accordingly, the purchaser of the minority shareholders' interest does not thereafter hold a minority interest.³⁸²

This fact impacts both the minority discount and liquidity discount issues. One of the rationales for both these discounts is that the purchaser would pay less because he or she would not be able to exercise any control over the investment after the purchase. This obviously is not true if the purchaser is the majority shareholder. But also, if the purchaser is a corporation, the effect of the purchase is to increase the control which a majority shareholder already has. For example, if shareholdings were split on a 60:20:20 ratio and the corporation purchased one 20% holding, the 60% shareholder would then hold 75% and he alone could provide the two-thirds approval necessary for some corporate action in some states.³⁸³

The identity of the purchaser particularly impacts the liquidity issue. Only actions by those in control can trigger the events that give rise to the need for valuation. A cash-out merger can only be initiated and approved by those in control, thereby giving rise to dissenters' rights. Alternative remedies, such as judicial buy-outs, are generally triggered by oppressive conduct; normally, it is the majority that oppresses the minority, not the converse. Accordingly, it is the voluntary act of those in con-

382 See *Diligenti v. R.W.M.D. Operations Kelowna Ltd.*, 4 B.C.L.R. 134, 165-66 (1977).

383 See, e.g., *Johnston v. Hickory Creek Nursery, Inc.*, 167 Ill. App. 3d 449, 455, 521 N.E.2d 236, 239-40 (1988) ("discounting does not apply in the instant case when a minority interest is being assumed by the remaining shareholders resulting in a substantial *pro rata* increase in their share and control of the corporation" (emphasis added)).

trol that both (i) creates the need for a valuation and also (ii) provides liquidity by triggering statutory provisions that, in effect, provide a market for the minority's shares.

The incongruity of discounting the minority share when the purchaser is the "oppressor" or the corporation controlled by the oppressor was analyzed by the *Brown* court. Part of the theory of the liquidity discount is that the market will pay less because the buyer is at the sufferance of the majority. However, "if . . . the controlling shareholder has been using his position to insure that *no* benefits, such as dividends or employment, *ever* accrue to the owners of the minority shares, then an argument could be made that the value of the minority shares should be reduced even further, perhaps to zero."³⁸⁴ Thus, the greater the misconduct by the majority, the less they need to pay for the minority's shares. Surely, this cannot be what the legislatures and courts had in mind when they created a buy-out remedy at "fair value." Rather, public policy argues against a discounting process in order that there be a disincentive to acting in an oppressive fashion. If oppressive conduct is deterred, resort to the courts will be avoided.

f. *Abrogation of the Right to Decide When to Sell*

Closely related to the previous argument is the fact that the acts of those in control, by squeezing-out or freezing-out the minority shareholders, have abrogated the right of such minority shareholders to continue to hold such shares and to await a more favorable sale opportunity. Since the majority has determined when the minority must sell, the majority should not be further rewarded by acquiring such shares at a discount.

In *In Re Bird Precision Bellows Ltd.*, the court recognized that the sale by a wronged minority pursuant to buy-out provisions as an alternative to dissolution is a "forced sale" because those in control have "made it no longer tolerable for him to retain his interest in the company."³⁸⁵ Accordingly, the court concluded that "it would not merely not be fair, but most unfair, that he should be bought out on the fictional basis applicable to a free election to sell his shares . . . or indeed on any other basis which involved a discounted price."³⁸⁶

Were the minority shareholder not being squeezed-out or frozen-out, he or she would have the right to continue to enjoy the perquisites of employment, which as previously discussed are most valuable,³⁸⁷ or to await a more beneficial price from a third party. While the counter argument is that this alternative-sale possibility may never eventuate, there are numerous cases where the majority has acquired the minority's shares, through one technique or another, shortly before events oc-

384 *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 487, 154 Cal. Rptr. 170, 176 (1979).

385 *In re Bird Precision Bellows Ltd.*, Ch. 419, 430 (1984), *aff'd*, 2 W.L.R. 158 (1986).

386 *Id.*

387 See *supra* notes 311-13 and accompanying text.

curred that substantially enhanced the value of the corporation's shares.³⁸⁸

The action of those in control, by setting in motion events which lead to the buy-out of the minority (thereby providing liquidity), forecloses the minority from participating in any future growth or future advantageous sale. Having lost the ability to alienate these shares more advantageously, it would again be paradoxical to discount minority shares for lack of alienability when the majority, through triggering a buy-out have created a market *now* but foreclosed the possibility of a more attractive market *later*.

VII. Conclusion

In the last thirty years, enormous strides have been made in realistically appraising the relationships between those in control of closely held corporations and minority shareholders. When the business was incorporated, the goal of all the shareholders was participation, not control. Because of unforeseen circumstances, one shareholder can become the odd person out. It is only at this point that control becomes important because it enables the new majority to exclude the unpopular shareholder from participation in the corporation's affairs and profits. Given that control is not an important issue when the business is incorporated, it is incongruous to make it a critical factor in valuation when one member is forced out.

Undue deference to business judgment has been scaled back in order that action by those in control can be critically evaluated to determine whether such actions are truly business judgments or a ploy to benefit the majority at the expense of the minority. With the recognition that the majority bears fiduciary duties to the minority, remedies now exist to enjoin unfair treatment of minority interests. But, most importantly, vehicles now exist to enable the minority to exit the corporation on fair terms. The concept of oppression has been expansively defined. While the rhetoric that "dissolution is a drastic remedy" still is to be found, empirical data demonstrates that, if a business is sound, death of the juristic entity has no impact upon continuation of the business enterprise. In another context, leveraged buy-outs have demonstrated that there are many ways to fund the purchase of viable businesses.

Both courts and legislatures have responded to the concern about dissolution by developing alternative remedies, particularly buy-outs of the minority shareholders. With a less drastic remedy in place, less drastic conduct has been found to be oppressive. This has culminated in the development of the reasonable expectations test to determine if the actions of those in control have oppressed the minority.

Exiting the corporation, however, is a realistic remedy only if the price is fair. In developing the reasonable expectations test, courts have recognized that the owners of closely held businesses receive profits through salary and other forms of compensation. This recognition has

³⁸⁸ Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

led courts to see more clearly the need to adjust income and assets for nonfunctional compensation in valuing the shares of the minority for buy-out purposes. Of critical concern in the buy-out area is the need to reject minority and liquidity discounts that can have a dramatic and devastating impact on the value of minority interests. In this area, courts have generally rejected minority discounts. But it is incongruous to apply a liquidity discount in a proceeding in which legislatures or courts have created liquidity. And it is incomprehensible that wrongful conduct that drives the minority out of the corporation can doubly advantage those in control by driving down the value of minority shares. Developments in the past thirty years have proceeded geometrically, not linearly. If the present trend continues, the view of minority shareholders as a "locked-in frozen-out" constituency will be a historical anomaly.