SUPPRESSING MINORITY SHAREHOLDER OPPRESSION

*Peter J. Horne**

MODEL BUSINESS CORPORATIONS ACT § 14.30 – MINORITY SHAREHOLDER OPPRESSION – A varied landscape exists for the treatment of aggrieved minority shareholders in closely-held corporations. The Model Business Corporation Act provides for standard language in defining shareholder oppression. However, three competing theories – upholding fiduciary duties, preserving reasonable expectations, and enforcing strict contract rights – have been employed across jurisdictions in order to resolve shareholder disputes. This article surveys and assesses these three approaches and concludes that a more narrow interpretation of shareholder oppression consistent with contract principles is the optimal solution. The applicable law in each jurisdiction on this issue is included in the Appendix.

INTRODUCTION

A corollary to the concept of economic scarcity proposes that business assets will be used solely[1] to increase wealth and enhance productivity.[2] However, as an increasing frequency of courts and scholars have illustrated,[3] when it comes to assets in the ownership of corporations,[4] shareholders often exhibit dissension or even diametric opposition toward certain business decisions and the transfer of ownership rights to others, despite decisions made by a majority and the receipt of potentially handsome payouts.[5] Hence, owners, and more generally the corporation, are thrust into conflict. This adversarial context

* J.D. Candidate, Spring 2014, Duquesne University School of Law; BSBA Economics, Duquesne University.

1. *See e.g.*, *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919). "The business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes." *Id*.

2. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times Mag., Sept. 13, 1970, at 32-33, 122-26. (citing his own book, *Capitalism and Freedom*). Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, (1962). In addition, Professors Marks and Miller draw a cogent comparison between Machiavellian principles and the modern CEO. *See generally* Colin Marks & Paul S. Miller, *Plato, the Prince, and Corporate Virtue: Philosophical Approaches to Corporate Social Responsibility*, 45 U.S.F. L. Rev. 1 (2010).

3. Robert C. Illig, *Minority Investor Protections As Default Norms: Using Price to Illuminate the Deal in Close Corporations*, 56 Am. U. L. Rev. 275, n. 4 (2006).

4. Professor Stout presents an interesting critique of the misalignment between shareholder interests in publically-traded companies and the actual decisions of boards of directors. *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189, 1191 (2002) (primarily arguing that shareholders have misguided claims of actual ownership). However, this article will address how dissension may arise under different circumstances in the context of closely-held corporations. *See* Section I *infra*.

5. John C. Coffee, Jr. et al, *Knights, Raiders, and Targets: The Impact of the Hostile Takeover*, Oxford University Press, (1988). There is little doubt that a target firm would not financially benefit from a merger. *Id*.; *see also* Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. Corp. L. 285, 290 (1990). "Majority shareholders in close corporations will not often sell their stock . . . even if the financial return in the reinvested proceeds of the sale exceeds the financial return they receive from operating the business." *Id*.

often becomes a matter of great public attention during what some would affectionately[6] refer to as a corporate takeover. In stark contrast to the great social interest of corporate takeovers, ownership changes in closely-held corporations present drastically different circumstances, yet they usually cause greater of strife, because publicly-traded companies can be diffused by stock transactions. Conversely, close corporations still offer the opportunity for shareholders to exchange shares for cash or cash equivalents, albeit in a somewhat limited and precarious market.[7] Nonetheless, for a variety of reasons, these cash transfers and buy-outs are not always sought through traditional derivative actions. Instead, legislators and courts have fashioned a myriad of remedies for close corporation shareholders who dissent from perceived infringements on their ownership rights or other controversial management decisions. These varying remedies have created a dizzying array of disparities across jurisdictions.[8] In order to unravel this twisted framework of complaining shareholder rights, a level of ingenuity comparable to Alexander the Great's solution to the Gordian knot[9] offers a swift resolution. This paper attempts not to lend itself to such associations, but instead will offer perhaps

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6. *See e.g.*, Norman Berry, *The Logic and Morality of Corporate Takeovers*, 50 *The Freeman* 7 (July 2000), *available at*: http://www.thefreemanonline.org/columns/the-logic-and-morality-of-takeovers/. "Despite the desperate ululating of communitarians, the takeover process has not led to the collapse of caring societies and the triumph of greed. Corporate and individual giving has never been higher in America, and membership of voluntary groups is as great as it was when Tocqueville first noticed it. America is a highly mobile society, and her citizens have always been prepared to go where the jobs are. Communities are quite safe from the ravages of the market because they emerge from the conditions of the market itself: free choice under the rule of law." *Id*.

7. This author supports Professor Easterbrook and Professor Fischel's original commentary on the transfer of minority shareholder ownership interests, "[t]he absence of a liquid market has profound implications. Many assume that it invites a unique risk of exploitation. Because minority shareholders cannot dispose of their shares, the argument runs, a majority can 'oppress' them by diverting a disproportionate share of the firm's income to itself, eventually forcing the minority to sell their shares at a distress price. But this argument really has little to do with the absence of a market. Consider the extreme case in which a majority shareholder appropriates 100 percent of the firm's income for himself. Even if a minority stockholder had an unrestricted ability to sell his shares, nobody would buy them. Illiquidity is not the problem." Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271, 274-75 (1986).

8. *See* Section II *infra*.

9. Merriam-Webster's online dictionary defines Gordian knot as "a knot tied by Gordius, king of Phrygia, held to be capable of being untied only by the future ruler of Asia, and cut by Alexander the Great with his sword." Judge Northcutt referenced this allegory in his decision to resolve a shareholder rights case. Tower Hill-Connellsville Coke Co. of W. Va. v. Piedmont Coal Co., 64 F.2d 817, 829 (4th Cir. 1933).

a more workable and economically-efficient proposal to cut through the threads which entangle the minority dissent process, available shareholder remedies, and the potential for court-sanctioned dissolution of closely-held corporations.

As a brief prelude to mapping the forthcoming plan to sever the existing legal tapestry, the scope of this paper needs to be narrowed considerably and delineated carefully. At common law, the unanimous consent of shareholders was required in order to authorize any significant change to their corporate charter, including changes in ownership.[10] However, state legislatures have long since adjusted these shareholder dynamics through modern corporate statutes,[11] providing for wide discretionary powers to an organization's board of directors and introducing the doctrine of majority rule.[12] Thus, the ability to achieve a quorum or controlling enclave to determine the use of all corporate assets and personnel has led to the unavoidable conflict between majority shareholder interests versus minority shareholder protections.[13] Assuredly these opportunities for controversy are exacerbated in closely-held corporations.[14] As a result, dissension claims for close corporations demand much more attention and perhaps more scrutiny than their public counterparts. Therefore, the focus of this article will be the reform of shareholder rights in response to claims of minority shareholder abuse and oppression in closely-held corporations. The concepts discussed will presumably be applied to those firms with few shareholders, limited markets for the transfer of owner-

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10. Fletcher Cyc. Corp § 2949.10 vol. 6A (referencing, among others, *Geddes v. Anaconda Copper Min. Co.*, 254 U.S. 590 (1921) and *Pomierski v. W. R. Grace & Co.*, 282 F. Supp. 382 (N.D. Ill. 1967)). Tracing back even further, English common law would likely not have recognized a minority shareholder's surrender of the corporate charter, even if he had laid it at the King's feet. Edward H. Warren, *Voluntary Transfers of Corporate Undertakings*, 30 Harv. L. Rev. 335, 336-37 (1917) (citing Stewart Kyd, *A Treatise on the Law of Corporations*, 447 (London, Fleet-Street 1974)).

11. *See* Section II *infra*.

12. Although not entirely dedicated to closely-held organizations, Brett W. King, Ph.D., provides a comprehensive overview and chronology of majority voting power in the United States. *See generally* Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 Del. J. Corp. L. 895 (1996).

13. Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 Del. J. Corp. L. 377, 383-84 (2004).

14. *Id*.

ship interests, and substantial participation of shareholders in the actual management of the business.[15] Further, this paper will attempt to distinguish between minority shareholder abuses[16] versus discretionary business judgments;[17] however, its primary concern will be the assessment of direct shareholder remedies in regards to the much maligned term across many jurisdictions: minority shareholder oppression.[18]

This article proposes a market efficiency approach which revives the traditional contract theory of corporations[19] as opposed to the many jurisdictions which have recently favored extra-contractual and non-derivative claims for fellow shareholder actions.[20] The latter of these suits have arguably been more wasteful than equitable.[21] Therefore, to minimize these costs and restore traditional contract theory, the common-law and statutory definitions of oppression should be substantially narrowed. Correspondingly, available remedies for dissenters' claims, excluding true shareholder abuse,[22] should be abolished or at least diffused away from individual attacks on fellow shareholders. As will be explained *infra*, efficiencies will be gained by reducing claims to only derivative suits, whereby shareholders will trigger buy-outs and receive the fair value of their assets or only obtain other equitable remedies in truly irreparable situations. As a prelude to this proposition, this article will describe the position and plight of minority shareholders as well as their two primary theories of relief. Second, the statutory rights of dissent will be surveyed from the Model Business Corporation Act ("MBCA")[23] across all fifty states. Following that survey, there will then be a reconciliation and critique of the most

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15. *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975) (drafting a commonly cited description of closely-held organizations).

16. Illegal acts, fraud, and misappropriation of assets are listed as grounds for valid shareholder claims in many state statutes. Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 Bus. Law. 699, 708 (1993) (collectively, these actions are best distinguished as abuse, not oppression).

17. *See* Section I *infra*.

18. Thompson, *supra* n. 16, at 709-19.

19. Namely, enforcing shareholder agreements, and in their absence, implying fiduciary duties. *See* Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271, 290, 296 (discussing how buy-outs and withdrawals of capital should be limited, while standards of fiduciary duties should be implied and / or strict).

20. F. Hodge O'Neal & Robert B. Thompson, *Close Corp and LLCs: Law and Practice* § 9:28 (Rev. 3d ed.) (outlining how the frustration of a shareholder's reasonable expectations can be the basis for relief in oppression suits).

21. There is also a wealth of cases where claims of minority shareholder oppression have been largely unfounded. *See, e.g.*, *McCormick v. Dunn & Black, P.S.*, 167 P.3d 610 (Wash. App. 2007); *Abel v. Forrest Realty, Inc.*, 484 So. 2d. 1069 (Ala. 1986); *Matter of Murphy*, 502 N.Y.S.2d 518 (N.Y. 1986); *Jesser v. Mayfair Hotel, Inc.*, 316 S.W.2d 465 (Mo. 1958).

22. *See supra* n. 16.

23. Model Business Corporation Act § 14.30 (2007).

salient features across those jurisdictions. Finally, a reformation plan predicated upon legislative and judicial austerity in the interest of preserving contract rights will be offered as an indication that the pen can be as sharp as Alexander's sword.